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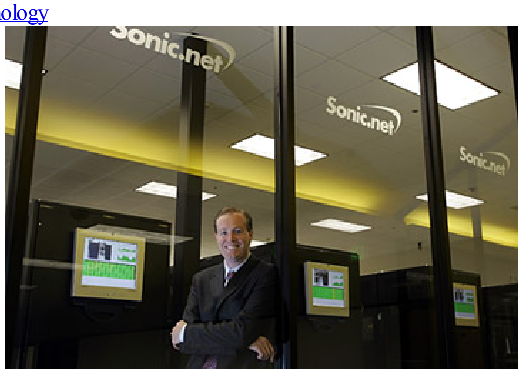
  - 

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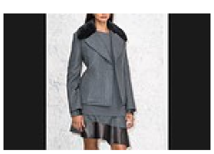

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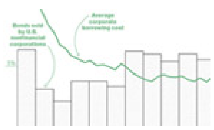
  - 

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The Next Warren Buffett?

November 21, 2004

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 up Buffett-style returns averaging 29% a year. His top-drawer clients range from media mogul David Geffen and Dell Inc. (DELL

) founder Michael S. Dell to the Tisch family of Loews Corp. (LTR

) 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. (S

), whose stock soared 24% on 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. (AZO

), and the biggest national chain of car dealers, AutoNation Inc. (AN

), as well as a small stake in telecom giant MCI (MCIP

).

The key to his ambitions, though, is a 53% stake in Kmart Holding Corp. (KMRT

). If a fading textile maker in New Bedford, Mass., called Berkshire Hathaway Inc. (BRKB

) 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 -- than 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 Kmart 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 runs Third Avenue Management LLC, which teamed up with Lampert when Kmart was in bankruptcy court and now owns a 4.6% stake in the retailer. "That's what I am valuing into the stock."

For Lampert, more than just superior investment returns are riding on Kmart. In a series of lengthy interviews with BusinessWeek, he makes clear that he also wants to earn respect as a businessman 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-striped shirt, he acknowledges 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 ESL'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 will be applied to him. Buffett, for his part, declined to comment on Lampert.

From the start of his career, Lampert has sought out high-powered mentors. At various stages he worked with former Goldman Sachs & Co. (GS

) head Robert E. Rubin, economics Nobelist James Tobin, and investor Richard Rainwater. Rubin, now at Citigroup (C

), 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 leaving to start his own fund, the future Treasury Secretary argued that he was forfeiting a golden career. "He had a clear-eyed view 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 discounter, behind Wal-Mart Stores Inc. (WMT

) and Target Corp. (TGT

) -- 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. (HD

) and Sears to raise a total of $846.9 million. 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 ubs 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. (GPS

) 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 upmarket brands to Kmart's clothing lineup, which will widen margins. And Kmart is beefing up its consumer electronics selection, adding such brands as Sony. Lampert has also retained the architectural firm Pompei A.D. LLC, which designs interiors for teen retailer Urban Outfitters Inc. (URBN

), to start testing a much-needed redesign of Kmart's stodgy outlets. And on Oct. 18 he named a new CEO, Aylwin Lewis, a PepsiCo Inc. (PEP

) veteran who's expected to sharpen the chain's operations and marketing. Even before that move, Kmart resumed TV advertising and for the first time ran apparel ads in Vogue and Vanity Fair in a bid to outdo rival Target and present a hipper image.

But investors aren't thinking about Kmart's trendier clothes or blue-light specials as they snap up its soaring stock. Indeed, after climbing from $15 a share to $96 in 18 months, Kmart's stock sports a Buffett-like premium. The company now boasts a stock-market capitalization of $8.6 billion, on a par with Federated Department Stores Inc. (FD

), 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."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. By 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.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 doesn't waste money -- ever."

For all their similarities, Lampert is no Buffett clone. For one thing, he can be much more assertive with management. He played rough at AutoZone, where he started amassing shares in 1997. After his stake reached 15.7% he got a board seat in 1999. The management tried to crimp his power, but Lampert ran rings around them. CEO John C. Adams Jr. left shortly afterward. Adams says he voluntarily retired.

Lampert runs a tight ship at ESL, too. Not a penny gets invested without his approval, say former employees. His analysts either research Lampert's ideas or bring their own to him. Gavin Abrams, an ESL analyst in the second half of the 1990s, says Lampert has an uncanny ability to see how the pieces of an investment fit together. "When an art critic looks at a piece of art, he can talk to you not just about the color and technique but the history and where it fits into art in general," he says. "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. Oberndorf, 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, allexpenses-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 Lampert's main point person. He also sits on Kmart's board and oversees the chain's finances. Former Kmart CEO Day says he got 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 in the future. Given the outsize 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 neatly 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. (KO

) 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 buddies, 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 remember 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 Tobin, 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 suggest 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 department. Lampert thrived on the work, which entailed analyzing whether a just-announced transaction, such as a takeover, would succeed and then betting millions on the outcome -- all in minutes. He says the experience taught him how to evaluate risk quickly in a situation, often with incomplete information. Doing this day after day as news events broke offered the best investment training possible, he adds. "It's like shooting layups or foul shots."

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 argued 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 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 Expedition, 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 his first public comments on the kidnapping case. "Your imagination goes absolutely wild. I was thinking about my mother and my son and my wife. What would their lives be like? Would it be painful when they shot me?" In the adjoining room, he recalls, the television was switched on to the news about the search for the body of Laci Peterson. But as the kidnappers became increasingly nervous, Lampert convinced them that if they let him go, he would pay them $40,000 a couple of days later, the source says. The hoodlums let him off on the side of a road in Greenwich early on that Sunday morning and were later arrested and convicted. Lampert arrived home to a house full of friends who had been camping out, waiting for news. "It was very much like going to your own funeral," he says. He was soon back in Kmart negotiations.

So far, Kmart has proved to be a big success. But the track record of ESL's Sears investment has been spotty. Lampert won't discuss the company, where he isn't on the board, but notes that he hasn't sold any shares. In a move that Lampert supported -- some say influenced -- Sears sold its $28 billion credit-card business last year to raise cash. Initially, the stock jumped but then fell back because of deteriorating results, until recently. So the jury is out on whether Sears is better off without credit cards, once its biggest source of profits. As with Kmart, Lampert's probable safety net is Sears' real estate. Vornado -- which bought the big Sears stake this month -- evidently agrees. As Sears scrambles to develop new big-box stores, its traditional mall-based department stores could prove more valuable to others.

On the other hand, ESL's 26.8% stake in AutoZone continues to be a big winner. Although the shares are down 17% from last year's peak of $103, they're up 320% from 1997, when Lampert started buying. Its margins remain the envy of other auto-part retailers. Still, weakening same-store sales and recent quarterly profit misses have led some analysts to contend that the retailer has underinvested in its business and kept prices too high while spending too much on share buybacks.

Lampert and Buffett crossed paths in dealmaking in the early '90s. In 1989 and 1990, Buffett bought a 19.9% stake in PS Group, which ran a stagnant aircraft-leasing business. Buffett made that investment -- which caught Lampert's eye -- because of a promising new division that would recycle industrial metals, but that unit ran into trouble. As PS Group's stock sank, Lampert jumped in, attracted by the value of the PS aircraft, and began amassing a 19.7% stake at bargain-basement prices in 1993.

Buffett stayed on the sidelines, recalls Larry Guske, PS Group's vice-president for finance, but Lampert -- convinced PS had no future -- kept prodding management to sell assets and pay dividends. In the end, Lampert doubled his money while Buffett lost about a third of his -- because he had paid much more for his shares, Guske calculates. Buffett's overall record will be extremely hard to beat. But at least in this instance, the pupil had outperformed the master. By Robert Berner with Susann Rutledge in New York

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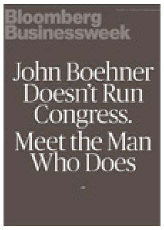

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