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Hidden in Plain Sight

By Peter Lynch

If I had a hammer--and I probably do, somewhere--it would have to be a Sears Craftsman. Like many, many people, I have a long history with Sears, Roebuck and Co. S I've been a Sears investor almost as long as I've been a Sears customer. I've spent more time on the phone with Harry Wren, the company's longtime head of investor relations (now retired), than with many people outside my family. I used to talk frequently with Edward Brennan, who was Sears's CEO from 1986 through 1995, and I keep current with Arthur Martinez, who succeeded Ed. I've always liked the company. Sears is a sensational brand name whose best products are sensational brands of their own--not only Craftsman but also WeatherBeater, Kenmore, DieHard, and, until it was spun off in probably the best move a Sears shareholder ever saw, Allstate. The company has always sold real things that real people need.

But to understand Sears now, you have to start over. Forget what you think you know about the company. Sears has a 112-year history and, during that time, has been an example of just about every investing lesson imaginable, but right now the one that matters is this: Sometimes it's necessary to look at familiar companies in new ways.

I have notes from a 1994 meeting with ed brennan. He talked about the corporate restructuring he had begun the previous year, and he mentioned that he had tapped a great executive for the head spot in the merchandise group. That was Arthur Martinez, who joined the company in 1992 after establishing a strong merchandising reputation at Saks Fifth Avenue. This guy is going to be dynamite, Brennan said. He and Martinez had some plans and had already begun putting them in place. Unfortunately for Sears, most analysts and money managers didn't want to listen to the story--or perhaps believe it.

When I sat down with Ed Brennan that day, Sears--at the time a $50 billion company with 360,000 employees--just wasn't running on all eight cylinders. It was still reeling from 1992, a year in which Hurricane Andrew cost Allstate $825 million (the total loss from Andrew would eventually come to about $1.65 billion) and the merchandise group lost an incredible $1.47 billion. Sears's stock gained just 2.4 percent that year, while the Standard & Poor's 500 Stock Index was rising 12.7 percent. Wall Street had decided this company was old and haggard.

Brennan's ideas fell under the heading of recognizing value. The company was so big and so diverse that it had billions of dollars' worth of assets that weren't reflected in the stock price. You might say these assets were hidden in plain sight. Brennan had begun to make some moves intended to realize their value.

Brennan and Martinez set out to redefine Sears--for Wall Street, for Sears customers, and for Sears employees. What was their goal? This will seem odd, because Sears is one of the few great retail success stories of this century, but they wanted to make Sears a retail company. How could Sears be anything other than a retail company? In 1990, 58 percent of its earnings came from Allstate--an insurance company. Dean Witter (a stock brokerage) and Coldwell Banker (a mortgage underwriter and

residential-real-estate company) accounted for another 21 percent. The merchandise group also accounted for 21 percent of earnings, but all of the company's profit came from the Sears credit card.

This wasn't a retail company; it was a crazy quilt of financial-services outfits stitched to a retail operation. Yet who on Wall Street was likely to be following this company? Retail analysts. To these folks, Sears looked unwieldy, complicated, and tired. A retail analyst forced to develop an opinion on Sears back then might very well have concluded, Hey, I'll skip this one and look at that other company--that simple, fast-growing one, Wal-Mart. The march to a new retail identity for sears, step one, 1993: Brennan shuts down the catalog operation. He kills the Big Book. It would be difficult to overstate the significance of this to the company, because Sears's corporate identity is intimately tied to the company's long history. For decades, Sears was absolutely preeminent in American business; for almost 40 years after World War II, its sales consistently represented 1 to 2 percent of the gross national product. As for the catalog, it was simply a piece of the fabric of this country. Americans regarded it as their first (and, in some parts of the U.S., only) source for everything from underwear to bathtubs, screwdrivers to guitars. It was the source for everything that made an American home and even for the homes themselves: Between 1908 and 1940, Sears sold more than 100,000 houses through the Big Book.

But in the modern era, the catalog was an increasingly iffy proposition. Here's a story I remember hearing almost 30 years ago on a vacation with my wife to Alaska: A miner sent five dollars to Sears asking for 100 rolls of toilet paper. Sears wrote back and said he'd have to order through the catalog. The miner replied that if he had the catalog he wouldn't need the toilet paper. The point: Sears spent so much money printing and distributing the catalog that it would always be a struggle to recoup the costs. So say good-bye to that bit of tradition. Say good- bye to the real-estate operation, too--Brennan sold the bulk of Coldwell Banker for roughly half a billion dollars. Then he sold 20 percent of Allstate, bringing $2.4 billion into Sears's coffers. Next to go was Dean Witer. Sears shareholders received 0.39 shares of Dean Witter for each share of Sears they owned.

Brennan's last big move was perhaps the biggest of all: He spun off Sears's remaining 80 percent share in Allstate. (Allstate had been in the Sears family since 1931.) Each share of Sears entitled the holder to 0.93 shares of Allstate; I still have mine.

I recently called Jerry Leshne, the vice president of investor relations at Sears, and asked him to help me figure out how valuable the Dean Witter and Allstate spin-offs have been for shareholders. The numbers are impressive: An investor who held $10,000 in Sears shares in 1992, and who retained the Dean Witter and Allstate shares given to him and who reinvested his dividends in all three stocks, would now have stock worth about $57,000. That's a compound annual return of 33.5 percent, compared with 20.4 percent for the S&P; 500. Or let's say you liked Sears and nothing but Sears. An investor who started with $10,000 in Sears stock in 1992, and who sold his spin-off shares upon receiving them to buy more Sears stock, would now have about $39,000 in Sears shares. That doesn't just beat the S&P.; It also beats the retail index.

The spin-offs enabled Sears to focus on retailing again. It was time for Martinez, who became CEO in mid-1995, to show why Brennan had been so high on him.

as head of the merchandise group, martinez had already begun to close inefficient stores. Now, as CEO, he continued to implement the plan he and Brennan had developed. He placed a great emphasis on remodeling stores to make them more attractive and more profitable--he redid a total of 50 million square feet and, in the process, converted 5.5 million square feet of nonproductive space to usable retail space. He developed incentive plans to re-energize employees. He worked hard on clarifying Sears's pricing policies, having learned from research that the public thought Sears's prices were all over the map. As for that hammer I may or may not own, the company decided I didn't need to have 30 options for buying another. Sears now sells a handful of different hammers rather than dozens.

These moves were all critical because Sears was in a serious fight. There was no single competitor that attempted to do everything Sears did, but add together a Wal-Mart, a Gap, a Home Depot, a Pep Boys, and a Circuit City--a combination found in plenty of communities--and you had a clear and present danger.

Sears's biggest national competitor at the time, particularly in the crucial area of soft goods (apparel, shoes, bedding, so-called home fashions, that sort of thing), was J. C. Penney. Penney, too, owned most of its stores, and it had a much better focus. The two companies were going after the same middle-income customer, and Penney was doing the better job.

Martinez was smart about taking on Penney. He set a goal for Sears of getting the same kinds of margins on soft goods that Penney was getting. He also targeted women--despite the fact that many Americans thought of Sears as primarily a place to buy tools and tires. Sears, Martinez realized, was missing the boat with women: It didn't bother with plus sizes and petite sizes in most women's apparel, for example. It didn't feel like a place that wanted female customers. As he straightened this out, Martinez put a lot of corporate energy into an ad campaign: "The softer side of Sears," which was all about making women feel more welcome. It had a great impact. Soft goods now account for 67 percent of the retail space in a Sears store, up from 58 percent four years ago. Even maternity-wear sales are up sharply.

Finally, it's time to talk about the sears brands, because with Sears functioning as a relatively straightforward retail company, these brands are the very heart of the story. I can keep this simple. WeatherBeater is the number-one exterior house paint in the country for do-it- yourselfers. Diehard is the most popular auto battery. Craftsman is the number-one line of tools. Kenmore is the number-one line of appliances.

What's more, the company has developed several good new brands. The Canyon River Blues line of jeans and other casual apparel, for example, brings in a quarter of a billion a year in revenue. And that's a heck of a lot more profitable than selling the same quantity of Lee's or Levi's. Add to that lines like Circle of Beauty (cosmetics and fragrances), Eagle Golf (golf apparel), and Fieldmaster (rugged apparel).

So Sears has a very good brand lineup. The question is how the company can make the best use of these brands in a changing retail environment.

The answer is not just the big, full-line stores--though there are 833 of those. Sears's push for the past few years has been in what it calls neighborhood stores--small, usually freestanding outlets away from the big malls. Sears now has 225 hardware stores; some are called Sears Hardware and some Orchard Supply Hardware (Sears bought the Orchard chain, which comprises 65 stores in California, in 1996).

Craftsman, not surprisingly, is king at these outlets. To sell Diehard batteries and other automotive products (including 10 percent of all the tires sold in the U.S.), Sears now operates 326 NTB (for National Tire and Battery) stores, plus 576 Parts America stores. Sears doesn't have a big name brand in furniture, but it does have 129 freestanding furniture stores, called HomeLife.

Finally, Sears has about 600 (and is shooting for 900) of what it calls dealer stores. Selling only hard goods, these stores are in small towns. The products, the look, and the prices come from Sears, but the businesses are owned (and tailored to local tastes) by local entrepreneurs. It's important and profitable to do business away from urban centers--Wal-Mart is proof of that.

There you have the retail side of Sears. But we shouldn't slight two other important sources of earnings for the company. First is the Sears credit card, which is another one of those things that remind you of the incredible depth of Sears's reach into America. Nearly half the households in the United States have a Sears card. Last year, 32 million Sears cards were used at least once.

The credit-card business has traditionally been a very good profit producer for Sears, not least because a Sears card carries a very high interest rate--generally 21 percent. But 1997 was a traumatic year for the card division. Sears had been very aggressive about getting the card into new households and, as a result, picked up a lot of bad debt. Then the company went after some of its debtors in a way that a federal court deemed too aggressive and was smacked with a huge fine. That more than ate up the division's profits for the year.

And there's also the home-services division, which may have a relatively low profile but still generates a lot of money. Sears has a network of 15,000 technicians who do everything from install air conditioners to fix dishwashers to spray for bugs to sell warranties for customers' used appliances. The market for these kinds of services is about $170 billion. Sears's piece is about $3 billion, leaving plenty of room for growth.

The new sears, then, still has a financial-services angle, but for the most part it's a great big retail company that is on good terms with just about everyone you or I know. Wall Street saw the change happening and rewarded shareholders appropriately. The stock opened 1995 at around $25 a share and closed the year at about $40. By the summer of 1997, the share price had crossed $60.

But in 1998, Sears has been in the dumps--the stock has skidded from the high $50s to the high $40s. The new freestanding stores aren't all producing, and the softer side of Sears, joked The Wall Street Journal in July, appears to be the company's earnings. The harsh truth is that yesterday's reinvention doesn't mean as much as today's execution and tomorrow's competition. Just as old companies sometimes have to learn new tricks, new companies have to keep changing. Can Sears do that?

The first thing Sears needs to square away is its credit business. Martinez says the 1997 problem was a onetime occurrence whose effects will soon have run through the system. I find that reasonable. Not all analysts believe Sears can return to the kind of credit-card profits it made as recently as 1996, but there's a broad sense that Sears's credit- card division can return to its role as a moneymaker for the company. Sears is also starting to offer its best customers better rates.

Walter Loeb, a longtime Sears analyst and president of Loeb Associates in New York, thinks the neighborhood stores will work. He also likes Martinez's next big venture: The Great Indoors. There's only one Great Indoors store so far, in Denver. With 150,000 square feet (about twice the size of the average full-line Sears), the store brings together everything Sears does relating to the interior of the American home.

Maggie Gilliam, of Gilliam & Co. in New York, is another analyst who sees Sears's greatest strength as its comprehensiveness in the area of home retailing. "Who else has a combination of appliances, furniture, credit, home improvement, and services?" she asks. "There are tons of competitors in the different sectors, but only Sears does the whole thing. Soft side as well as hard side."

But what about the matter of those soft earnings? In 1997, earnings from continuing operations fell to $2.99 a share from $3.12 the previous year. The future, fortunately, looks brighter: The consensus estimate (from First Call) for 1998 is for a 16 percent kick up to $3.46. For 1999, the estimate is for a 13 percent increase to $3.91. You don't have to pay a lot for those earnings, either: Sears trades at a price-to- earnings ratio of about 14.

Some investors dismiss old-line companies like Sears simply because they aren't fresh and exciting. That's a mistake. Let someone else take the companies with cachet; I'll settle for the ones that have valuable assets and management that knows how to use them. For the past five years, that has been a good description of Sears, which is why I'm keeping an eye on this familiar face.

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