Sears Canada's Demise Started Around 2005

Description

The truth is painful.

The loss of 12,000 jobs at Sears Canada is a result of events that unfolded more than a decade ago in 2005. To blame **Amazon.com, Inc.** (NASDAQ:AMZN) is easy to do, but it does little to provide answers about how the department stores left standing in Canada and the U.S. can wriggle out of this situation.

The mess that is Sears Canada's liquidation is the result of several poor decisions made by the powers that be in the C-suite circa 2005.

Take a look at the 2005 annual report

Two things stand out for me.

1. On August 31, 2005, Sears Canada agreed to sell its credit card division to **JPMorgan Chase & Co.** for $2.3 billion.

"This is a great alliance for Sears, our customers and our shareholders as we expect to return substantial proceeds [to shareholders]," stated then CEO Brent Hollister. "Over the next few months, we will be taking steps to align our cost structure with the Canadian and North American competitive retail industry sector."

Translation: If you're a shareholder, you're about to get a massive windfall. If you're an employee, expect the nickel-and-diming to begin.

Bond-rating agency DBRS's senior vice-president of retail at the time — Jack Alvo, who now works the credit desk at **Manulife** — was critical of the company's move citing three reasons.

“The first is the company is selling a division that’s been a significant contributor to earnings,” stated Alvo. “Secondly, what it is going to be left with is a merchandise business that remains challenged. And thirdly, the use of proceeds.”

Let’s deal with each of these three points to understand where Alvo was coming from.

Significant contributor to earnings

In fiscal 2004 (the last full fiscal year with credit card business in the fold), its credit card operations reported revenue of $432 million and EBIT earnings of $101.3 million. That was just 7% of the company’s $6.2 billion in revenue but 41% of the company’s overall EBIT of $248 million.

So, Sears Canada gave up 41% of its earnings power for one-time proceeds of $2.3 billion, of which, only $677 million was its after-tax gain.

What was left had issues

With the credit card operations gone, Sears Canada was left with its merchandising operations and its ownership interests in 14 shopping centres across Canada.

The company’s merchandising operations in 2005 had revenues of $5.8 billion, 0.5% higher than 2004, and EBIT of $140.7 million, 17.3% higher than a year earlier. Sounds good, right? Except same-store sales decreased by 2.9% in 2005 — 450 basis points worse than in 2004.

Even that wouldn’t be so bad if it did something to stop the bleeding and grow sales on a same-store basis, but that’s not what happened.

The use of proceeds

Before I get into the $2.3 billion windfall and how it was used, remember what I said earlier about the $677 million after-tax gain; that’s crucial to Sears Canada’s demise.

Of the $2.3 billion it received from JPMorgan, $470.4 million, or $4.38 per share, was a return of capital to existing shareholders. I guess that’s the original amount Sears Canada invested in its credit card operation. It then distributed $1.53 billion, or $14.26 per share, to shareholders as a special dividend. That left $300 million, which stayed with the company.

Why did it pay out more than the $677 million after-tax gain? That will likely never be answered, leading me to my second point.

2. When Sears Canada did the deal with JPMorgan, **Sears Holdings Corp.** (NASDAQ:SHLD) owned 54% of the company. Between the special dividend and the return of capital payment, SHLD got $1.1 billion of the $2 billion paid out; the other 46% received $900 million, and Sears Canada a measly $300 million, which would soon get frittered away by share repurchases meant to strengthen Eddie Lampert’s grip on the company.

The final nail in the coffin

That came with subsequent special dividends of $7 per share in 2010 and $5 in 2013, which resulted in SHLD hauling in another $941 million, and its majority owner, Eddie Lampert, getting $141 million.

Sears Canada paid out $2.2 billion in three special dividends to its parent and hedge fund owner and another $900 million to shareholders, while leaving soon-to-be ex-employees and former employees with a $327 million pension deficit.

“The fish rots from the head” describes Eddie Lampert’s influence on Sears Canada to a tee. It’s not a coincidence that the company’s demise began soon after Lampert took control of K-Mart followed by Sears.

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