Financier **EDDIE LAMPERT** has turned once-bankrupt Kmart into a $3 billion cash cow. Will he build it into a new Berkshire Hathaway?

**THE NEXT WARREN BUFFETT?**

*BY ROBERT BERNER (P.144)*
SECURITY IS TIGHT AT EDDIE LAMPERT’S OFFICE. THAT’S NO SURPRISE: Last year he was kidnapped at gunpoint while leaving work and held for ransom for two days before talking his way free. In fact, there is no sign on the low-rise building in Greenwich, Conn., that his $9 billion private investment fund, ESL Investments Inc., is even there at all. There’s also no sign on ESL’s door upstairs—and certainly no indication that the man sitting there might be the next Warren E. Buffett.

If anyone is destined to inherit Buffett’s perch as the leading investment wizard of his day, it just might be Edward S. Lampert. Since he started ESL in 1988 with a grubstake of $28 million, he has racked Buffett-style returns averaging 29% a year. His top-drawer clients range from media mogul David Geffen and Dell Inc. founder Michael S. Dell to the Tisch family of Loews Corp. and the Ziff family publishing heirs. Only 42, Lampert has amassed a fortune estimated at nearly $2 billion. So focused is he on his goals that he was back at work negotiating a big deal two days after his kidnappers released him. Says Thomas J. Tisch, son of Loews’s founder Laurence Tisch: “Eddie is one of the extraordinary investors of our age, if not the most extraordinary.”

Like the 74-year-old Buffett, Lampert has built his success on some of the least sexy investments around. He searches for companies that are seriously undervalued, and he’ll even risk jumping into ones that are reeling from bad management or lousy strategies—because the potential returns are far greater.

Right now, ESL has stakes in a grab bag of retailers. It holds 14.6% of Sears, Roebuck & Co., whose stock soared 24% on the day Lampert revealed he was building a cash offer for Kmart. He also has a 19% stake in Kmart itself, and he controls 20% of Allied Stores Corp., another struggling retailer. ESL is also building a major stake in Nestle S.A., the Swiss food giant. Louise P. Renne, chairman of ESL, calls Lampert “one of the most creative and creative managers in the world.”

Lampert has already made a name for himself as a turnaround artist. In 1989 he turned around Kmart, which had filed for bankruptcy in 1982. Lampert bought the chain out of bankruptcy, fired its top officers, and reorganized the management. Under Lampert’s leadership, the once-tired Kmart chain has been transformed into a $3 billion cash cow—and Lampert has held out the prospect of turning it into a new Berkshire Hathaway, if he chooses. For now, he’s concentrating on hitting the next round of target companies.
Nov. 5 after real estate investment trust Vornado Realty Trust bought a 4.3% stake. It also owns a big chunk of the No. 1 auto-parts retailer, AutoZone Inc., and the biggest national chain of car dealers, AutoNation Inc., as well as a small stake in telecom giant MCI.

The key to his ambitions, though, is a 53% stake in Kmart Holding Corp. If a fading textile maker in New Bedford, Mass., called Berkshire Hathaway Inc. provided the launchpad for Buffett, then Kmart might do the same for Lampert. Much like the textile mill when Buffett got hold of it, the once-bankrupt Kmart is now throwing off far more cash—it has $3 billion on-hand—it can use in the business. It also has $3.8 billion in accumulated tax credits, which can offset taxes on future income, and a fast-rising stock that is valuable in deal-making. Those advantages make Buffett a perfect vehicle for bankrolling big acquisitions. They give Lampert “the ability to buy a lot of companies and shield a lot of income from taxes,” says John C. Phelan, a former ESL principal who is now managing partner of MSD Capital, which also manages Dell family money.

A Key Signal

THE FIRST HINT Buffett gave of how he planned to transform Berkshire into an investment powerhouse was in regulatory filings in the late 1960s. In an echo of that move, Kmart disclosed in August that the board had given Lampert authority to invest Kmart’s “surplus cash” in other businesses. Wall Street is reading that move as a signal that Kmart may be on the way to becoming Lampert’s Berkshire Hathaway. “There is no question he will turn Kmart into an investment vehicle like Warren Buffett’s,” says legendary value investor Martin Whitman. He believes that Vineyard Avenue Management LLC, which teamed up with Lampert when Kmart was in bankruptcy court and now owns a 4.6% stake in the retailer, “is the same test we are using to hedge our bets on Lampert’s future.”

For Lampert, more than just superior return expectations are riding on Kmart. In a series of lengthy interviews with BusinessWeek, Buffett makes clear that he also wants to earn respect as a man who provides expertise in how a company is run. Like Buffett, he wants chief executives to open their arms and partner with him. Dressed in a hand-tailored suit with a subtle pinstripe and an open-collared blue shirt, Lampert has the know-how that his role model is a tough comparison. Berkshire Hathaway has earned 25% a year since Buffett gained control in 1965—not quite as much as RIL’s 29% average return but over a far longer period. “Buffett’s investments have stood the test of time,” he says, noting that the same test was applied to him. Buffett, for his part, declined to comment on Lampert.

From the start of his career, Lampert has sought out high-powered merchandisers. At various stages he worked with former Goldman Sachs & Co. head Robert E. Rubin, economics Nobelist James Tobin, and investor Richard Rainwater. Rubin, now at Citigroup, was taken by his self-assurance, independence, and discipline when Lampert worked for him at Goldman after graduating from Yale University. When Lampert, then 25, told him he was going to start his own fund, the future Treasury Secretary argued that he was forfeiting a golden career. “He had a clear vision of the risk he was taking and the likelihood he would succeed,” Rubin recalls. “I’d say it worked.”

Kmart is a classic example of how Lampert works. He got control of a $23 billion retail chain—the nation’s third-largest discounters, behind Wal-Mart Stores Inc. and Target Corp.—for less than $1 billion in bankruptcy court. He emerged as the largest shareholder and became chairman 18 months ago as part of a reorganization in which virtually all of its debt was converted into shares. Lampert’s goal is to keep Kmart humming so it can continue throwing off cash. Even if Kmart eventually fails, keeping it going as long as possible lets him extract top dollar for its valuable real estate by selling the stores over time. “We are going to have to generate traffic [in the stores],” says investor Whitman. “Even to this day, it is no slam dunk.”

So far, Lampert has been milking Kmart for cash. Although same-store sales continue to sink, the company has been in the black for the past three quarters because cash flow has surged. A favorite Lampert gripe: Retailers are too willing to chase unprofitable sales. Instead, he has imposed a program of keeping the lid on capital spending, holding inventory down, and stopping the endless clearance sales. And he pushed for Kmart to sell 68 stores to Home Depot Inc. and Sears to raise a total of $4.9 billion. That’s nearly as much as the $879 million value placed on all of Kmart’s real estate—1,513 stores, 16 distribution centers, and the fixtures—in bankruptcy proceedings. Thanks to the measures Lampert has put in place, says IBK analyst Gary Balter, Kmart could have as much as $4.2 billion of cash in hand by the end of next year’s first quarter.

Lampert is also angling to boost profits at a smaller, more focused Kmart. He has quietly consulted former Gap Inc. Chief Executive Millard Drexler on apparel strategy and hired two former Gap merchandising and design executives as a result. One of their first moves was to add four upscale stores to the company and owner of Bloomingdale’s and Macy’s. “Why would it reflect that kind of value?” asks Robert Miller, a principal at Miller Mathes, a New York-based restructuring advisory firm. “Because Lampert is a smart cookie. Essentially he is transforming the assets into a more valuable state.”

Studying the Sage

IF LAMPERT DOES turn Kmart into the next Berkshire Hathaway, he could simply follow Buffett’s blueprint. Buffett started with an investment fund he founded at age 25, the same as Lampert when he started ESL. Then in 1962, Buffett started to buy shares of the textile company and by the late 1960s he was using the mill’s excess cash to invest in other businesses—first a Nebraska insurance company and then an Illinois bank. Buffett's returns were so predictable that they become Buffett’s trademark. The company now boasts a stock-market capitalization of $86.6 billion, on a par with Federated Department Stores Inc., the No. 1 department-store company and owner of Bloomingdale’s and Macy’s. “Why would it reflect that kind of value?” asks Robert Miller, a principal at Miller Mathes, a New York-based restructuring advisory firm. “Because Lampert is a smart cookie. Essentially he is transforming the assets into a more valuable state.”

LEARNING FROM THE MASTER

Eddie Lampert’s investment style is similar to Warren Buffett’s. They both:

- Look for companies with long-term value that the markets are missing
- Invest at a low enough price to protect their downside
- Buy a few companies they know intimately
- Seek out mature and easily understandable companies that throw off lots of cash; avoid tech
- Act like businessmen who team up with CEOs and influence the way companies are run
- Focus intensely on how their companies allocate capital to maximize returns

But there’s one big difference between the two:

- Buffett invests largely in well-run companies, while Lampert is more willing to target poorly run ones because they can produce greater growth if the right changes are made. As a result, Lampert is more hands-on with management.
Friends trace Lampert’s drive to succeed to the shock of his father’s death from a heart attack at age 47

1970 he had dissolved the fund, selling off its investments and giving the partners a choice of cash or shares in Berkshire Hathaway. Many investors believe that Lampert is poised to do the same: using Kmart to make new investments while keeping ESL for his earlier investments, or alternatively dissolving it at some point by selling its assets.

Lampert has carefully studied Buffett for years. He started reading and rereading Buffett’s writings while working at Goldman after college. He would analyze Buffett’s investments, he says, by “reverse engineering” deals, such as his purchase of insurance company Geico. Lampert went back and read Geico’s annual reports in the couple of years preceding Buffett’s initial investment in the 1970s. “Putting myself in his shoes at that time, could I understand why he made the investments?” says Lampert. “That was part of my learning process.” In 1989 he flew out to Omaha and met Buffett for 90 minutes, peppering him with questions about his investing philosophy.

Like the Sage of Omaha, Lampert targets mature and easily understandable businesses that have strong cash flows. Both focus on a company’s ability to generate large amounts of cash over the long haul, so neither is particularly fazed by sharp ups and downs in profits and stock prices. In fact, says ESL President William C. Crowley, “Lampert would rather earn a bumpy 15% [return] than a flat 12%.” And just as Buffett progressed from minority stakes, where his influence isn’t guaranteed, to majority stakes, where he has control, Lampert is currently following the same path. Kmart marks his first majority play, and Lampert says it is the type of investment he plans for the future. “In a control position, our ability to create value goes up exponentially,” he explains.

WRINGING VALUE OUT OF KMART

Armed with the discount chain’s vast real estate holdings to protect his downside, Lampert is retooling Kmart to maximize cash flow. So far he has:

CLEANED UP the balance sheet by converting most debt to equity before the chain emerged from bankruptcy in 2003

SOLD 68 marginal stores to Sears and Home Depot

STRETCHED OUT payments to vendors, reduced inventories, raised prices, and kept a lid on capital spending.

CREATED four higher-quality apparel brands and in February will add a line of kitchenware and other home goods to goose sales and profits.

WILL ALWAYS WANT TO WORK THROUGH, AT A PRETTY HIGH LEVEL OF DETAIL, WHAT WE ARE GOING TO SPEND OUR MONEY ON AND WHAT THE BUSINESS BENEFITS WILL BE,” SAYS JULIAN C. DAY, WHO WAS KMART’S CEO UNTIL OCTOBER AND NOW IS A DIRECTOR. ADDS RICHARD PERRY, WHO WORKED WITH LAMPERT AT GOLDMAN AND WHOSE HEDGE FUND OWNS A MAJOR STAKE IN KMArt: “EDDIE TALKS ABOUT AN INVESTMENT THE SAME WAY.” CONSIDER SEARS’ RECENT PURCHASE OF 50 Kmart stores. The deal will both jump-start Sears’ strategy to move outside of malls and build stand-alone big-box stores and add hundreds of millions more to Kmart’s growing cash pile. “Great investors see deals within deals,” says William E. Oberndorfer, general partner of the SPO Partners & Co. value fund. “He’s in rarified company.”

What struck former ESL analyst Daniel Pike was how well Lampert understands risk. “He’s obsessed with protecting his downside,” he says. Lampert does this by holding just seven or eight major investments at a time—investments he knows intimately after intensive research. Pike recalls getting a taste of Lampert’s methods when he applied to work there after quitting an investment-banking job at about the time ESL was investing in AutoZone. Before hiring Pike, Lampert sent him on a grueling, all-expenses-paid field trip to visit auto-parts retailers throughout the country for a month to test his smarts.

Once ESL has invested, it stays in close touch with the company. ESL President Crowley, 47, a former Goldman Sachs banker, is Kmart’s main point person. He also sits on Kmart’s board and oversees the chain’s finances. Former Kmart CEO Day says he gets calls daily from Crowley on operational issues and discussed strategy with Lampert two to three times a week. At AutoZone, where ESL holds a 26.8% stake and Lampert sits on the board, Chairman and CEO Steve Odland says he talks to Lampert about three times a month.

One former employee notes that Lampert’s annual letters to investors have gotten shorter over the years. These days, they’re about two pages long. In each, he makes the standard Buffett point: That year’s performance will be hard to match.

Watch the Pennies

THERE IS NOTHING Lampert likes to control more than how money is spent. He is probably even more obsessed than Buffett with making sure that every dollar he invests in a company earns the highest return. That means his companies have often used cash to buy back shares rather than boost capital spending. The CEOs of his companies, who are reluctant to talk without Lampert’s permission, say a big part of their conversations with him focus on discussing how best to allocate capital. “He will always want to work through, at a pretty high level of detail, what we are going to spend our money on and what the business benefits will be,” says Julian C. Day, who was Kmart’s CEO until October and now is a director. Adds Richard Perry, who worked with Lampert at Goldman and whose hedge fund owns a major stake in Kmart: “Eddie talks about an investment the same way.” Consider Sears’ recent purchase of 50 Kmart stores. The deal will both jump-start Sears’ strategy to move outside of malls and build stand-alone big-box stores and add hundreds of millions more to Kmart’s growing cash pile. “Great investors see deals within deals,” says William E. Oberndorfer, general partner of the SPO Partners & Co. value fund. “He’s in rarified company.”

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Given the outside returns he achieves, investors aren’t inclined to bug him for more details. “Based on the
way he thinks about investments, I trust Eddie,” says Tisch.
Lampert runs his fund with just 15 employees, mostly research
analysts. As Lampert walks the floor, Crowley is locked on the
phone in his office. Lampert’s is next door, a corner suite whose
central focus is a dual set of black, flat-panel computer screens
perched on his desk. Most of the room is lined with books, but on
one wall hangs a picture of Lampert with former President
George H.W. Bush. Outside, several people work silently in near-
ly kept cubicles. Lampert notes how quiet and unlike a trading
floor the office is. “It’s a more studious atmosphere,” he jokes.
Friends trace Lampert’s intense drive to succeed to the shock
of his father’s death from a heart attack at 47. Overnight, young
Eddie became the man of the house at just 14. The family lived in
the prosperous suburb of Roslyn, N.Y., and his father, Floyd, a
lawyer in New York City, had been deeply involved with both
Lampert and his younger sister, Tracey, coaching Little League
and teaching them bridge. His stay-at-home mother had to go off
to work as a clerk at Saks Fifth Avenue, and financial security was
a big issue. “Eddie really assumed the responsibility, knowing
that life had changed and we had to accomplish something by
ourselves now,” says his mother, Dolores.

It was Lampert’s grandmother who sparked Lampert’s interest
in investing. She would watch Louis Rukeyser’s Wall Street Week
on TV religiously and invest in stocks such as Coca-Cola Co. that
paid large dividends. From the age of about 10, his mother recalls,
Eddie would sit at his grandmother’s knee as she read stock
quotes in the paper and they would talk about her investments. By
the ninth grade, while he was watching sports on TV with his bud-
dies, Lampert would also be reading corporate reports or finance
textbooks, says Jonathan Cohen, Lampert’s closest childhood
friend. “He would mark things with a highlighter,” says Cohen,
who believes the death of Lampert’s father must play some role in
“his need for financial success.” Surely, his father’s death left a big
hole in his psyche. At his wedding in 2001, held outdoors on his
Greenwich estate, he looked up into the sky and made a toast:
“How am I doing, Dad?” Dolores recalls him saying.

“A Light Burning”
COBBLING TOGETHER FINANCIAL AID, savings from summer
jobs, and student loans, Lampert enrolled at Yale University,
where he majored in economics. There, he served as Phi Beta
Kappa president for his class, joined the elite Skull & Bones secret
society—and began to seek out the mentors who would propel
his career. Says Earl G. Graves Jr., president of Black Enterprise
magazine, who was in Skull & Bones with Lampert: “I remem-
ber telling my girlfriend there is a light burning in this guy that
doesn’t burn in many people.” In his last three years at Yale,
Lampert worked as a research assistant for Professor James To-
bin, who had just won the Nobel prize in economics in 1981.
Lampert also was a member of the Yale student investment club,
a group on campus that invested donations from alumni that
eventually became part of Yale’s endowment. Joseph “Skip”
Klein, student chairman of the group, says Lampert would sug-
gest complex investments such as risk-arbitrage plays: “Most of
us [wondered]: ‘How the heck does he know about this?’ ”

Lampert parlayed a summer internship at Goldman Sachs
into a full-time job upon graduation in 1984. But he didn’t start
on the ground floor. Instead, he persuaded Rubin, who oversaw
the fixed-income and arbitrage departments, to allow him to
work directly for Rubin on special projects. Within months, that
translated into a job in Goldman’s high-powered arbitrage de-
partment. Lampert thrived on the work, which entailed ana-
lyzing whether a just-announced transaction, such as a
takeover, would succeed and then betting millions on the out-
come—all in minutes. He says the experience taught him how
to evaluate risk quickly in a situation, often with incomplete in-
formation. Doing this day after day as news events broke of-
ered complex investments such as risk-arbitrage plays: “Most of
us [wondered]: ‘How the heck does he know about this?’ ”

Lampert persuaded his kidnappers to let him go—
on a promise that he would pay them $40,000 in a few days

Even in a department filled with hotshots, Lampert stood out,
says Frank P. Brosens, who became Lampert’s boss when Rubin
became co-CEO of Goldman. He remembers how Lampert ar-
gued during the summer before the October, 1987, market crash
that stocks were overvalued, given that long-term interest rates
were so high. As a result, the department cut its stock holdings by
30% before the crash. “Eddie was the most independent thinker
in our area,” Brosens says.

At a time when most people his age are just getting started at
The audacity of his Kmart investment is what really put Lampert on the map. He scooped up debt as others fled.

Goldman, Lampert quit and moved to Fort Worth in 1988. He had met Richard E. Rainwater, the fund manager for the Bass family and other well-heeled clients, the summer before on Nantucket Island. Rainwater invited him to use his offices and gave him a chunk of the $28 million in seed money for a fund, which Lampert named ESL—his own initials. Rainwater also introduced him to high-powered clients such as Geffen. But Lampert and Rainwater later had a falling out, which neither will discuss. Shareholder activist Robert A.G. Monks, who temporarily worked in Rainwater's offices with Lampert, says it was over control of the fund's investments. Rainwater pulled his money out of ESL, but most other clients stayed.

The audacity of his Kmart investment put Lampert on the map. With Kmart in Chapter 11 in 2002, he scooped up its debt as creditors fled. But his investment swooned as the retailer got even sicker. So Lampert doubled down and bought yet more debt, enough to give him control of the bankruptcy process. Then in January, 2003, at the height of the negotiations, Lampert was leaving ESL on a Friday night when he was kidnapped in the parking garage. Four hoodlums, led by a 23-year-old ex-Marine, had targeted Lampert after a search for rich people on the Internet.

They stuffed him into a Ford Blazer, took him to a cheap motel, and held him bound in the bathtub. They called Lampert's wife, Kinga, playing a tape of his voice. Court documents are sealed, but one person close to the case says the men told Lampert they had been hired to kill him for $5 million but would let him go for $1 million.

Lampert was convinced he was going to be killed, he says in an audio version to guests at ESL's annual investors' dinner in 2001. The couple has a son and a daughter.

The audacity of his Kmart investment is what really put Lampert on the map. He scooped up debt as others fled.