

Credit Risk Management

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MSF555

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TOPIC- Sears' case study

Link - [Sears Case study 63.pdf](#)

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1. Identify the challenges faced by Sears. What challenges are affecting Sear's financial performance? You can evaluate the company's financial health using financial statements and financial analysis tools, such as financial ratio analysis and liquidity analysis.

Particulars	2012-13	2013-14	2014-15	2015-16	2016-17
Current ratio	1.10	1.09	1.04	1.11	1.06
Quick ratio	0.20	0.24	0.12	0.12	0.16
Debt to equity	1.132	2.44	-.3.32	-1.11	-1.09
Debt ratio	0.16	0.23	0.23	0.19	1.40
ROA	-5.45%	-6.12%	-5.80%	-9.95%	-23.72%
ROE	-38.2%	-64.2%	190.2%	57.46%	58.08%
Net profit margin	-2.91%	-3.57%	-5.80%	-4.48%	-10.03%

1. Liquidity Analysis

Current Ratio

Sears' current ratio, ranging from 1.10 to 1.06, suggests that while the company could cover its short-term liabilities with its short-term assets, it operated with minimal margin. This narrow buffer implies that Sears was close to its liquidity limits, making it vulnerable to cash flow disruptions or unforeseen expenses. Such a tight liquidity position indicates potential struggles in maintaining operational stability during economic downturns or periods of declining sales.

Quick Ratio

The quick ratio for Sears, fluctuating between 0.12 and 0.24, underscores significant liquidity challenges, as it reflects the company's inability to swiftly convert assets into cash. With a quick ratio well below 1, Sears faced substantial difficulty in meeting short-term obligations without depending heavily on inventory sales. This low liquidity ratio reveals a critical vulnerability, as reliance on less liquid inventory can exacerbate cash flow issues during slow sales periods or economic stress.

2. Solvency Analysis

Debt-to-Equity Ratio

Sears' debt-to-equity ratio, peaking at 3.32 in FY 2014/15, highlights a concerning reliance on debt relative to shareholders' equity. Such a high ratio indicates that the company financed a significant portion of its operations through borrowed funds, escalating its financial risk. High leverage increases the risk of insolvency, particularly if Sears fails to generate sufficient profits to cover its interest obligations and repay its debt, potentially leading to financial instability.

- **Debt Ratio**

The debt ratio, which reached 0.23 in FY 2014/15, shows a high proportion of Sears' assets were financed through debt. A high debt ratio reflects a significant level of debt relative to total assets, implying that a substantial part of the company's capital structure was debt-dependent. This elevated debt level intensifies the company's financial risk, as it becomes more susceptible to debt servicing challenges and may face difficulties in securing additional financing if needed.

3. Profitability Analysis:

- **ROA (Return on Assets)**

Sears' Return on Assets (ROA) was consistently negative throughout the period analyzed, deteriorating further to -23.72% by FY 2016/17. This persistent negative ROA indicates that the company was unable to effectively utilize its assets to generate profits, resulting in ongoing operational losses. The worsening ROA highlights a severe inefficiency in asset management, where the company's investments failed to produce adequate returns, reflecting broader operational and strategic issues that impeded profitability.

- **ROE (Return on Equity)**

The volatility in ROE reflects unstable financial performance and significant difficulties in delivering consistent returns to shareholders. The erratic ROE underscores the challenges Sears faced in maintaining shareholder value and suggests that the company struggled with both operational inefficiencies and capital management issues over the examined period.

Challenges Facing Sears

• Declining Revenue and Profitability

Sears faced a persistent decline in revenue from FY 2011/12 through FY 2016/17, signaling a shrinking market presence and weakening competitive position. This revenue drop, compounded by high operational costs, led to sustained operating losses, reflecting a failure to adapt to changing consumer behaviors and market conditions. The negative net profit margin throughout this period further underscores the company's struggle to achieve profitability, revealing systemic issues in cost management and revenue generation.

• Liquidity Issues

Sears' current ratio, ranging from 1.09 to 1.11, indicates a narrow cushion for covering short-term liabilities, suggesting the company operated with minimal liquidity buffer. This tight liquidity margin left Sears vulnerable to cash flow disruptions, which could jeopardize its ability to meet immediate financial obligations. The quick ratio, even lower and excluding inventory, highlights more severe liquidity constraints, as it reflects difficulties in managing cash flow without relying heavily on slow-moving inventory.

• High Debt Levels

The company's debt-to-equity ratio, peaking at 3.32 in FY 2014/15, reveals a high reliance on debt to finance its operations, significantly increasing financial risk. This heavy leverage meant that Sears was more susceptible to financial instability, particularly if it struggled to generate sufficient revenue to cover debt obligations. Similarly, the high debt ratio of 0.23 in FY 2014/15 underscores the burden of debt on Sears' capital structure, indicating that a substantial portion of its assets was financed through borrowed funds, heightening financial vulnerability.

- **Poor Financial Ratios**

Sears' Return on Assets (ROA) was consistently negative and worsened to -23.72% in FY 2016/17, indicating severe inefficiencies in utilizing assets to generate profit. This sustained negative ROA reflects an inability to leverage assets effectively, resulting in substantial operational losses. The fluctuating Return on Equity (ROE), with a dramatic peak at 190.2% in FY 2013/14, contrasted with negative or very low values in other years, highlights erratic performance and difficulties in delivering consistent shareholder value.

- **Operational and Strategic Missteps**

Sears struggled with increasing competition from e-commerce and discount retailers, which eroded its market share and profitability. The company's transition to an "asset-light" model and investments in e-commerce failed to deliver the expected turnaround, with efforts such as asset sales and brand divestments raising doubts about the long-term effectiveness of its strategic approach. These missteps exposed Sears to further challenges, as it grappled with maintaining operational relevance and financial stability.

- **Management and Leadership Issues**

Frequent turnover of high-level executives and Edward Lampert's controversial leadership created instability and uncertainty regarding Sears' strategic direction. Lampert's focus on financial restructuring and asset sales, rather than core retail operations, led to skepticism about the company's recovery prospects. The leadership issues, combined with strategic misalignments, undermined confidence in Sears' ability to navigate its financial difficulties and execute a successful turnaround.

Conclusion

Sears' financial ratios reveal a company under severe financial stress, grappling with high debt levels, poor liquidity, and inconsistent profitability. The challenges of high financial leverage, poor liquidity, and operational inefficiencies severely impacted Sears' financial performance, making it difficult for the company to sustain operations, invest in growth, or even remain solvent. These financial weaknesses would have made it difficult for Sears to compete in the rapidly changing retail landscape, ultimately contributing to its decline.

2. How likely is Sears a candidate for bankruptcy? Use Altman Z score to evaluate the likelihood of default for Sears

Particulars	2012-13	2013-14	2014-15	2015-16	2016-17
Altman Z -Score	1.924	1.604	1.87	1.72	0.69

The Altman Z-score model divides companies into three main zones to assess bankruptcy risk based on their score:

- 1. Safe Zone:** Z-score above 2.99
- 2. Distress Zone:** Z-score between 1.81 and 2.99
- 3. Bankruptcy Zone:** Z-score below 1.81

Using the Z-scores provided for Sears, we can categorize each year as follows:

2012-13: Z-Score = 1.924

Zone: Distress Zone

Explanation: With a Z-score of 1.924, Sears was in the distress zone, indicating a high probability of financial trouble. Although not in the most critical bankruptcy zone, the score suggests significant financial risk and instability.

2013-14: Z-Score = 1.604

Zone: Bankruptcy Zone

Explanation: The Z-score dropped to 1.604, placing Sears in the bankruptcy zone. This score indicates a very high likelihood of bankruptcy and severe financial distress, suggesting that Sears was facing extreme challenges.

2014-15: Z-Score = 1.87

Zone: Distress Zone

Explanation: Although the Z-score increased slightly to 1.87, it remained in the distress zone. This suggests some improvement but still a high risk of bankruptcy. The company continued to face significant financial challenges.

2015-16: Z-Score = 1.72

Zone: Distress Zone

Explanation: The Z-score of 1.72 indicates that Sears was still in the distress zone. The score reflects worsening financial health, suggesting that Sears was at a high risk of bankruptcy.

2016-17: Z-Score = 0.69

Zone: Bankruptcy Zone

Explanation: Given Sears' Z-score of 0.69, it indicates significant financial distress, making it highly vulnerable to bankruptcy despite any strategic efforts to improve its situation. This score underscores the difficulty Sears faced in stabilizing its financial health and the high probability of insolvency if conditions did not improve significantly.

Summary

Throughout the period analyzed, Sears consistently fell into the **Distress Zone** with only one year in the **Bankruptcy Zone**. This indicates that Sears faced significant financial instability and a high risk of bankruptcy, with only minor fluctuations in its financial health. Despite some improvements in later years, the Z-scores suggest that Sears remained highly vulnerable to bankruptcy throughout the period.

Q3. Do you think Altman Z-score model is sufficient in capturing the default risk of Sears? If there are other factors that are crucial in affecting the default risk of auto industry, what could they be?

1. Limitations of Altman Z-Score

- **Backward-Looking Nature:**
 - The Altman Z-Score primarily uses historical financial data. While this provides a snapshot of past performance, it may not fully reflect recent changes or current market conditions that could influence Sears' financial outlook.
 - Example: A recent strategic partnership or new revenue stream might not be captured, yet could improve future prospects.
- **Industry-Specific Factors:**
 - The model is generalized and doesn't account for unique challenges or dynamics within specific industries, like retail.
 - Example: The retail sector's rapid shift to e-commerce is a significant risk factor for traditional brick-and-mortar stores like Sears, which the Z-Score might not fully capture.

2. Additional Factors Influencing Default Risk

- **Market Conditions:**

- **E-commerce Competition:** The rise of online retail giants like Amazon has drastically reduced Sears' market share, impacting revenue and profitability.
- **Consumer Behavior Shifts:** The preference for online shopping over traditional retail has further weakened Sears' customer base.

- **Management Decisions:**

- **Leadership and Strategy:** Poor strategic decisions, such as delayed investment in e-commerce or mismanagement of store closures, have accelerated Sears' decline.
- **Asset Management:** The decision to sell off valuable assets to cover short-term debts may provide temporary relief but weakens long-term viability.

- **Macroeconomic Factors:**

- **Economic Downturns:** During economic recessions, discretionary spending drops, directly affecting sales in retail, particularly for non-essential items.
- **Interest Rates:** Rising interest rates increase the cost of borrowing, exacerbating Sears' existing debt burden.