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INSIGHT

VIEWPOINT

Is it Just a Game of Jenga®?

JAMIE FARNHAM & ANTHONY GARCIA | APRIL 26, 2018

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Mr. Farnham joined TCW in 2009 as the Director of Credit Research and a Specialist Portfolio Manager in the Fixed Income group. Previously with Metropolitan West Asset Management LLC (MetWest), Mr. Farnham served as a Portfolio Manager where he led a team of credit analysts and oversaw the firm's proprietary credit research process within the corporate, high yield, and leveraged loan markets. Prior to that, he was a Private Equity Investor at Primus Capital after working as an Investment Banker at Merrill Lynch in New York, focusing on new issue origination of equity and fixed income securities, as well as mergers and acquisitions. Mr. Farnham holds an AB in Economics from Princeton University and an MBA from the UCLA Anderson School of Management.

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Mr. Garcia joined TCW in 2013 as a Credit Analyst with the Fixed Income group where he is responsible for credit research in gaming, lodging, retail, restaurants, and REITs. Prior to joining the firm, he was a Credit Analyst at Bank of America Merrill Lynch in High Yield Research. Mr. Garcia earned his BS in Business Administration from the University of California, Berkeley and is currently an MBA candidate at the UCLA Anderson School of Management.

Jenga® is a timeless game, each turn requiring calm to remove part of the base foundation and featherlike-touch to reapply the removed piece to the formation's rising top. As the game evolves, the tower progressively weakens with each turn becoming more nerve-racking than the last. The structure's height finally overwhelms its foundation, leading to an exciting collapse. The credit cycle is akin to an intricate Jenga® game where covenant erosion progressively weakens the tower base as its height rises due to increasing debt levels.

Sears Holding appears to be nearing the end of a lengthy Jenga® game. From our perspective, ESL Investments ('ESL'), Sears' ('SHLD') principal owner/manager[1] has been systemically depleting asset value via mechanisms such as subsidiary spinoffs to shareholders, brand divestitures and real estate sales while not reducing debt. The progressive transfer of valuable SHLD assets away from creditors has been occurring against a backdrop of eroding operating metrics, including declining sales per square feet and 18 consecutive years of negative same-store sales growth, concurrent with substantial share repurchases.

1 ESL reports ownership of ~73% of SHLD equity, its executive serves as Chairman/CEO and another ESL executive is a board member (out of a six-member board of directors)

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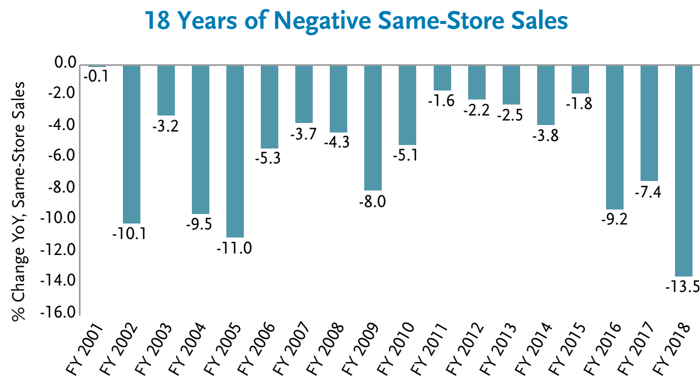

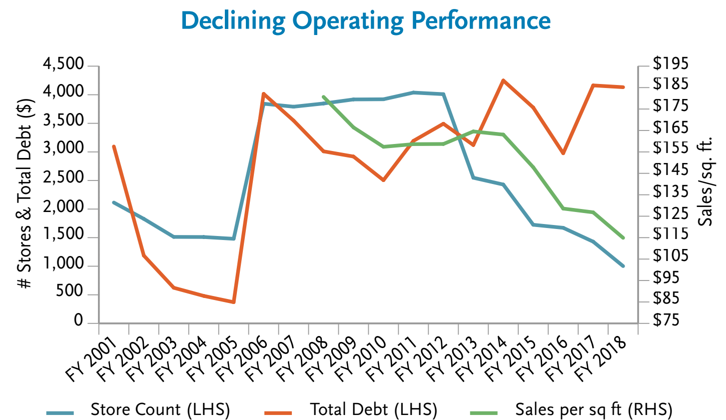

Source: Bloomberg, Company Reports, TCW

Based on broker credit market quotes, our analysis of SHLD bonds and CDS imply an over 80% default probability within the next two years. While the company incorporated a "going concern" warning in its 2016 10k SEC filing, interestingly the same language was not included in its recent 2017 SEC filing. The implication is that the board deliberated as to whether the company's financial condition was in the "zone of insolvency," which would trigger a shift in the board's fiduciary duty from its shareholders to its creditors.

With that backdrop, recent disclosure of an offer to buy some of SHLD's few remaining assets is another stark reminder of the dangers lurking in the credit markets. In an SEC filing, SHLD disclosed receipt by its board of an offer by ESL to purchase all or a portion of (i) the rights to its Kenmore appliance brand name, (ii) the SHLD home improvement business, and (iii) the parts direct business of the SHLD home services segment in exchange for $500m in cash. The offer would require certain debtholders to exchange or tender existing debt at a price below par as a condition of the sale. ESL also expressed interest in making an offer for SHLD's remaining real estate, if requested by SHLD's board. ESL would then own these key assets 'free and clear,' out of reach from SHLD debt claims. Meanwhile creditors would lock in a valuation ceiling without certainty it achieved the most beneficial consideration in return.

From an outsider's perspective, delineating the divergent incentives between ESL and SHLD appear quite difficult given ESL's representation on both sides. The U.S. Bankruptcy Code provides some mechanisms to combat fraudulent conveyance/transfer of assets of insolvent companies in exchange for consideration that is viewed as below reasonably equivalent value. However, successful litigation of such allegations is difficult. In a more typical bankruptcy an insolvent company would seek protection and weigh how best to maximize the enterprise's value for the benefit of its creditors. This might include attempting to divest certain assets post-bankruptcy filing using Section 363 of the U.S. Bankruptcy Code. However, asset sale processes under Section 363 have been used as a stick against creditors as well. Experienced credit investors likely recall the use of Section 363 asset sale processes to swiftly sell the ongoing businesses of General Motors and Chrysler out from under bondholders amid the market volatility of the Great Recession in 2009.

The SHLD development bears some similarity to such a Section 363 sale via the proposed less-than-arm's-length transaction but instead it skips right over the bankruptcy step, which we believe is a dangerous development for credit market participants. Creditors might have avoided such a predicament with thorough diligence to identify the confluence of a strong business, effective management and covenants/structure that align incentives, including requiring substantial company assets such as these to be part of the collateral package and/or restricted group. Credit market historians can help remind investors that the longer a credit cycle stretches, the more market conventions are challenged. As in Jenga®, the longer the game persists the less secure the foundation and the more spectacular the collapse. ■

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