The New Alchemy At Sears

It has quietly created $1.8 billion in securities based on Kenmore, Craftsman, and DieHard

BY ROBERT BERNER

SEARS HOLDINGS CORP. Chairman Edward S. Lampert talks lovingly of his plans to reinvent Sears and Kmart Corp. He makes great theater out of his surprise visits to stores to check out the displays of power tools and the length of the checkout lines. The stock analysts who cover the Hoffman Estates (Ill.) giant follow his lead in counting foot traffic and poring over profit margin data.

But much of the real action at Sears is taking place far from the retail front lines, on a theoretical plane where few have traveled before. Sears is on the cutting edge of a financial innovation so important that it could unlock trillions of dollars in capital across Corporate America and change the way managers of a wide range of businesses think about their balance sheets.

BusinessWeek has learned that Sears has created $1.8 billion worth of securities based on the brand names Kenmore, Craftsman, and DieHard. In essence, it has transferred ownership of the brands to another entity, which it then pays for the right to use the brands. The deal, carried off last May, was the biggest "securitization" of intellectual property in history, according to Eric Hedman, an analyst at Standard & Poor's, which, like *BusinessWeek*, is a unit of The McGraw-Hill Companies. The story hasn't gotten out until now because the bonds haven't actually changed hands—Sears is holding them in its Bermuda-based insurance subsidiary—and because Sears has never disclosed them, nor has it had to do so. But that could change if Sears were to decide to sell them to outside investors and collect the cash.

Such daring shouldn't come as a surprise at a Lampert-run shop. When he looks at a company, he sees value hidden from plain view—value that traditional accounting methods often miss. That keen eye is what prompted him to buy up a majority of Kmart's bonds at a deep discount after it filed for bankruptcy protection in 2002. He saw that Kmart's real estate was deeply undervalued by creditors, and figured that would protect his investment. He was right.

Now, Sears could be on the cusp of turning a much squishier asset, intellectual property, into actual cash. Don Davis, managing director and general counsel at Commercial Strategy, a Boston intellectual property consulting firm, says the potential for a market in bonds backed by intangible assets could be even bigger than the market for junk bonds, given that 70% to 80% of the total value of the stock market rests on intangibles such as intellectual property. "The scale is astounding," he says.

But if Sears opens the floodgates for a new market, things could get messy. Junk bonds caused plenty of upheaval when the debt market turned ugly in the late 1980s. Sears' brand bonds are worrisome in one sense, say securitization lawyers and accountants: The company has put the ownership of its three core brands out of the reach of existing bondholders if the retailer ever ends up in bankruptcy. "Lampert has mortgaged Sears' crown jewels," says Thomas Lys, an accounting professor at Northwestern University. Sears, through a spokesman, says the bonds' only purpose is to provide liquidity in the coffers of its insurance subsidiary to offset any potential losses there. It also says Lampert had nothing to do with the transaction but was briefed on it. And it says Sears' outstanding debt is small relative to the company's total value and is less than the cash it has on hand. Lampert declined to comment.

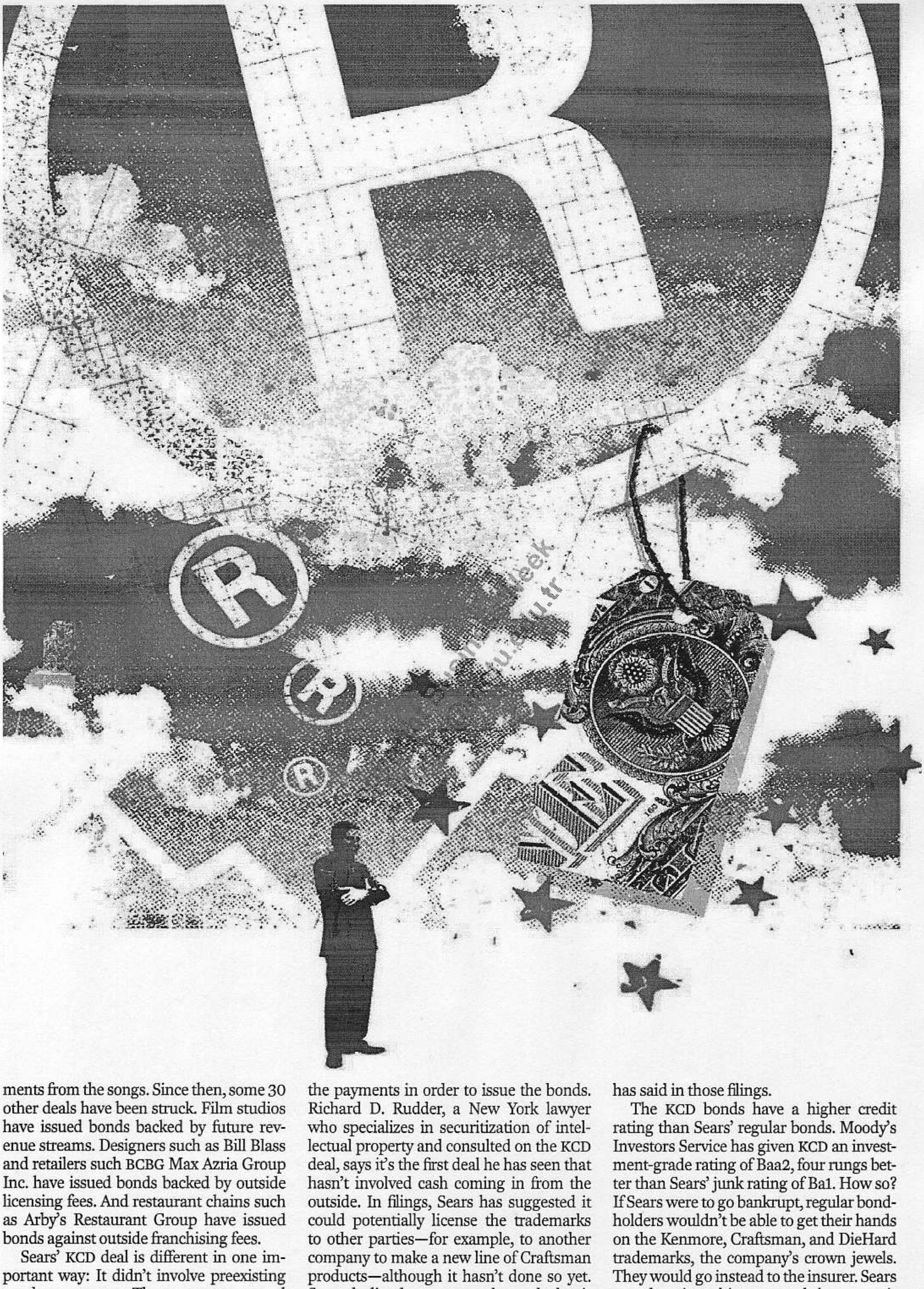
FROM WHOLE CLOTH

THE JOURNEY TO FIGURE OUT what's going on inside Sears' inner sanctum starts with some footnotes buried deep in financial filings. Sears has disclosed that it has created a "separate, wholly owned, bankruptcy-remote subsidiary"—essentially a company within a company. Called KCD IP (for Kenmore Craftsman DieHard intellectual property), the entity has issued $1.8 billion worth of bonds backed by the intellectual property of Sears' three biggest brands, according to filings with the Patent & Trademark Office.

Sears has, in essence, created licensing income from whole cloth. First it transferred ownership of the brand names into KCD. Now, KCD charges Sears royalty fees to license those brands and uses the royalties to pay the interest on the bonds. It has sold the bonds to the insurance subsidiary, where, like any other security on an insurer's books, it serves as protection against future loss. The insurer, meanwhile, protects Sears from financial trouble—and because it's a subsidiary, it does so at a lower cost than Sears could get from an outside party.

If you're confused, that's because it's all circular: The payments net out to zero because Sears owns every piece. But that would change if Sears were to sell the bonds to outsiders. Then *voilà*, Sears would be holding up to $1.8 billion in cash, and investors would be holding the bonds.

Intellectual property bonds got their start with an unlikely financier: David Bowie. The rock star floated $55 million worth in 1997, backed by 300 song titles, with the interest covered by royalty pay-



GARY NEILL

ments from the songs. Since then, some 30 other deals have been struck. Film studios have issued bonds backed by future revenue streams. Designers such as Bill Blass and retailers such BCBG Max Azria Group Inc. have issued bonds backed by outside licensing fees. And restaurant chains such as Arby's Restaurant Group have issued bonds against outside franchising fees.

Sears' KCD deal is different in one important way: It didn't involve preexisting royalty payments. The company created the payments in order to issue the bonds. Richard D. Rudder, a New York lawyer who specializes in securitization of intellectual property and consulted on the KCD deal, says it's the first deal he has seen that hasn't involved cash coming in from the outside. In filings, Sears has suggested it could potentially license the trademarks to other parties—for example, to another company to make a new line of Craftsman products—although it hasn't done so yet. Sears declined to comment beyond what it has said in those filings.

The KCD bonds have a higher credit rating than Sears' regular bonds. Moody's Investors Service has given KCD an investment-grade rating of Baa2, four rungs better than Sears' junk rating of Ba1. How so? If Sears were to go bankrupt, regular bondholders wouldn't be able to get their hands on the Kenmore, Craftsman, and DieHard trademarks, the company's crown jewels. They would go instead to the insurer. Sears says there is nothing unusual about securitizing assets; many companies, including most of the largest retailers, evaluate alternatives to create value from their brands, real estate, and other assets.

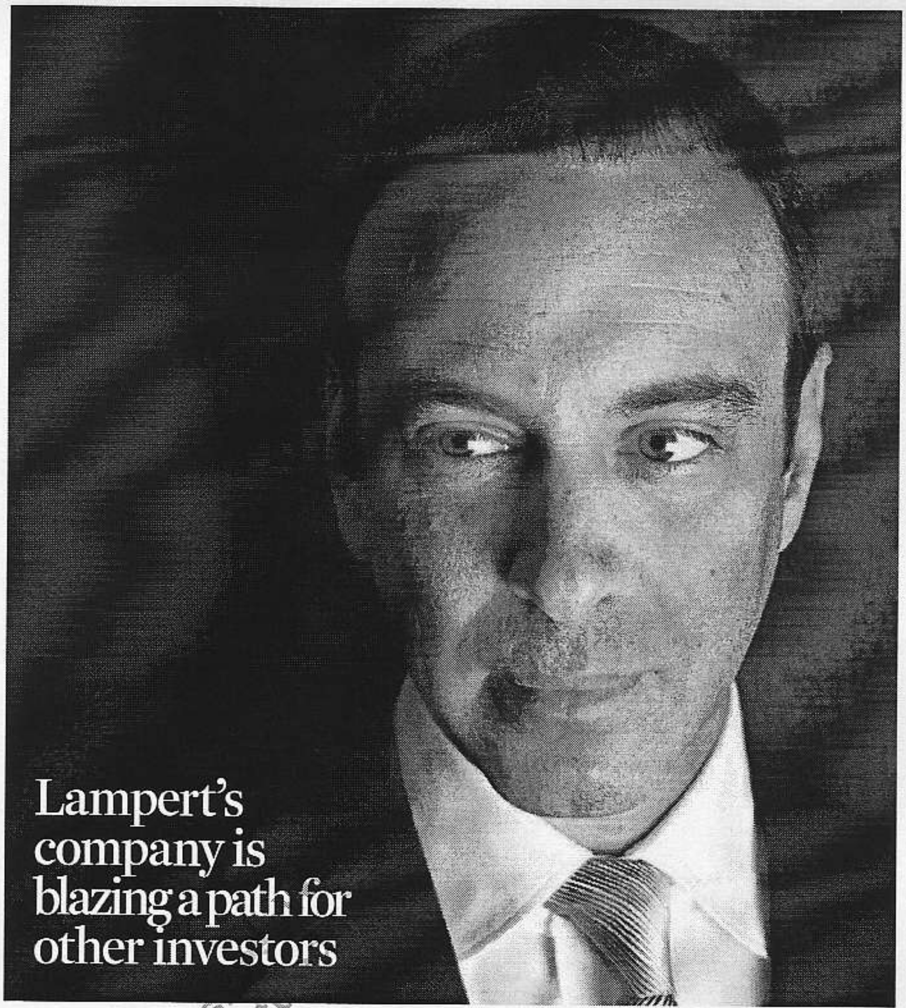
Getting details on the bond offering isn't easy. Moody's issued a detailed report dated May 18, 2006, and a press release with few specifics dated May 19. The detailed report was listed on Alacra.com, a seller of financial research, as recently as Feb. 8, at a cost of $700. When *BusinessWeek* tried to obtain the report from Moody's, the rating agency said it didn't exist. "No additional information is available," says Moody's spokesman Michael N. Adler. Alacra no longer shows the report on its site. "It was pulled," says Carol Ann Thomas, head of marketing at Alacra. "It is very, very unusual. I only know that from our management."

SETTING A PRECEDENT

MOST COMPANIES that "securitize" assets sell the bonds immediately to get the proceeds. Sears says it created the brand bonds for its Bermuda insurance company to hold in its coffers as protection should the insurer suddenly face trouble. In fact, it says the majority of the insurer's assets are made up of bonds issued by Sears' own subsidiaries. But insurers typically hold investment-grade securities unrelated to their company or their parent. To use the bonds of its own company to meet Bermudan regulatory standards, Sears would have to get special permission from the Bermuda Monetary Authority, says Shelby Weldon, the BMA's director of insurance compliance. As to whether the BMA has ever allowed an insurer to hold a majority of such bonds, "I have never seen it," says Richard J. Irwin, a partner and insurance expert at PricewaterhouseCoopers' Bermuda office. Nor has Andy McComb, president of Bermuda's Allegro Insurance & Risk Management Ltd. The BMA declined comment on Sears. Sears says only that it has obtained all necessary regulatory approvals.

In theory, there are plenty of things Sears could do with its fresh source of capital besides using it to strengthen its insurance subsidiary. Obviously, it could sell them and use the proceeds to pay down debt or buy a company. It could even trade them for the debt of another company—say the revolving credit line of another retailer. "Gap Inc. could wake up one morning and have Eddie Lampert as its lender," says Commercial Strategy's Davis. A takeover could follow. Sears declined to comment on any other potential uses for the capital.

Another possibility is that Sears is holding the bonds because it thinks they will grow in value. Davis calls the process "seasoning": The bonds will probably increase in value over time if Sears demonstrates steady royalty and lease payments. Sears declined to comment.



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'INTEREST IS EXPLODING'

WHATEVER SEARS' PLANS may be, there's no doubt it's blazing a path for other private investors. Eric Hedman, a director in S&P's Structural Finance Group, says "interest [in intellectual property deals] is exploding." Rudder, the attorney, expects much of the rise to be driven by private equity firms seeking cheaper financing for acquisitions. Carlyle Group and its other private equity partners in the Dunkin' Donuts acquisition last year used the method on a $1.7 billion issue backed by the chain's brands and actual franchise fees. "What has been done so far is only scratching the surface," says Rudder. Ellen Welsher, S&P's managing director of new assets, agrees that any company with intellectual property could unlock value this way. Adds Ronald S. Borod, a Boston lawyer specializing in intellectual property securitization: "It could become the modern day equivalent of junk bonds."

Robert W. D'Loren, CEO of NexCen Brands Inc., is building a whole business model around the securitization of intellectual property. Since August, using debt and proceeds from a public offering, NexCen acquired the Athlete's Foot chain, Bill Blass apparel brand, and the Maggie Moo's and Marble Slab Creamery ice-cream stores. D'Loren has already created an entity to hold the brands and issue bonds backed by franchising fees from the sneaker and ice-cream chains, and from Bill Blass licensing fees. The diversity of those fees will enable NexCen to issue lower-cost bonds to pay off earlier debts and fund further acquisitions. "We have created a platform to become a consistent issuer of intellectual-property-backed bonds," D'Loren says.

So too, it seems, has Sears. There's no sign of what the endgame may be. But one thing is certain: With the news of the brand bond out, you can bet others will watch closely—and read the financial footnotes—to see what Sears might be up to next. ■

Big Deals

Brand bonds could be the next big trend in finance. Here are the biggest trademark and franchise fee deals thus far.

ISSUER	SIZE	YEAR
KCD IP (SEARS)	$1.8 billion	2006
DUNKIN' BRANDS	$1.7 billion	2006
ARBY'S	$290 million	2000
QUIZNOS	$250 million	2005
GUESS?	$75 million	2003