SEARS HOLDINGS CORP
Form 10-Q
August 25, 2009
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

x **Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the Quarterly Period Ended August 1, 2009**

Or

¨ **Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

Commission file number 000-51217

SEARS HOLDINGS CORPORATION

(Exact name of registrant as specified in its charter)

Delaware	**20-1920798**
(State of Incorporation)	**(I.R.S. Employer Identification No.)**
3333 Beverly Road, Hoffman Estates, Illinois	**60179**
(Address of principal executive offices)	**(Zip Code)**

Registrant s Telephone Number, Including Area Code: (847) 286-2500

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months and (2) has been subject to such filing requirements for the past 90 days.

Yes x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes ¨ No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer x Accelerated filer ¨ Non-accelerated filer ¨ Smaller reporting company ¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes ¨ No x

As of August 21, 2009, the registrant had 118,811,028 common shares, $0.01 par value, outstanding.

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SEARS HOLDINGS CORPORATION

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13 and 26 Weeks Ended August 1, 2009 and August 2, 2008

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SEARS HOLDINGS CORPORATION

Condensed Consolidated Statements of Operations

(Unaudited)

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

millions, except per share data	**13 Weeks Ended August 1, 2009**	**13 Weeks Ended August 2, 2008**	**26 Weeks Ended August 1, 2009**	**26 Weeks Ended August 2, 2008**
REVENUES				
Merchandise sales and services	$ 10,551	$ 11,762	$ 20,606	$ 22,830
COSTS AND EXPENSES				
Cost of sales, buying and occupancy	7,756	8,640	14,938	16,685
Selling and administrative	2,630	2,694	5,203	5,509
Depreciation and amortization	228	247	454	495
Gain on sales of assets	(5)	(6)	(59)	(38)
Total costs and expenses	10,609	11,575	20,536	22,651
Operating income (loss)	(58)	187	70	179
Interest expense	(63)	(65)	(122)	(131)
Interest and investment income	14	20	19	31
Other loss	(31)	(1)	(47)	(2)
Income (loss) before income taxes	(138)	141	(80)	77
Income tax (expense) benefit	52	(56)	28	(28)
Net income (loss)	(86)	85	(52)	49
Income attributable to noncontrolling interest	(8)	(20)	(16)	(40)
NET INCOME (LOSS) ATTRIBUTABLE TO HOLDINGS SHAREHOLDERS	$ (94)	$ 65	$ (68)	$ 9
EARNINGS (LOSS) PER COMMON SHARE ATTRIBUTABLE TO HOLDINGS SHAREHOLDERS				
Basic and diluted earnings (loss) per share	$ (0.79)	$ 0.50	$ (0.57)	$ 0.07
Basic and diluted weighted average common shares outstanding	119.1	128.8	120.0	130.3

See accompanying notes.

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SEARS HOLDINGS CORPORATION

Condensed Consolidated Balance Sheets

millions	(Unaudited) August 1, 2009	(Unaudited) August 2, 2008	January 31, 2009
ASSETS			
Current assets			
Cash and cash equivalents	$ 1,189	$ 1,534	$ 1,173
Restricted cash	103		124
Accounts receivable	896	1,020	839
Merchandise inventories	9,377	9,754	8,795
Prepaid expenses and other current assets	390	468	458
Deferred income taxes	32	29	27
Total current assets	11,987	12,805	11,416
Property and equipment, net	7,867	8,568	8,091
Goodwill	1,392	1,660	1,392
Trade names and other intangible assets	3,244	3,322	3,283
Other assets	1,270	434	1,160
TOTAL ASSETS	$ 25,760	$ 26,789	$ 25,342
LIABILITIES			
Current liabilities			
Short-term borrowings	$ 1,015	$ 974	$ 442
Current portion of long-term debt and capitalized lease obligations	283	390	345
Merchandise payables	3,361	3,494	3,006
Accrued expenses and other current liabilities	3,088	3,340	3,226
Unearned revenues	1,029	1,106	1,069
Other taxes	468	569	424
Total current liabilities	9,244	9,873	8,512
Long-term debt and capitalized lease obligations	1,941	2,250	2,132
Pension and post-retirement benefits	2,045	1,135	2,057
Other long-term liabilities	2,883	3,008	2,942
Total Liabilities	16,113	16,266	15,643
EQUITY			
Total Equity	9,647	10,523	9,699
TOTAL LIABILITIES AND EQUITY	$ 25,760	$ 26,789	$ 25,342

See accompanying notes.

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SEARS HOLDINGS CORPORATION

Condensed Consolidated Statements of Cash Flows

(Unaudited)

millions	**26 Weeks Ended August 1, 2009**	**26 Weeks Ended August 2, 2008**
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income (loss)	$ (52)	$ 49
Adjustments to reconcile net income (loss) to net cash used in operating activities:		
Depreciation and amortization	454	495
Gain on sales of assets	(59)	(38)
Pension and post-retirement plan contributions	(96)	(135)
Settlement of Canadian dollar hedges		(64)
Change in operating assets and liabilities (net of acquisitions and dispositions):		
Deferred income taxes	32	(17)
Merchandise inventories	(486)	180
Merchandise payables	307	23
Income and other taxes	(98)	(138)
Mark-to-market adjustments on Sears Canada U.S. dollar option contracts	59	
Other operating assets	45	52
Other operating liabilities	(178)	(409)
Net cash used in operating activities	(72)	(2)
CASH FLOWS FROM INVESTING ACTIVITIES		
Proceeds from sales of property	10	75
Decrease (increase) in investments and restricted cash	61	(13)
Purchases of property and equipment	(122)	(277)
Net cash used in investing activities	(51)	(215)
CASH FLOWS FROM FINANCING ACTIVITIES		
Proceeds from debt issuances		5
Repayments of long-term debt	(302)	(184)
Increase in short-term borrowings, primarily 90 days or less	573	812
Debt issuance costs	(81)	
Additional purchase of noncontrolling interest	(7)	
Purchase of treasury stock	(134)	(477)
Net cash provided by financing activities	49	156
Effect of exchange rate changes on cash and cash equivalents	90	(27)
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	16	(88)
CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR	1,173	1,622
CASH AND CASH EQUIVALENTS, END OF PERIOD	$ 1,189	$ 1,534

SUPPLEMENTAL CASH FLOW DATA:

Income taxes paid, net of refunds	$ 120	$ 178
Cash interest paid	85	106

See accompanying notes.

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SEARS HOLDINGS CORPORATION

Condensed Consolidated Statements of Equity

(Unaudited)

	Equity Attributable to Holdings Shareholders							
millions	Number of Shares	Common Stock	Capital in Excess of Par Value	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive Income (Loss)	Noncontrolling Interest	Total
Balance at February 2, 2008 as reported	132	$ 1	$ 10,419	$ 4,509	$ (4,331)	$ 69	$	$ 10,667
Effects of adoption of SFAS No. 160							313	313
Balance at February 2, 2008 as adjusted	132	$ 1	$ 10,419	$ 4,509	$ (4,331)	$ 69	$ 313	$ 10,980
Comprehensive income								
Net income				9			40	49
Cumulative translation adjustment						(15)	(10)	(25)
Total Comprehensive Income								24
Shares repurchased	(6)				(477)			(477)
Other			(14)		10			(4)
Balance at August 2, 2008	126	$ 1	$ 10,405	$ 4,518	$ (4,798)	$ 54	$ 343	$ 10,523
Balance at January 31, 2009 as reported	122	$ 1	$ 10,441	$ 4,562	$ (5,012)	$ (612)	$	$ 9,380
Effects of adoption of SFAS No. 160							319	319
Balance at January 31, 2009 as adjusted	122	$ 1	$ 10,441	$ 4,562	$ (5,012)	$ (612)	$ 319	$ 9,699
Comprehensive income								
Net income (loss)				(68)			16	(52)
Pension and postretirement adjustments, net of tax						19		19
Cumulative translation adjustment						79	42	121
Total Comprehensive Income								88
Canadian shares purchased			(2)				(5)	(7)
Shares repurchased	(3)				(134)			(134)
Other			35		(31)	(3)		1
Balance at August 1, 2009	119	$ 1	$ 10,474	$ 4,494	$ (5,177)	$ (517)	$ 372	$ 9,647

See accompanying notes.

SEARS HOLDINGS CORPORATION

Notes to Condensed Consolidated Financial Statements

(Unaudited)

NOTE 1 BASIS OF PRESENTATION

Sears Holdings Corporation (Holdings, we, us, our or the Company) is the parent company of Kmart Holding Corporation (Kmart) and Se Roebuck and Co. (Sears). Holdings was formed as a Delaware corporation in 2004 in connection with the merger of Kmart and Sears (the Merger), which was completed on March 24, 2005. We are a broadline retailer with approximately 2,300 full-line and 1,250 specialty retail stores in the United States, operating through Kmart and Sears, and approximately 390 full-line and specialty retail stores in Canada operating through Sears Canada Inc. (Sears Canada), a 73%-owned subsidiary.

These interim unaudited Condensed Consolidated Financial Statements have been prepared in accordance with the rules and regulations of the Securities and Exchange Commission (SEC). Accordingly, they do not include all of the information and footnotes required in annual consolidated financial statements prepared in accordance with accounting principles generally accepted in the United States of America. In accordance with Statement of Financial Accounting Standard (SFAS) No. 165, Subsequent Events, we performed an evaluation of subsequent events for the accompanying Condensed Consolidated Financial Statements and Notes through August 24, 2009, the date this report was issued. In the opinion of management, all adjustments (which include normal recurring adjustments) considered necessary for a fair presentation have been included. Certain prior period amounts have been reclassified to conform to the current interim period presentation. Operating results for the interim period are not necessarily indicative of the results that may be expected for the full fiscal year. The retail business is seasonal in nature, and we generate a high proportion of our revenues and operating cash flows during the fourth quarter of our fiscal year, which includes the holiday season. These interim financial statements and related notes should be read in conjunction with the audited consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the fiscal year ended January 31, 2009.

NOTE 2 BORROWINGS

Total borrowings were as follows:

millions	August 1, 2009	August 2, 2008	January 31, 2009
Short-term borrowings:			
Unsecured commercial paper	$ 20	$ 174	$ 7
Secured borrowings	995	800	435
Long-term debt, including current portion:			
Notes and debentures outstanding	1,560	1,935	1,813
Capitalized lease obligations	664	705	664
Total borrowings	$ 3,239	$ 3,614	$ 2,919

The fair value of long-term debt and capitalized lease obligations was $2.0 billion at August 1, 2009, $2.1 billion at August 2, 2008 and $2.0 billion at January 31, 2009. The fair value of our debt was estimated based on quoted market prices for the same or similar issues or on current rates offered to us for debt of the same remaining maturities.

Credit Agreement

During the second quarter, we extended the maturity date of our credit agreement (Original Credit Agreement) by entering into an amended credit agreement (the Amended Credit Agreement) which has an expiration date of June 22, 2012. The Amended Credit Agreement is a revolving credit facility under which Sears Roebuck Acceptance Corp. (SRAC) and Kmart Corporation are the borrowers. Our Original Credit Agreement, which was to expire on March 24, 2010, provided $4.0 billion of borrowing capacity, however only approximately $3.8 billion

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SEARS HOLDINGS CORPORATION

Notes to Condensed Consolidated Financial Statements (Continued)

(Unaudited)

had been available since September 2008 when an affiliate of Lehman Brothers notified us it would no longer fund its proportionate share of commitments under the Original Agreement. Also during the second quarter of fiscal 2009, we agreed, for a fee, to allow one of the lenders in our Amended Credit Agreement to exit its commitment, which decreased our total borrowing capacity by $65 million at August 1, 2009. As a result of the amendment and changes to the facility during the second quarter, our total borrowing capacity increased to $4.1 billion at August 1, 2009. The fee we received related to the exit of one of our lenders was recorded as a reduction to interest expense during the second quarter of fiscal 2009.

The amended terms and conditions of the asset based credit facility provide for a bifurcation of the $4.1 billion Amended Credit Agreement into a $2.4 billion tranche maturing on June 22, 2012 and bearing an interest rate of the London Interbank Offered Rate (LIBOR) plus 4.00% (the Extended Tranche), with a LIBOR floor of 1.75%, and a $1.7 billion tranche maturing March 24, 2010, bearing an initial interest rate of LIBOR plus 0.875% (the Existing Tranche). The bifurcation into the Extended Tranche provides Holdings and its subsidiaries more than adequate liquidity for standby letters of credit and working capital needs. The Amended Credit Agreement also gives us the flexibility, subject to certain terms and conditions, to increase the size of the credit facility or add a term loan tranche to the Amended Credit Agreement in an aggregate amount of up to $1.0 billion. The amendment and extension revises certain terms of the credit agreement to reflect current market conditions. It imposes various requirements, including a requirement that, if availability under the credit facility is beneath a certain threshold, the fixed charge ratio as of the last day of any fiscal quarter be not less than 1.0 to 1.0, a cash dominion requirement if excess availability on the revolver falls below designated levels, and limitations on our ability to make restricted payments, including dividends and share repurchases. In connection with the Amended Credit Agreement, the Company agreed to limit the amount of cash accumulated when borrowings are outstanding under the credit facility. Similar to the Original Credit Agreement, the Amended Credit Agreement has a $1.5 billion letter of credit sub-limit, is secured by a first lien on most of our domestic inventory and credit card and pharmacy receivables, and determines availability pursuant to a borrowing base formula.

At August 1, 2009, we had $995 million of borrowings and $801 million of letters of credit outstanding under the Amended Credit Agreement. Our availability under the agreement, given total outstanding borrowings and letters of credit of $1.8 billion, was $2.3 billion at August 1, 2009. The majority of the letters of credit outstanding are used to provide collateral for our insurance programs.

Orchard Supply Hardware LLC (OSH LLC) Credit Agreement

In November 2005, OSH LLC entered into a five-year, $130 million senior secured revolving credit facility (the OSH LLC Facility), which includes a $25 million letter of credit sub-limit. The OSH LLC Facility was amended in December 2006 to expire in December 2011. The OSH LLC Facility is available for OSH LLC s general corporate purposes and is secured by a first lien on substantially all of OSH LLC s non-real estate assets. Availability under the OSH LLC Facility is determined pursuant to a borrowing base formula based on inventory and account and credit card receivables, subject to certain limitations. As of August 1, 2009, there were no borrowings outstanding under the OSH LLC Facility and $6 million in outstanding letters of credit.

NOTE 3 DERIVATIVE FINANCIAL INSTRUMENTS

On February 1, 2009, we adopted SFAS No. 161, Disclosures about Derivative Instruments and Hedging Activities An Amendment of FASB Statement No. 133. The standard supplements the required disclosures provided under SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities, as amended, with additional qualitative and quantitative information. Accordingly, the disclosures that follow should be read along with our existing disclosure in Note 5 to the consolidated financial statements in our Annual Report on Form 10-K for the year ended January 31, 2009.

SEARS HOLDINGS CORPORATION

Notes to Condensed Consolidated Financial Statements (Continued)

(Unaudited)

We are exposed to fluctuations in foreign currency exchange rates as a result of our net investment in Sears Canada. Further, Sears Canada is exposed to fluctuations in foreign currency exchange rates due to inventory purchase contracts denominated in U.S. dollars. As a result, we primarily use derivatives as a risk management tool to decrease our exposure to fluctuations in the foreign currency market. While we have some variable rate debt, our use of derivatives to hedge exposure to changes in interest rates is not material.

Earnings Effects of Derivatives on the Statements of Operations

For derivatives that were designated as hedges of our net investment in Sears Canada, we assessed effectiveness based on changes in spot currency exchange rates. Changes in spot rates on the derivatives were recorded in the currency translation adjustments line in Accumulated Other Comprehensive Income and will remain there until we substantially liquidate or sell our holdings in Sears Canada.

Changes in the fair value of any derivatives that are not designated as hedges are recorded in earnings each period. Sears Canada mitigates the risk of currency fluctuations on offshore merchandise purchases denominated in U.S. currency by purchasing U.S. dollar denominated option contracts for a portion of its expected requirements. Since Holdings functional currency is the U.S. dollar, we are not directly exposed to the risk of exchange rate changes due to Sears Canada s merchandise purchases, and therefore we do not account for these instruments as a hedge of our foreign currency exposure risk.

Hedges of Net Investment in Sears Canada

We, from time to time, enter into foreign currency forward contracts, which have typically been designated and qualify as hedges of the foreign currency exposure of our net investment in Sears Canada. We had no such foreign currency forward contracts outstanding as of August 1, 2009, August 2, 2008 or January 31, 2009.

Sears Canada Hedges of Merchandise Purchases

At August 1, 2009, Sears Canada had entered into foreign currency option contracts with a total notional value of $305 million. We recorded a mark-to-market asset related to the option contracts of $15 million at August 1, 2009, $5 million at August 2, 2008 and $74 million at January 31, 2009. We recorded mark-to-market and settlement losses on these contracts of $43 million and $66 million in other loss for the 13- and 26- week periods ended August 1, 2009, respectively.

In addition, we recorded a mark-to-market asset and gains on Sears Canada s U.S. dollar denominated merchandise purchase contracts (considered to be embedded derivatives under relevant accounting rules), which the foreign currency option contracts are designed to hedge. We recorded an asset of $10 million at August 1, 2009 and a liability of $6 million at January 31, 2009 related to these embedded derivatives. We recorded mark-to-market gains of $10 million and $15 million for the 13- and 26- week periods ended August 1, 2009, respectively, related to the change in the fair value of this embedded derivative. See Note 4 for further information regarding fair value of these derivatives and the respective balance sheet classifications as of August 1, 2009.

Counterparty Credit Risk

We actively manage the risk of nonpayment by our derivative counterparties by limiting our exposure to individual counterparties based on credit ratings, value at risk and maturities. The counterparties to these instruments are major financial institutions with credit ratings of single-A or better as of August 1, 2009.

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Notes to Condensed Consolidated Financial Statements (Continued)

(Unaudited)

NOTE 4 FAIR VALUE OF FINANCIAL ASSETS AND LIABILITIES

We determine fair value of financial assets and liabilities based on the following fair value hierarchy, as prescribed by SFAS No. 157, Fair Value Measurements , which prioritizes the inputs to valuation techniques used to measure fair value into three levels:

Level 1 inputs unadjusted quoted prices in active markets for identical assets or liabilities that we have the ability to access. An active market for the asset or liability is one in which transactions for the asset or liability occur with sufficient frequency and volume to provide ongoing pricing information.

Level 2 inputs inputs other than quoted market prices included in Level 1 that are observable, either directly or indirectly, for the asset or liability. Level 2 inputs include, but are not limited to, quoted prices for similar assets or liabilities in an active market, quoted prices for identical or similar assets or liabilities in markets that are not active and inputs other than quoted market prices that are observable for the asset or liability, such as interest rate curves and yield curves observable at commonly quoted intervals, volatilities, credit risk and default rates.

Level 3 inputs unobservable inputs for the asset or liability.

Cash and cash equivalents, accounts receivable, merchandise payables, credit facility borrowings and accrued liabilities are reflected in the Condensed Consolidated Balance Sheet at cost, which approximates fair value due to the short-term nature of these instruments. The fair value of our debt is disclosed in Note 2 to the Condensed Consolidated Financial Statements. The following table provides the fair value measurement amounts for other financial assets and liabilities recorded on our Condensed Consolidated Balance Sheet at fair value as of August 1, 2009, August 2, 2008 and January 31, 2009:

millions	**Total Fair Value Amounts at August 1, 2009**	**Level 1**	**Level 2**	**Level 3**
Short-term investments[1]	$ 16	$	$ 16	$
Foreign currency derivative assets[1]	25		25	
Total	$ 41	$	$ 41	$

millions	**Total Fair Value Amounts at August 2, 2008**	**Level 1**	**Level 2**	**Level 3**
Foreign currency contracts[1]	$ 5	$	$ 5	$
Total	$ 5	$	$ 5	$

millions	**Total Fair Value Amounts at January 31, 2009**	**Level 1**	**Level 2**	**Level 3**
Short-term investments[1]	$ 38	$	$ 38	$
Foreign currency derivative assets[1]	74		74	

Foreign currency derivative liabilities[2]	(6)		(6)	
Total	$ 106	$	$ 106	$

[1] Included within Prepaid expenses and other current assets on the Condensed Consolidated Balance Sheet.
[2] Included within Other current liabilities on the Condensed Consolidated Balance Sheet.

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SEARS HOLDINGS CORPORATION

Notes to Condensed Consolidated Financial Statements (Continued)

(Unaudited)

Short-term investments are typically valued at the closing price in the principal active market as of the last business day of the quarter. Short-term investments at August 1, 2009 and January 31, 2009 include $16 million and $38 million, respectively, on deposit with The Reserve Primary Fund, a money market fund that has temporarily restricted withdrawals while it liquidates its holdings to generate cash to distribute. The fair value of this investment was determined by using estimates based on the values of similar assets and information obtained from The Reserve Primary Fund.

The fair values of derivative assets and liabilities traded in the over-the-counter market are determined using quantitative models that require the use of multiple inputs including interest rates, prices and indices to generate pricing and volatility factors. The predominance of market inputs are actively quoted and can be validated through external sources, including brokers, market transactions and third-party pricing services. Our derivative instruments are valued using Level 2 measurements.

Investments in equity securities are typically valued at the closing price in the principal active market as of the last business day of the quarter. Principal active markets for equity prices include published exchanges such as NASDAQ and the New York Stock Exchange. We do not adjust prices to reflect after-hours market activity. Our investments in equity securities are valued using Level 1 measurements.

NOTE 5 ACQUISITION OF NONCONTROLLING INTEREST IN SEARS CANADA

During the first quarter of fiscal 2009, the Company increased its controlling interest in Sears Canada by acquiring approximately 0.5 million common shares in open market transactions. The Company paid a total of $7 million for the additional shares and accounted for the acquisition of additional interest in Sears Canada as an equity transaction in accordance with SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements, an amendment of Accounting Research Bulletin (ARB) No. 51. The acquisition of the additional interest in Sears Canada was not material to our financial position. We did not purchase any additional shares of Sears Canada during the second quarter of fiscal 2009. Our majority interest in Sears Canada remains at 73%.

NOTE 6 STORE CLOSINGS

We made the decision to close 28 underperforming stores during the second quarter of fiscal 2009. These closings include 22 stores in our Kmart segment and 6 stores in our Sears segment. We recorded charges related to these store closings of $33 million in the second quarter of 2009. The charges include $17 million of inventory markdowns recorded in cost of sales and $16 million recorded in selling and administrative expenses for store closing and severance costs. We expect to record an additional charge of approximately $5 million related to these store closings during the second half of 2009 as the stores complete operations.

During the second quarter of 2009, we closed 24 stores we originally announced would close during the fourth quarter of fiscal 2008, as well as other small support locations throughout the U.S. In accordance with SFAS No. 146, Accounting for Costs Associated with Exit or Disposal Activities, expenses related to future rent payments for which the Company no longer intends to receive any economic benefit are accrued for when the Company ceases to use the leased space. We recorded a charge of $28 million for future rent payments in the second quarter when we vacated the retail space at these locations. During the first quarter of fiscal 2009, we closed 4 stores we previously announced would close and recorded a charge of $3 million for the related under-utilized leased space, which, when added to the charges incurred for the 24 stores in the second quarter of 2009, resulted in a total charge for the first half of 2009 of $31 million.

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SEARS HOLDINGS CORPORATION

Notes to Condensed Consolidated Financial Statements (Continued)

(Unaudited)

Total store closing charges recorded during the first half of fiscal 2009 were $78 million, of which $17 million was recorded in cost of sales for inventory markdowns and $61 million was recorded in selling and administrative expenses for store closing and severance costs.

NOTE 7 CLAIMS RESOLUTION AND BANKRUPTCY-RELATED SETTLEMENTS

On May 6, 2003, Kmart Corporation (the Predecessor Company), a predecessor operating company of Kmart, emerged from reorganization proceedings under Chapter 11 of the federal bankruptcy laws pursuant to the terms of a plan of reorganization (the Plan of Reorganization). The Predecessor Company is an indirect, wholly owned subsidiary of Kmart and an indirect, wholly owned subsidiary of Holdings.

During fiscal 2008, we completed the settlement of all of the claims associated with the discharge of the Predecessor Company s liabilities subject to compromise pursuant to the Plan of Reorganization. Accordingly, all of the 31.9 million shares set aside for distribution to creditors as part of the Plan of Reorganization have been distributed as of this date.

NOTE 8 SHAREHOLDERS EQUITY

Share Repurchase Program

During the 13- and 26- week periods ended August 1, 2009, we repurchased 1.7 million and 2.7 million of our common shares at a total cost of $94 million and $134 million, respectively, under our share repurchase program. Our repurchases for the 13- and 26- week periods ended August 1, 2009 were made at average prices of $54.87 and $49.90 per share, respectively. As of August 1, 2009, we had $371 million of remaining authorization under our common share repurchase program. The share repurchase program, authorized by our Board of Directors, has no stated expiration date and share repurchases may be implemented using a variety of methods, which may include open market purchases, privately negotiated transactions, block trades, accelerated share repurchase transactions, the purchase of call options, the sale of put options or otherwise, or by any combination of such methods.

NOTE 9 BENEFIT PLANS

Pension and Post-retirement Benefit Plans

We provide benefits to certain associates who are eligible under various defined benefit pension plans, contributory defined benefit pension plans and other post-retirement plans, primarily retiree medical benefits. The following table summarizes the components of total net periodic benefit expense for our retirement plans:

millions	**13 Weeks Ended August 1, 2009**	**13 Weeks Ended August 2, 2008**	**26 Weeks Ended August 1, 2009**	**26 Weeks Ended August 2, 2008**
Components of net periodic expense:				
Benefits earned during the period	$ 4	$ 6	$ 8	$ 13
Interest costs	105	109	209	218
Expected return on plan assets	(72)	(108)	(143)	(215)
Amortization of experience gains/losses	16		31	
Net periodic expense	$ 53	$ 7	$ 105	$ 16

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SEARS HOLDINGS CORPORATION

Notes to Condensed Consolidated Financial Statements (Continued)

(Unaudited)

Contributions

During the 13- and 26- week periods ended August 1, 2009, we made total contributions of $44 million and $96 million, respectively, to our pension and post-retirement plans. During the 13- and 26- week periods ended August 2, 2008, we made total contributions of $50 million and $135 million, respectively, to our pension and post-retirement plans. We anticipate making aggregate contributions of approximately $140 million over the remainder of fiscal 2009.

NOTE 10 INCOME TAXES

At August 1, 2009, we had gross unrecognized tax benefits of $343 million. Of this amount, $134 million would, if recognized, impact our effective tax rate, with the remaining amount being comprised of unrecognized tax benefits related to gross temporary differences or any other indirect benefits. Included in the $134 million are $55 million of tax liabilities, net of federal tax benefit, related to uncertain tax positions of previously acquired entities taken prior to their acquisition by Holdings that would, with the adoption of SFAS 141(R), Business Combinations which revised SFAS No. 141, Business Combinations, impact our effective tax rate if recognized (see Note 14). During the 13- and 26- week periods ended August 1, 2009, we reduced gross unrecognized tax benefits by $15 million and $17 million, respectively, for federal and state tax settlements. We expect that our unrecognized tax benefits could decrease up to $63 million over the next 12 months for federal and state settlements and for federal and state tax positions related to prior business dispositions due to both the expiration of the statute of limitations for certain jurisdictions as well as expected related settlements.

We classify interest expense and penalties related to unrecognized tax benefits and interest income on tax overpayments as components of income tax expense. At August 1, 2009, the total amount of interest and penalties recognized on our condensed consolidated balance sheet was $93 million ($60 million net of federal benefit). The total amount of interest and penalties recognized in our Condensed Consolidated Statements of Operations for the 13- and 26- week periods ended August 1, 2009 was $1 million (net of federal tax benefit) and $3 million (net of federal tax benefit), respectively.

We file income tax returns in the United States as well as various foreign jurisdictions. The U.S. Internal Revenue Service (IRS) has commenced an audit of the Holdings federal income tax returns for the fiscal years 2006 and 2007. The IRS has completed its examination of Sears federal income tax returns for the fiscal years 2002 2005 and Holdings federal income tax return for the fiscal year 2005. We have resolved with the IRS all matters arising from these exams. In addition, Holdings and Sears are under examination by various state, local and foreign income tax jurisdictions for the fiscal years 2001 2007, and Kmart is under examination by such jurisdictions for the fiscal years 2003 2007.

At August 1, 2009, we had Federal net operating loss (NOL) carryforwards from the Predecessor Company of approximately $269 million subject to an overall annual section 382 limitation of $96 million, generating deferred tax assets of approximately $94 million. The federal NOL carryforwards will expire in 2021, 2022, 2023, and 2028. We also have credit carryforwards of $108 million, which will expire between 2015 and 2028.

At the end of fiscal 2008, we had a state NOL deferred tax asset of $186 million and a valuation allowance of $117 million. In the first half of fiscal 2009, there were no adjustments to the state NOL deferred tax asset and valuation allowance. The state NOL s will predominantly expire between 2017 and 2028.

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SEARS HOLDINGS CORPORATION

Notes to Condensed Consolidated Financial Statements (Continued)

(Unaudited)

NOTE 11 SUMMARY OF SEGMENT DATA

We have three reportable segments: Kmart, Sears Domestic and Sears Canada.

	For the 13 Weeks Ended August 1, 2009			
millions	**Kmart**	**Sears Domestic**	**Sears Canada**	**Sears Holdings**
Merchandise sales and services	$ 3,756	$ 5,701	$ 1,094	$ 10,551
Costs and expenses				
Cost of sales, buying and occupancy	2,927	4,082	747	7,756
Selling and administrative	845	1,532	253	2,630
Depreciation and amortization	36	167	25	228
Gain on sales of assets	(1)	(3)	(1)	(5)
Total costs and expenses	3,807	5,778	1,024	10,609
Operating income (loss)	$ (51)	$ (77)	$ 70	$ (58)
Total assets	$ 6,135	$ 16,143	$ 3,482	$ 25,760

	For the 13 Weeks Ended August 2, 2008			
millions	**Kmart**	**Sears Domestic**	**Sears Canada**	**Sears Holdings**
Merchandise sales and services	$ 4,005	$ 6,367	$ 1,390	$ 11,762
Costs and expenses				
Cost of sales, buying and occupancy	3,087	4,590	963	8,640
Selling and administrative	863	1,524	307	2,694
Depreciation and amortization	34	181	32	247
Gain on sales of assets	(1)	(5)		(6)
Total costs and expenses	3,983	6,290	1,302	11,575
Operating income	$ 22	$ 77	$ 88	$ 187
Total assets	$ 6,284	$ 17,095	$ 3,410	$ 26,789

For the 26 Weeks Ended

	August 1, 2009			
millions	Kmart	Sears Domestic	Sears Canada	Sears Holdings
Merchandise sales and services	$ 7,349	$ 11,273	$ 1,984	$ 20,606
Costs and expenses				
Cost of sales, buying and occupancy	5,662	7,907	1,369	14,938
Selling and administrative	1,659	3,060	484	5,203
Depreciation and amortization	72	333	49	454
Gain on sales of assets	(10)	(4)	(45)	(59)
Total costs and expenses	7,383	11,296	1,857	20,536
Operating income (loss)	$ (34)	$ (23)	$ 127	$ 70
Total assets	$ 6,135	$ 16,143	$ 3,482	$ 25,760

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SEARS HOLDINGS CORPORATION

Notes to Condensed Consolidated Financial Statements (Continued)

(Unaudited)

	For the 26 Weeks Ended August 2, 2008			
millions	Kmart	Sears Domestic	Sears Canada	Sears Holdings
Merchandise sales and services	$ 7,738	$ 12,467	$ 2,625	$ 22,830
Costs and expenses				
Cost of sales, buying and occupancy	5,953	8,919	1,813	16,685
Selling and administrative	1,719	3,178	612	5,509
Depreciation and amortization	67	364	64	495
Gain on sales of assets	(2)	(4)	(32)	(38)
Total costs and expenses	7,737	12,457	2,457	22,651
Operating income	$ 1	$ 10	$ 168	$ 179
Total assets	$ 6,284	$ 17,095	$ 3,410	$ 26,789

NOTE 12 SUPPLEMENTAL FINANCIAL INFORMATION

Accrued expenses and other current liabilities at August 1, 2009, August 2, 2008 and January 31, 2009 consisted of the following:

millions	August 1, 2009	August 2, 2008	January 31, 2009
Payroll and benefits payable	$ 341	$ 355	$ 339
Outstanding checks in excess of funds on deposit	203	261	228
Current portion of self-insurance reserves	369	374	364
Customer deposits	303	366	362
Accrued expenses and other current liabilities	1,872	1,984	1,933
Total	$ 3,088	$ 3,340	$ 3,226

Other long-term liabilities as of August 1, 2009, August 2, 2008 and January 31, 2009 consisted of the following:

millions	August 1, 2009	August 2, 2008	January 31, 2009
Unearned revenues	$ 856	$ 923	$ 889
Self-insurance reserves	850	829	826
Other	1,177	1,256	1,227
Total	$ 2,883	$ 3,008	$ 2,942

NOTE 13 LEGAL PROCEEDINGS

Maurice Levie, individually and on behalf of all others similarly situated v. Sears, Roebuck & Co., et al. Following the announcement of the Merger on November 17, 2004, a lawsuit was filed in the United States District Court for the Northern District of Illinois relating to the transaction. This suit asserts claims under the federal securities laws on behalf of a class of former Sears stockholders against Sears, Alan J. Lacy, Edward S. Lampert and ESL Partners, L.P. for allegedly failing to make timely disclosure of merger discussions during the period September 9 through November 16, 2004, and seeks damages. On July 17, 2007, the Court granted in part and denied in part plaintiffs motion for class certification, certifying a class of Sears stockholders who sold

SEARS HOLDINGS CORPORATION

Notes to Condensed Consolidated Financial Statements (Continued)

(Unaudited)

shares of Sears stock between September 9, 2004 and November 16, 2004, excluding short sellers who covered their positions during the class period. On September 24, 2007, the Seventh Circuit Court of Appeals denied defendants petition for leave to appeal the class certification order. Merits and expert discovery are concluded. Defendants have filed motions for summary judgment and decertification. Briefing on the motions is scheduled to conclude in September 2009 with a decision tentatively scheduled for November 2, 2009.

In re: Sears Holdings Corporation Securities Litigation In May and July 2006, two class action lawsuits, which each name as defendants Sears Holdings Corporation and Edward S. Lampert, were filed in United States District Court for the Southern District of New York, purportedly on behalf of a class of persons that sold shares of Kmart Holding Corporation stock on or after May 6, 2003 through June 4, 2004. The plaintiffs in each case allege that Kmart s Plan of Reorganization and Disclosure Statement filed on January 24, 2003 and amended on February 25, 2003 misrepresented Kmart s assets, particularly its real estate holdings, as evidenced by the prices at which Kmart subsequently sold certain of its stores in June 2004 to Home Depot and Sears. The plaintiffs seek damages for alleged misrepresentations. On December 19, 2006, the Court consolidated the actions and plaintiffs filed their consolidated complaint. On April 15, 2008, the Court denied without prejudice defendants motion to dismiss. After taking some additional discovery, defendants filed another motion to dismiss. On July 21, 2009, the Court granted defendants motion to dismiss and entered a final order of dismissal. Plaintiffs filed a notice of appeal on August 20, 2009.

AIG Annuity Insurance Company, et al. v. Sears, Roebuck and Co. On October 12, 2004, an action was filed against Sears in the District Court, 192nd Judicial District, Dallas County, Texas by several holders of certain bonds issued by Sears from 1991 through 1993. Plaintiffs purport to allege under theories of breach of contract and misrepresentation, that Sears prematurely redeemed the bonds in 2004 following Sears sale of the credit business in 2003. On February 2, 2007, a jury in the case reached a verdict against Sears and the Court subsequently awarded plaintiffs $61 million plus post-judgment interest. Sears then filed a notice of appeal. On August 21, 2008, the appellate court reversed the trial court s judgment and entered judgment in favor of Sears on all counts. Plaintiffs subsequent motion for rehearing was denied. Plaintiffs have filed a petition for review with the Texas Supreme Court. Briefing on the petition is completed and we await a decision from the Court.

As previously reported in Kmart s Annual Report on Form 10-K for its fiscal year ended January 26, 2005, the staff of the Securities and Exchange Commission had been investigating, and the U.S. Attorney for the Eastern District of Michigan had undertaken an inquiry into, the manner in which Kmart recorded vendor allowances before a change in accounting principles at the end of fiscal 2001 and the disclosure of certain events bearing on the Predecessor Company s liquidity in the fall of 2001. Kmart cooperated with the SEC and U.S. Attorney s office with respect to these matters. The Company understands the SEC s and U.S. Attorney s investigations into Kmart are now closed. As previously reported, on August 23, 2005, the SEC filed a complaint in the United States District Court for the Eastern District of Michigan against the Predecessor Company s former chief executive officer Charles Conaway and its former chief financial officer John McDonald alleging that they misled investors about the Predecessor Company s liquidity and related matters in the months preceding its bankruptcy in violation of federal securities law. Kmart was not named as a defendant in the action. Mr. McDonald agreed to settle with the SEC shortly before trial in the matter. On June 1, 2009 and following a jury trial in the matter, Mr. Conaway was found liable on all counts. Although Mr. Conaway has filed post-judgment motions seeking to overturn the verdict, based on these developments, the Company believes that all outstanding securities regulatory matters concerning the Predecessor Company have been concluded.

We are a defendant in several lawsuits containing class-action allegations in which the plaintiffs are current and former hourly and salaried associates who allege various wage and hour violations and unlawful termination

SEARS HOLDINGS CORPORATION

Notes to Condensed Consolidated Financial Statements (Continued)

(Unaudited)

practices. The complaints generally seek unspecified monetary damages, injunctive relief, or both. Further, certain of these proceedings are in jurisdictions with reputations for aggressive application of laws and procedures against corporate defendants. One of these class-action lawsuits described above is *Moldowan, et al. v. Sears, Roebuck and Company, et al.*, a lawsuit filed on August 12, 2004 in the Superior Court of the State of California, County of Sonoma in which plaintiffs allege that Sears failed to pay them for all hours worked and otherwise failed to pay them correctly for work performed in accordance with California law. Plaintiffs seek monetary damages in an unspecified amount, together with attorneys fees, interest, statutory penalties and punitive damages. The parties have settled the matter and the Court has approved the settlement. In agreeing to the settlement, defendants did not admit any wrongdoing and denied committing any violation of law. Defendants agreed to the settlement solely to eliminate the uncertainties, burden and expense of further protracted litigation. We previously established a reserve for the expected settlement and it did not have a material adverse effect on our annual results of operations, financial position, liquidity or capital resources.

We are subject to various other legal and governmental proceedings, many involving litigation incidental to our businesses. Some matters contain class action allegations, environmental and asbestos exposure allegations and other consumer-based claims, each of which may seek compensatory, punitive or treble damage claims (potentially in large amounts), as well as other types of relief.

In accordance with SFAS No. 5, Accounting for Contingencies, we accrue an undiscounted liability for those contingencies where the incurrence of a loss is probable and the amount can be reasonably estimated and we do not record liabilities when the likelihood that the liability has been incurred is probable but the amount cannot be reasonably estimated, or when the liability is believed to be only reasonably possible or remote. Because litigation outcomes are inherently unpredictable, these assessments often involve a series of complex assessments by management about future events and can rely heavily on estimates and assumptions. While the consequences of certain unresolved proceedings are not presently determinable, an adverse outcome from certain matters could have a material adverse effect on our earnings in any given reporting period. However, in the opinion of our management after consulting with legal counsel, and taking into account insurance and reserves, the ultimate liability is not expected to have a material adverse effect on our financial position, liquidity or capital resources.

NOTE 14 RECENT ACCOUNTING PRONOUNCEMENTS

In December 2007, the FASB issued SFAS No. 141(R), which we adopted on February 1, 2009. SFAS No. 141(R) has a significant impact on the accounting for transaction costs, restructuring costs as well as the initial recognition of contingent assets and liabilities assumed during a business combination. The provisions of SFAS No. 141(R) are applied prospectively from the date of adoption, except for adjustments to valuation allowances recorded on previously acquired entities deferred tax assets and uncertain tax position balances occurring outside the measurement period, which are recorded as a component of income tax expense in the period of adjustment, rather than goodwill. We expect SFAS 141(R) will have an impact on our consolidated financial statements, but the nature and magnitude of the specific effects will depend upon the nature, terms and size of the acquisitions we consummate after the effective date. As of August 1, 2009, we have recorded $57 million of unrecognized tax benefits and $8 million of related interest, net of federal tax benefit, for tax positions of the Predecessor Company and tax positions of acquired entities taken prior to their acquisition by Holdings. Liabilities settled for different amounts will affect our income tax expense in the period of settlement or reversal. Settlements recorded in the first half of 2009 did not have a material impact on our results of operations.

On February 1, 2009 we adopted SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements an amendment of ARB No. 51, which amends ARB No. 51, Consolidated Financial Statements, to establish

SEARS HOLDINGS CORPORATION

Notes to Condensed Consolidated Financial Statements (Continued)

(Unaudited)

new standards that govern the accounting for and reporting of noncontrolling interests in partially-owned consolidated subsidiaries and the loss of control of subsidiaries. SFAS No. 160 requires that: (1) noncontrolling interest, previously referred to as minority interest, be reported as part of equity in the consolidated financial statements; (2) losses be allocated to a noncontrolling interest even when such allocation might result in a deficit balance, reducing the losses attributed to the controlling interest; (3) changes in ownership interests be treated as equity transactions if control is maintained; (4) changes in ownership interests resulting in gain or loss be recognized in earnings if control is gained or lost; and (5) in a business combination the noncontrolling interest s share of net assets acquired be recorded at the fair value, plus its share of goodwill. The provisions of SFAS No. 160 are prospective upon adoption, except for the presentation and disclosure requirements. The presentation and disclosure requirements must be applied retrospectively for all periods presented. Accordingly, our Condensed Consolidated Balance Sheets as of August 2, 2008 and January 31, 2009, our Condensed Consolidated Statements of Operations for the three and six months ended August 2, 2008, and Condensed Consolidated Statements of Cash Flows and Condensed Consolidated Statements of Equity for the six months ended August 2, 2008 have been retrospectively adjusted to reflect noncontrolling interests in Sears Canada and OSH (which represent 27% and 19.9% of the subsidiaries ownership, respectively).

In March 2008, the FASB issued SFAS No. 161, Disclosures about Derivative Instruments and Hedging Activities, an amendment of SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities. We adopted SFAS No. 161 on February 1, 2009. See Note 3 to the Condensed Consolidated Financial Statements for further discussion.

In May 2009, the FASB issued SFAS No. 165, Subsequent Events. We adopted SFAS No. 165 during the second quarter of fiscal 2009. SFAS No. 165 incorporates the principles and accounting guidance for recognizing and disclosing subsequent events that originated as auditing standards into the body of authoritative literature issued by the FASB as well as prescribes disclosure regarding the date through which subsequent events have been evaluated. We are required to evaluate subsequent events through the date our financial statements are issued. As SFAS No. 165 is not intended to significantly change the current practice of reporting subsequent events, it did not have an impact on our results of operations, cash flows or financial positions. As disclosed in Note 1, we performed an evaluation of subsequent events for the accompanying Condensed Consolidated Financial Statements and Notes through August 24, 2009, the date this report was issued.

In June 2009, the FASB issued SFAS No. 168, The FASB Accounting Standards Codification (Codification) and the Hierarchy of GAAP , which replaces SFAS No. 162, The Hierarchy of GAAP and establishes the Codification as the single source of authoritative U.S. GAAP recognized by the FASB to be applied by nongovernmental entities. SEC rules and interpretive releases also continue to be sources of authoritative GAAP for SEC registrants. SFAS No. 168 modifies the GAAP hierarchy to include only two levels of GAAP: authoritative and non-authoritative. SFAS No. 168 is effective beginning for periods ended after September 15, 2009. As SFAS No. 168 is not intended to change or alter existing GAAP, it is not expected to impact our results of operations, cash flows or financial position. We will adjust historical GAAP references in our Quarterly Report on Form 10-Q for the third quarter 2009 to reflect accounting guidance references included in the codification.

In April 2009, the FASB issued FSP FAS No. 107-1 and Accounting Principles Board (APB) No. 28-1, Interim Disclosures about Fair Value of Financial Instruments. This FSP amends SFAS No. 107, Disclosures about Fair Value of Financial Instruments, and requires disclosures about fair value of financial instruments for interim reporting periods as well as for annual financial statements. Additionally, this FSP amends APB Opinion No. 28, Interim Financial Reporting, and requires those disclosures in summarized financial information at

SEARS HOLDINGS CORPORATION

Notes to Condensed Consolidated Financial Statements (Continued)

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interim reporting periods. These disclosures are required for interim reporting periods ending after June 15, 2009. We adopted FSP FAS No. 107-1 and APB No. 28-1 in the second quarter of 2009. As this FSP provides only disclosure requirements, the adoption of this standard will not have a material impact on our financial condition or operating results.

In December 2008, the FASB issued FSP FAS No. 132(R)-1, Employers Disclosures about Postretirement Benefit Plan Assets, which requires additional disclosures for employers pension and other postretirement benefit plan assets. As pension and other postretirement benefit plan assets were not included within the scope of SFAS No. 157, the FSP requires employers to disclose information about fair value measurements of plan assets similar to the disclosures required under SFAS No. 157, the investment policies and strategies for the major categories of plan assets, and significant concentrations of risk within plan assets. FSP FAS 132(R)-1 is effective for fiscal years ending after December 15, 2009. As FSP FAS 132(R)-1 provides only disclosure requirements, the adoption of this standard will not have a material impact on our financial condition or operating results.

SEARS HOLDINGS CORPORATION

13 and 26 Weeks Ended August 1, 2009 and August 2, 2008

Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

The following discussion should be read in conjunction with Part II, Item 7 of our Annual Report on Form 10-K for the year ended January 31, 2009.

OVERVIEW OF HOLDINGS

Holdings, the parent company of Kmart and Sears, was formed in connection with the March 24, 2005 Merger of these two companies. We are a broadline retailer with approximately 2,300 full-line and 1,250 specialty retail stores in the United States operating through Kmart and Sears and approximately 390 full-line and specialty retail stores in Canada operating through Sears Canada, a 73%-owned subsidiary. We currently conduct our operations in three business segments: Kmart, Sears Domestic and Sears Canada. The nature of operations conducted within each of these segments is discussed within the Business Segments section of Part I, Item 1 of our Annual Report on Form 10-K for the year ended January 31, 2009**.**

CONSOLIDATED RESULTS OF OPERATIONS

	13 Weeks Ended		**26 Weeks Ended**	
millions, except per share data	**August 1, 2009**	**August 2, 2008**	**August 1, 2009**	**August 2, 2008**
REVENUES				
Merchandise sales and services	$ 10,551	$ 11,762	$ 20,606	$ 22,830
COSTS AND EXPENSES				
Cost of sales, buying and occupancy	7,756	8,640	14,938	16,685
Gross margin dollars	2,795	3,122	5,668	6,145
Gross margin rate	*26.5%*	*26.5%*	*27.5%*	*26.9%*
Selling and administrative	2,630	2,694	5,203	5,509
Selling and administrative expense as a percentage of total revenues	*24.9%*	*22.9%*	*25.2%*	*24.1%*
Depreciation and amortization	228	247	454	495
Gain on sales of assets	(5)	(6)	(59)	(38)