

SEARS HOLDINGS CORP
Form 10-Q
August 29, 2008
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-Q

Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 for the Quarterly Period Ended August 2, 2008
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
(State of Incorporation)

20-1920798
(I.R.S. Employer Identification No.)

3333 Beverly Road, Hoffman Estates, Illinois
(Address of principal executive offices)

60179
(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 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.

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Large accelerated filer 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

As of August 22, 2008, the registrant had 126,416,383 common shares, \$0.01 par value, outstanding.

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SEARS HOLDINGS CORPORATION

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(Unaudited)

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

millions, except per share data

| | 13 Weeks Ended | | 26 Weeks Ended | |
|--|-------------------|-------------------|-------------------|-------------------|
| | August 2, 2008 | August 4, 2007 | August 2, 2008 | August 4, 2007 |
| REVENUES | | | | |
| Merchandise sales and services | \$ 11,762 | \$ 12,260 | \$ 22,830 | \$ 24,007 |
| COSTS AND EXPENSES | | | | |
| Cost of sales, buying and occupancy | 8,640 | 8,869 | 16,685 | 17,306 |
| Selling and administrative | 2,694 | 2,802 | 5,509 | 5,446 |
| Depreciation and amortization | 247 | 262 | 495 | 524 |
| Gain on sales of assets | (6) | (5) | (38) | (10) |
| Total costs and expenses | 11,575 | 11,928 | 22,651 | 23,266 |
| Operating income | 187 | 332 | 179 | 741 |
| Interest and investment income | (20) | (42) | (31) | (82) |
| Interest expense | 65 | 71 | 131 | 144 |
| Other (income) loss | 1 | (12) | 2 | (17) |
| Income before income taxes and minority interest | 141 | 315 | 77 | 696 |
| Income tax expense | 56 | 128 | 28 | 276 |
| Minority interest | 20 | 14 | 40 | 24 |
| NET INCOME | \$ 65 | \$ 173 | \$ 9 | \$ 396 |
| EARNINGS PER COMMON SHARE | | | | |
| Basic earnings per share | \$ 0.50 | \$ 1.15 | \$ 0.07 | \$ 2.60 |
| Diluted earnings per share | \$ 0.50 | \$ 1.15 | \$ 0.07 | \$ 2.60 |
| Basic weighted average common shares outstanding | 128.8 | 150.8 | 130.3 | 152.3 |
| Diluted weighted average common shares outstanding | 128.8 | 150.9 | 130.3 | 152.4 |

See accompanying notes.

Table of Contents**SEARS HOLDINGS CORPORATION****Condensed Consolidated Balance Sheets**

| <i>millions</i> | (Unaudited) | | |
|--|----------------------|----------------------|----------------------|
| | August 2, 2008 | August 4, 2007 | February 2, 2008 |
| ASSETS | | | |
| Current assets | | | |
| Cash and cash equivalents | \$ 1,534 | \$ 2,634 | \$ 1,622 |
| Accounts receivable | 1,020 | 751 | 744 |
| Merchandise inventories | 9,754 | 10,158 | 9,963 |
| Prepaid expenses and other current assets | 468 | 433 | 438 |
| Deferred income taxes | 29 | 240 | 35 |
| Total current assets | 12,805 | 14,216 | 12,802 |
| Property and equipment, net | 8,568 | 8,842 | 8,863 |
| Goodwill | 1,660 | 1,714 | 1,686 |
| Tradenames and other intangible assets | 3,322 | 3,391 | 3,353 |
| Other assets | 434 | 420 | 693 |
| TOTAL ASSETS | \$ 26,789 | \$ 28,583 | \$ 27,397 |
| LIABILITIES | | | |
| Current liabilities | | | |
| Short-term borrowings | \$ 974 | \$ 80 | \$ 162 |
| Current portion of long-term debt and capitalized lease obligations | 390 | 551 | 242 |
| Merchandise payables | 3,494 | 3,448 | 3,487 |
| Income taxes payable | | 17 | 54 |
| Accrued expenses and other current liabilities | 3,340 | 3,774 | 3,971 |
| Unearned revenues | 1,106 | 1,118 | 1,121 |
| Other taxes | 569 | 593 | 525 |
| Total current liabilities | 9,873 | 9,581 | 9,562 |
| Long-term debt and capitalized lease obligations | 2,250 | 2,646 | 2,606 |
| Pension and post-retirement benefits | 1,135 | 1,467 | 1,258 |
| Minority interest and other long-term liabilities | 3,351 | 3,265 | 3,304 |
| Total Liabilities | 16,609 | 16,959 | 16,730 |
| SHAREHOLDERS EQUITY | | | |
| Preferred stock, 20 shares authorized; no shares outstanding | | | |
| Common stock \$0.01 par value; 500 shares authorized; 126, 144, and 132 shares outstanding, respectively | 1 | 2 | 1 |
| Capital in excess of par value | 10,405 | 10,364 | 10,419 |
| Retained earnings | 4,518 | 4,080 | 4,509 |
| Treasury stock at cost | (4,798) | (2,898) | (4,331) |
| Accumulated other comprehensive income | 54 | 76 | 69 |
| Total Shareholders Equity | 10,180 | 11,624 | 10,667 |
| TOTAL LIABILITIES AND SHAREHOLDERS EQUITY | \$ 26,789 | \$ 28,583 | \$ 27,397 |

See accompanying notes.

Table of Contents**SEARS HOLDINGS CORPORATION****Condensed Consolidated Statements of Cash Flows**

(Unaudited)

| <i>millions</i> | 26 Weeks Ended | |
|---|---------------------------|---------------------------|
| | August 2, 2008 | August 4, 2007 |
| CASH FLOWS FROM OPERATING ACTIVITIES | | |
| Net income | \$ 9 | \$ 396 |
| Adjustments to reconcile net income to net cash (used in) provided by operating activities: | | |
| Depreciation and amortization | 495 | 524 |
| Curtailed gain on Sears Canada's post-retirement benefit plans | | (27) |
| Loss on total return swaps, net | | 21 |
| Gain on sales of assets | (38) | (10) |
| Other non-cash items affecting earnings | (5) | 6 |
| Change in operating assets and liabilities (net of acquisitions and dispositions): | | |
| Deferred income taxes | (17) | (86) |
| Merchandise inventories | 180 | (184) |
| Merchandise payables | 23 | 89 |
| Income and other taxes | (138) | (329) |
| Other operating assets | 52 | 73 |
| Other operating liabilities | (563) | 39 |
| Net cash (used in) provided by operating activities | (2) | 512 |
| CASH FLOWS FROM INVESTING ACTIVITIES | | |
| Proceeds from sales of property and investments | 75 | 43 |
| Purchases of investments | (13) | |
| Purchases of property and equipment | (277) | (278) |
| Change in collateral on total return swaps, net | | 60 |
| Cash settlements on total return swaps, net | | (8) |
| Net cash used in investing activities | (215) | (183) |
| CASH FLOWS FROM FINANCING ACTIVITIES | | |
| Proceeds from debt issuances | 5 | |
| Repayments of long-term debt | (184) | (293) |
| Increase (decrease) in short-term borrowings, primarily 90 days or less | 812 | (14) |
| Purchase of treasury stock | (477) | (1,290) |
| Net cash provided by (used in) financing activities | 156 | (1,597) |
| Effect of exchange rate changes on cash and cash equivalents | (27) | 63 |
| NET DECREASE IN CASH AND CASH EQUIVALENTS | (88) | (1,205) |
| CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR | 1,622 | 3,839 |
| CASH AND CASH EQUIVALENTS, END OF PERIOD | \$ 1,534 | \$ 2,634 |

SUPPLEMENTAL DISCLOSURE ABOUT NON-CASH INVESTING AND FINANCING ACTIVITIES:

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| | | |
|---|-----|-------|
| Bankruptcy related settlements resulting in the receipt of treasury stock | \$ | \$ 27 |
| SUPPLEMENTAL CASH FLOW DATA: | | |
| Income taxes paid, net of refunds | 178 | 299 |
| Cash interest paid | 106 | 127 |
| See accompanying notes. | | |

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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 S. 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 1,200 specialty retail stores in the United States, operating through Kmart and Sears, and approximately 380 full-line and specialty retail stores in Canada operating through Sears Canada Inc. (Sears Canada), a 70%-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 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 February 2, 2008.

NOTE 2 CHANGES IN ACCOUNTING PRINCIPLE

Change in Sears Canada Year End

During the fourth quarter of 2007, Sears Canada changed its fiscal year end from the Saturday nearest to December 31st to the Saturday nearest to January 31st. Prior to this change, Sears Canada's results were consolidated into the consolidated results of Holdings on a one-month lag. While our historical policy of consolidating the results of Sears Canada on a one-month lag was considered acceptable, we believe elimination of the one-month reporting lag is preferable because it allows a full seasonal cycle, including the liquidation of holiday merchandise, for Sears Canada to be included in the results of Holdings. Furthermore, Sears Canada's fiscal year end is now aligned with the fiscal year end of Holdings.

In accordance with Statement of Financial Accounting Standards (SFAS) No. 154, Accounting Changes and Error Corrections A Replacement of Accounting Principles Board (APB) Opinion No. 20 and SFAS No. 3, changes in accounting policy are to be reported through retrospective application of the new policy to all prior financial statement periods presented. Accordingly, our financial statements for periods prior to 2007 have been adjusted to reflect the period-specific effects of applying this change. This change resulted in a one-month shift backwards of periods previously reported for Sears Canada. The impact of this change in accounting policy was not material to our consolidated financial position, results of operations or cash flows for fiscal 2007 or our condensed consolidated financial statements for the quarter ended August 4, 2007.

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Notes to Condensed Consolidated Financial Statements (Continued)

(Unaudited)

NOTE 3 BORROWINGS

Total borrowings were as follows:

| <i>millions</i> | August 2, 2008 | August 4, 2007 | February 2, 2008 |
|--|---------------------------|---------------------------|-----------------------------|
| Short-term borrowings: | | | |
| Unsecured commercial paper | \$ 174 | \$ 80 | \$ 145 |
| Secured borrowings | 800 | | 17 |
| Long-term debt, including current portion: | | | |
| Notes and debentures outstanding | 1,935 | 2,423 | 2,099 |
| Capitalized lease obligations | 705 | 774 | 749 |
| Total borrowings | \$ 3,614 | \$ 3,277 | \$ 3,010 |

Credit Agreement

We have a \$4.0 billion, five-year credit agreement (the *Credit Agreement*) in place as a funding source for general corporate purposes, which includes a \$1.5 billion letter of credit sublimit. The *Credit Agreement*, which has an expiration date of March 2010, is a revolving credit facility under which Sears Roebuck Acceptance Corp. (*SRAC*) and Kmart Corporation are the borrowers. The *Credit Agreement* is guaranteed by Holdings and certain of our direct and indirect subsidiaries and is secured by a first lien on our domestic inventory, credit card accounts receivable and the proceeds thereof. Availability under the *Credit Agreement* is determined pursuant to a borrowing base formula, based on domestic inventory levels, subject to certain limitations. As of August 2, 2008, we had \$800 million of borrowings and \$1.0 billion of letters of credit outstanding under the *Credit Agreement* with \$2.2 billion of availability remaining under the *Credit Agreement*. The \$800 million in borrowings, borrowed in the first half of fiscal 2008, are classified within short-term borrowings on our condensed consolidated balance sheet as of August 2, 2008 as we intend to repay the entire amount within the next 12 months. The *Credit Agreement* does not contain provisions that would restrict borrowings or letter of credit issuances based on material adverse changes or credit ratings.

The majority of the letters of credit outstanding under the *Credit Agreement*, and *Letter of Credit Agreement* discussed below, are used to provide collateral for our insurance programs.

Letter of Credit Agreement

In July 2008, we amended our secured letter of credit agreement with Bank of America, N.A. (the *LC Agreement*). As amended, the *LC Agreement* provides for a commitment amount of up to \$5 million and is scheduled to expire in July 2009. The *LC Agreement* continues to provide solely for the issuance of letters of credit and does not provide for direct borrowings. At August 2, 2008, \$2 million in letters of credit were outstanding under the *LC Agreement* and we had \$2 million posted as collateral under the *LC Agreement*.

Orchard Supply Hardware LLC (OSH LLC) Credit Agreement

In fiscal 2005, our subsidiary *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 sublimit. 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 accounts and credit card accounts receivable, subject to certain limitations. As of August 2, 2008, there were no borrowings outstanding under the *OSH LLC Facility* and \$2 million of letters of credit outstanding.

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SEARS HOLDINGS CORPORATION

Notes to Condensed Consolidated Financial Statements (Continued)

(Unaudited)

NOTE 4 DERIVATIVE FINANCIAL INSTRUMENTS

Foreign Currency Forwards

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 2, 2008.

Sears Canada Foreign Exchange Collars and Contracts

Sears Canada mitigates the risk of currency fluctuations on offshore merchandise purchases denominated in U.S. currency by purchasing U.S. dollar denominated forward contracts for a portion of its expected requirements at the time of placement. 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. We have recorded a mark to market fair value gain of \$5 million for the 26-week period ended August 2, 2008 in operating income.

Total Return Swap Investment

We, from time to time, invest our surplus cash in various securities and financial instruments, including total return swaps, which are derivative instruments designed to synthetically replicate the economic return characteristics of one or more underlying marketable equity securities. Such investments may be highly concentrated and involve substantial risks. We recognized investment gains of less than \$1 million and investment losses of \$21 million for the 13- and 26-week period ended August 4, 2007, respectively, related to these total return swaps. We had no total return swaps outstanding as of or during the 13- and 26- week periods ended August 2, 2008.

SFAS No. 157, Fair Value Measurements

On February 3, 2008, we adopted SFAS No. 157, *Fair Value Measurements*. The adoption of SFAS No. 157 is currently limited to financial instruments and to non-financial derivatives as, in February 2008, the Financial Accounting Standards Board (FASB) issued FSP No. 157-2, which delayed the effective date of SFAS No. 157 for one year for nonfinancial assets and liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis.

SFAS No. 157 defines fair value, establishes a framework for measuring fair value in GAAP and expands disclosure requirements about fair value measurements. Under SFAS No. 157, fair value is considered to be the exchange price in an orderly transaction between market participants to sell an asset or transfer a liability at the measurement date. The fair value definition under SFAS No. 157 focuses on an exit price, which is the price that would be received by Holdings to sell an asset or paid to transfer a liability versus an entry price, which would be the price paid to acquire an asset or received to assume a liability. Although SFAS No. 157 does not require additional fair value measurements, it applies to other accounting pronouncements that require or permit fair value measurements.

We determine fair value of financial assets and liabilities based on the following fair value hierarchy, as prescribed by SFAS No. 157, 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.

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Notes to Condensed Consolidated Financial Statements (Continued)

(Unaudited)

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.

The following table provides the fair value measurement amounts for assets and liabilities recorded on our condensed consolidated balance sheet at fair value at August 2, 2008:

| <i>millions</i> | Total Fair Value Amounts at August 2, 2008 | | | |
|---|---|----------------|----------------|----|
| | Level 1 | Level 2 | Level 3 | |
| Foreign currency contracts ⁽¹⁾ | \$ 5 | \$ 5 | \$ | \$ |
| Total | \$ 5 | \$ 5 | \$ | \$ |

⁽¹⁾ Included within Prepaid expenses and other current assets and Other current liabilities on the condensed consolidated balance sheet. 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.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities including an amendment of FASB Statement No. 115*, which permits entities to elect to measure many financial instruments and certain other items at fair value. For Holdings, SFAS No. 159 was effective as of February 3, 2008 and had no impact on amounts presented for periods prior to the effective date. We do not currently have any financial assets or financial liabilities for which the provisions of SFAS No. 159 have been elected. However, in the future, we may elect to measure certain financial instruments at fair value in accordance with this standard.

NOTE 5 INTEREST AND INVESTMENT INCOME

The following table sets forth the components of interest and investment income as reported in our condensed consolidated statements of operations.

| <i>millions</i> | 13 Weeks Ended | | 26 Weeks Ended | |
|--|---------------------------|---------------------------|---------------------------|---------------------------|
| | August 2, 2008 | August 4, 2007 | August 2, 2008 | August 4, 2007 |
| Interest income on cash and cash equivalents | \$ 7 | \$ 36 | \$ 16 | \$ 73 |
| Total return swap loss | | | | (21) |
| Other investment income | 13 | 6 | 15 | 30 |

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| | | | | |
|-------|-------|-------|-------|-------|
| Total | \$ 20 | \$ 42 | \$ 31 | \$ 82 |
|-------|-------|-------|-------|-------|

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SEARS HOLDINGS CORPORATION

Notes to Condensed Consolidated Financial Statements (Continued)

(Unaudited)

Interest Income on Cash and Cash Equivalents

We recorded interest income of \$7 million and \$16 million for the 13- and 26- week periods ended August 2, 2008, respectively, primarily related to interest earned on cash and cash equivalents. These cash and cash equivalents include all highly liquid investments with original maturities of three months or less at the date of purchase. Our invested cash may include, from time to time, investments in, but not limited to, commercial paper, U.S. federal, state and municipal government securities, floating-rate notes, repurchase agreements and money market funds. All invested cash amounts are readily available to us.

Total Return Swap Loss

As discussed in Note 4, from time to time we have invested in various securities and financial instruments, including total return swaps. We recognized investment gains of less than \$1 million and investment losses of \$21 million for the 13- and 26-week period ended August 4, 2007, respectively, related to these total return swaps. We had no total return swaps outstanding as of or during the 13- and 26-week periods ended August 2, 2008.

Other Investment Income

Other investment income primarily includes income generated by (and sales of investments in) certain real estate joint ventures and other equity investments in which we do not have a controlling interest. During the 13- and 26- week periods ended August 2, 2008, other investment income included a \$10 million dividend received on our cost method investment in Sears Mexico. Other investment income for the 26-week period ended August 4, 2007 included a \$20 million dividend received on our cost method investment in Sears Mexico.

NOTE 6 CLAIMS RESOLUTION

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 a direct, wholly owned subsidiary of Kmart and an indirect, wholly owned subsidiary of Holdings.

We have made significant progress in the reconciliation and settlement of various classes of claims associated with the discharge of the Predecessor Company's liabilities subject to compromise pursuant to the Plan of Reorganization. Differences between claim amounts filed and our estimates are being investigated and resolved through the claims resolution process. Since June 30, 2003, the first distribution date established in the Plan of Reorganization, approximately 29.8 million shares of the 31.9 million shares set aside for distribution have been distributed to holders of Class 5 claims, and approximately \$9 million and \$4 million in cash has been distributed to the holders of Class 6 and Class 7 claims, respectively. Further, we pro-rated approximately \$5 million from the settlement that the Creditor Trust received to holders of Class 4, 5, 6, 8, 10 and 11 claims. As we were unable to determine the ultimate amount of allowed claims until the claims resolution process was largely completed, a distribution reserve for Class 5 claim settlements was established. At February 3, 2007, our distribution reserve for Class 5 claim settlements was 5 percent of the total shares expected to be distributed. Based on the Class 5 claims resolved to date, we believe that the ultimate amount of the allowed Class 5 claims will be less than the \$4.3 billion provided for in the Plan of Reorganization. As such, the Class 5 distribution reserve of 5 percent was distributed to the allowed Class 5 creditors during the first quarter of fiscal 2007. The remaining shares left over after all Class 5 claims are ultimately settled will be distributed to the Class 5 creditors in proportion to their allowed claims.

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Notes to Condensed Consolidated Financial Statements (Continued)

(Unaudited)

NOTE 7 SHAREHOLDERS EQUITY*Share Repurchase Program*

During the 13- and 26- week periods ended August 2, 2008, we repurchased 5.6 million and 6.0 million of our common shares at a total cost of \$437 million and \$477 million, respectively, under our share repurchase program. Our repurchases for the 13- and 26- week periods ended August 2, 2008 were made at average prices of \$78.22 and \$79.34 per share, respectively. As of August 2, 2008, we had \$206 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.

Comprehensive Income (Loss) and Accumulated Other Comprehensive Income

The following table shows the computation of comprehensive income (loss):

| <i>millions</i> | 13 Weeks Ended | | 26 Weeks Ended | |
|---|-------------------|-------------------|-------------------|-------------------|
| | August 2, 2008 | August 4, 2007 | August 2, 2008 | August 4, 2007 |
| Net income | \$ 65 | \$ 173 | \$ 9 | \$ 396 |
| Other comprehensive income (loss): | | | | |
| Pension and post-retirement adjustments, net of taxes | | | | 16 |
| Foreign currency translation adjustments | (8) | (3) | (15) | 1 |
| Total other comprehensive income (loss) | (8) | (3) | (15) | 17 |
| Total comprehensive income (loss) | \$ 57 | \$ 170 | \$ (6) | \$ 413 |

The following table displays the components of accumulated other comprehensive income:

| <i>millions</i> | August 2, 2008 | August 4, 2007 | February 2, 2008 |
|---|-------------------|-------------------|---------------------|
| Foreign currency translation adjustments | \$ (64) | \$ (5) | \$ (49) |
| Cumulative unrealized derivative gain | 3 | 3 | 3 |
| Pension and post-retirement adjustments, net of tax | 115 | 78 | 115 |
| Accumulated other comprehensive income | \$ 54 | \$ 76 | \$ 69 |

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Notes to Condensed Consolidated Financial Statements (Continued)

(Unaudited)

NOTE 8 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:

| <i>millions</i> | 13 Weeks Ended | | 26 Weeks Ended | |
|-------------------------------------|-------------------|-------------------|-------------------|-------------------|
| | August 2, 2008 | August 4, 2007 | August 2, 2008 | August 4, 2007 |
| Components of net periodic expense: | | | | |
| Benefits earned during the period | \$ 6 | \$ 4 | \$ 13 | \$ 7 |
| Interest costs | 109 | 94 | 218 | 189 |
| Expected return on plan assets | (108) | (95) | (215) | (191) |
| Net periodic expense | \$ 7 | \$ 3 | \$ 16 | \$ 5 |

Sears Canada Curtailment Gain

In February 2007, Sears Canada announced amendments to its post-retirement programs including the introduction of a defined contribution component to its pension plan and the discontinuation of retiree medical, dental and life benefits for those Sears Canada associates who will not have achieved eligibility for such benefits by December 31, 2008. The amendments to the post-retirement programs resulted in a curtailment gain and reduction to the benefit plan obligation of \$27 million during the 26-week period ended August 4, 2007.

Contributions

During the 13- and 26- week periods ended August 2, 2008, we made total contributions of \$40 million and \$116 million, respectively, to our domestic pension plans. We anticipate making aggregate contributions of \$127 million over the remainder of fiscal 2008.

NOTE 9 INCOME TAXES

We account for income taxes in accordance with SFAS No. 109, *Accounting for Income Taxes*, which requires that deferred tax assets and liabilities be recognized using enacted tax rates for the effect of temporary differences between the financial reporting and tax basis of recorded assets and liabilities. SFAS No. 109 also requires that deferred tax assets be reduced by a valuation allowance if it is more likely than not that some portion of or all of the deferred tax asset will not be realized.

Effective at the beginning of fiscal 2007, we adopted FASB Interpretation No. 48 (*FIN 48*), *Accounting for Uncertainties in Income Taxes* an Interpretation of FASB Statement No. 109. The impact upon adoption was to decrease retained earnings by \$6 million and to increase our accruals for uncertain tax positions by a corresponding amount. In accordance with FIN 48, we increased goodwill and accruals for uncertain tax positions by \$13 million to reflect the measurement of uncertain tax positions associated with previous business acquisitions, and increased capital in excess of par value and decreased accruals for uncertain tax positions by \$2 million to reflect measurement of an uncertain tax position related to Predecessor Company pre-petition income tax liabilities. In accordance with the American Institute of Certified Public Accountants (*AICPA*) Statement of Position 90-7, *Financial Reporting by Entities in Reorganization under the Bankruptcy Code*, any resolution of these matters results in a direct credit to capital in excess of par value within shareholders' equity.

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SEARS HOLDINGS CORPORATION

Notes to Condensed Consolidated Financial Statements (Continued)

(Unaudited)

As of the second quarter of fiscal 2008, we had gross unrecognized tax benefits of \$420 million. Of this amount, \$105 million would, if recognized, affect our effective tax rate, with the remaining amount being comprised of unrecognized tax benefits related to gross temporary differences and prior business combinations or any other indirect tax benefits. During the quarter, we reduced gross unrecognized tax benefits by \$12 million. Of this reduction, \$13 million related to state tax settlements relating to pre-Merger periods. We expect that our unrecognized tax benefits could decrease up to \$64 million over the next 12 months for federal and state tax 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 completion of tax audits and 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. As of August 2, 2008, the total amount of interest and penalties recognized on our condensed consolidated balance sheet was \$99 million (\$64 million net of federal tax benefit). The total amount of interest and penalties recognized in our condensed consolidated statement of operations for the 13- and 26- week periods ended August 2, 2008 was \$2 million and \$3 million, (net of federal tax benefit), respectively.

We file income tax returns in both the United States and various foreign jurisdictions. The U.S. Internal Revenue Service (IRS) has commenced an audit of the Holdings federal income tax return for the fiscal year 2005 and the Sears federal income tax returns for the fiscal years 2004 and 2005 through the date of the Merger. The IRS has completed its examination of Sears federal income tax returns for the fiscal years 2002 and 2003, and we are working with the IRS to resolve certain matters arising from this exam. In addition, Holdings and Sears are subject to various state, local and foreign income tax examinations for the fiscal years 2001 2005 and Kmart is subject to such examinations for the fiscal years 2003 2005.

At the end of fiscal 2007, we had a state net operating loss (NOL) deferred tax asset of \$273 million and a valuation allowance of \$185 million. In the first half of fiscal 2008, there was no change to the state NOL deferred tax asset and our valuation allowance. We will continue to assess the likelihood of realization of these state deferred tax assets and will reduce the valuation allowance on such assets in the future if it becomes more likely than not that the net deferred tax assets will be utilized. To the extent that these valuation allowances relate to pre-Merger periods, and are reversed in the future, such effects would be recorded as a decrease to goodwill. Upon adoption of SFAS No. 141(R), as discussed in Note 13, adjustments to a previously acquired entity s deferred tax assets and uncertain tax position balances occurring outside the initial measurement period will be recorded as a component of income tax expense in the period of adjustment, rather than goodwill.

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Notes to Condensed Consolidated Financial Statements (Continued)

(Unaudited)

NOTE 10 SUMMARY OF SEGMENT DATA

We have three reportable segments: Kmart, Sears Domestic and Sears Canada. During the fourth quarter of 2007, Sears Canada changed its fiscal year end from the Saturday nearest December 31st to the Saturday nearest January 31st. This change has been retrospectively applied to all prior year amounts included in the following segment results. See Note 2 for further information on the impact of this change.

| <i>millions</i> | For the 13 Weeks Ended August 2, 2008 | | | |
|-------------------------------------|--|-------------------------------|-----------------|-------------------|
| | Kmart | Sears Domestic 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 |

| <i>millions</i> | For the 13 Weeks Ended August 4, 2007 | | | |
|-------------------------------------|--|-------------------------------|-----------------|-------------------|
| | Kmart | Sears Domestic Canada | | Sears Holdings |
| Merchandise sales and services | \$ 4,228 | \$ 6,706 | \$ 1,326 | \$ 12,260 |
| Costs and expenses | | | | |
| Cost of sales, buying and occupancy | 3,203 | 4,736 | 930 | 8,869 |
| Selling and administrative | 870 | 1,633 | 299 | 2,802 |
| Depreciation and amortization | 27 | 202 | 33 | 262 |
| Gain on sales of assets | | (2) | (3) | (5) |
| Total costs and expenses | 4,100 | 6,569 | 1,259 | 11,928 |
| Operating income | \$ 128 | \$ 137 | \$ 67 | \$ 332 |
| Total assets | \$ 7,557 | \$ 17,887 | \$ 3,139 | \$ 28,583 |

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Notes to Condensed Consolidated Financial Statements (Continued)

(Unaudited)

| <i>millions</i> | For the 26 Weeks Ended August 2, 2008 | | | |
|-------------------------------------|--|-----------------|---------------|---------------------------|
| | Kmart | Sears | | Sears Holdings |
| | | Domestic | Canada | |
| 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 |

| <i>millions</i> | For the 26 Weeks Ended August 4, 2007 | | | |
|-------------------------------------|--|-----------------|---------------|---------------------------|
| | Kmart | Sears | | Sears Holdings |
| | | Domestic | Canada | |
| Merchandise sales and services | \$ 8,243 | \$ 13,366 | \$ 2,398 | \$ 24,007 |
| Costs and expenses | | | | |
| Cost of sales, buying and occupancy | 6,258 | 9,365 | 1,683 | 17,306 |
| Selling and administrative | 1,710 | 3,211 | 525 | 5,446 |
| Depreciation and amortization | 53 | 408 | 63 | 524 |
| Gain on sales of assets | (1) | (1) | (8) | (10) |
| Total costs and expenses | 8,020 | 12,983 | 2,263 | 23,266 |
| Operating income | \$ 223 | \$ 383 | \$ 135 | \$ 741 |
| Total assets | \$ 7,557 | \$ 17,887 | \$ 3,139 | \$ 28,583 |

In January 2008, we announced that we would implement a new organizational structure and operating model designed to simplify the way our business lines are managed. While we have begun the process of transforming the Company to this new model, it will take some time to build the processes and information systems necessary to support the structure. We continue to assess the impact our new organizational structure will have on the business segment information used by our management to operate Holdings on an on-going basis.

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Notes to Condensed Consolidated Financial Statements (Continued)

(Unaudited)

NOTE 11 SUPPLEMENTAL FINANCIAL INFORMATION

Accrued expenses and other current liabilities as of August 2, 2008, August 4, 2007 and February 2, 2008 consisted of the following:

| <i>millions</i> | August 2, 2008 | August 4, 2007 | February 2, 2008 |
|--|---------------------------|---------------------------|-----------------------------|
| Payroll and benefits payable | \$ 355 | \$ 410 | \$ 367 |
| Outstanding checks in excess of funds on deposit | 261 | 330 | 405 |
| Current portion of self-insurance reserves | 374 | 347 | 377 |
| Customer deposits | 366 | 423 | 371 |
| Accrued expenses and other current liabilities | 1,984 | 2,264 | 2,451 |
| Total | \$ 3,340 | \$ 3,774 | \$ 3,971 |

Minority interest and other liabilities as of August 2, 2008, August 4, 2007 and February 2, 2008 consisted of the following:

| <i>millions</i> | August 2, 2008 | August 4, 2007 | February 2, 2008 |
|-------------------------|---------------------------|---------------------------|-----------------------------|
| Unearned revenues | \$ 923 | \$ 940 | \$ 945 |
| Self-insurance reserves | 829 | 823 | 802 |
| Minority interest | 343 | 236 | 313 |
| Other | 1,256 | 1,266 | 1,244 |
| Total | \$ 3,351 | \$ 3,265 | \$ 3,304 |

NOTE 12 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 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 discovery is underway.

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

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motion to dismiss. After taking some additional discovery, defendants have filed another motion to dismiss which the Court has set for hearing in October 2008.

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SEARS HOLDINGS CORPORATION

Notes to Condensed Consolidated Financial Statements (Continued)

(Unaudited)

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 and on April 16, 2008, the appellate court heard oral argument on the appeal. On August 21, 2008, the appellate court reversed the trial court's judgment and entered judgment in favor of Sears on all counts. As a result of the appellate court's decision to overturn the verdict, we eliminated the \$62 million reserve we previously established for this matter, which had the effect of improving pre-tax income by \$62 million in the second quarter of 2008.

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 has been investigating, and the U.S. Attorney for the Eastern District of Michigan has 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 has cooperated with the SEC and the U.S. Attorney's office with respect to these matters, which are ongoing.

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 and its former chief financial officer 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. The complaint seeks permanent injunctions, disgorgement with interest, civil penalties and officer and director bars. Kmart is not named as a defendant in the action. In its press release announcing the filing of the complaint, the SEC stated that its Kmart investigation is continuing.

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 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. Plaintiffs' motion for class certification is fully briefed and a hearing on the motion has not been scheduled pending settlement discussions between the parties, which are ongoing.

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) or 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,

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SEARS HOLDINGS CORPORATION

Notes to Condensed Consolidated Financial Statements (Continued)

(Unaudited)

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 13 RECENT ACCOUNTING PRONOUNCEMENTS

In December 2007, the FASB issued SFAS No. 141(R), *Business Combinations* which revised SFAS No. 141, *Business Combinations*. SFAS No. 141(R) is effective for fiscal years beginning on or after December 15, 2008, with early adoption prohibited. SFAS No. 141(R) will have a significant impact on the accounting for transaction costs and 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 a previously acquired entity's 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 have not yet assessed the impact this statement will have on our financial statements.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*. See Note 4 for further discussion regarding our adoption of SFAS No. 157 in the first quarter of 2008.

In September 2006, the FASB issued SFAS No. 158, *Employer's Accounting for Defined Benefit Pension and Other Postretirement Plans*, which changes the recognition and disclosure provisions and measurement date requirements for an employer's accounting for defined benefit pension and other postretirement plans. The recognition and disclosure provisions require an employer to (1) recognize the funded status of a benefit plan measured as the difference between plan assets at fair value and the benefit obligation in its statement of financial position, (2) recognize as a component of other comprehensive income (OCI), net of tax, the gains or losses and prior service costs or credits that arise during the period but are not recognized as components of net periodic benefit cost, and (3) disclose in the notes to financial statements certain additional information. SFAS No. 158 does not change the amounts recognized in the income statement as net periodic benefit cost. As required by SFAS No. 158, we adopted the recognition and disclosure provisions of the Statement as of February 3, 2007, and accordingly recognized the funded status of our defined benefit pension and other postretirement plans and provided the required additional disclosures. The adoption of these provisions of SFAS No. 158 did not have any material impact on our consolidated results of operations or cash flows.

As required under the Statement, we will adopt the measurement-date requirements of SFAS No. 158 effective fiscal 2008. Under the measurement-date requirements, an employer is required to measure defined benefit plan assets and obligations as of the date of the employer's fiscal year end. We currently measure our plan assets and obligations as of December 31. We will adopt the change in measurement date by re-measuring plan assets and benefit obligations as of our fiscal year end in fiscal 2008, pursuant to the transition requirements of SFAS No. 158. We are currently evaluating the impact, if any, the adoption of the measurement-date requirements of SFAS No. 158 will have on our financial statements.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities*. See Note 4 for further discussion regarding our adoption of SFAS No. 159 in the first quarter of 2008.

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SEARS HOLDINGS CORPORATION

Notes to Condensed Consolidated Financial Statements (Continued)

(Unaudited)

In December 2007, the FASB issued SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements, an amendment of Accounting Research Bulletin (ARB) No. 51. SFAS No. 160 is effective for fiscal years beginning on or after December 15, 2008, with early adoption prohibited. Before SFAS No. 160 was issued, limited guidance existed for reporting noncontrolling interests and many companies reported such interest as a liability in its balance sheet under the heading Minority Interest. SFAS No. 160 requires companies to report noncontrolling interests of consolidated subsidiaries as a component of equity in the consolidated statement of financial position. As a result, upon adoption of this Statement, Holdings will reclassify its noncontrolling interest in Sears Canada and OSH (which represents 30% and 19.9% of the subsidiaries ownership, respectively) from its current classification within the long-term liabilities section of Holdings condensed consolidated balance sheet to classification within the shareholders equity section.

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. SFAS No. 161 expands the disclosure requirements of SFAS No. 133 to require entities to make qualitative disclosures regarding objectives and strategies for using derivatives, quantitative disclosures regarding fair value amounts of and gains and losses on derivative instruments, and disclosures regarding credit-risk-related contingent features in derivative instruments. SFAS No. 161 is effective for fiscal years beginning after November 15, 2008 and we plan to adopt this standard beginning in the first quarter of fiscal 2009. As this statement relates only to disclosure requirements, we do not expect it to have a material impact on our financial condition or operating results.

In May 2008, the FASB issued SFAS No. 162, The Hierarchy of Generally Accepted Accounting Principles. SFAS No. 162 identifies the sources of accounting principles and the framework for selecting the principles used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles in the United States. SFAS No. 162 is effective 60 days following the SEC s approval of the Public Company Accounting Oversight Board amendments to Statement of Auditing Standards Section 411, The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles. We do not expect this statement to have a material impact on our financial condition or operating results.

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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 February 2, 2008.

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 1,200 specialty retail stores in the United States operating through Kmart and Sears and approximately 380 full-line and specialty retail stores in Canada operating through Sears Canada, a 70%-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 February 2, 2008.

CONSOLIDATED RESULTS OF OPERATIONS

| <i>millions, except per share data</i> | 13 Weeks Ended | | 26 Weeks Ended | |
|---|---------------------------|---------------------------|---------------------------|---------------------------|
| | August 2, 2008 | August 4, 2007 | August 2, 2008 | August 4, 2007 |
| REVENUES | | | | |
| Merchandise sales and services | \$ 11,762 | \$ 12,260 | \$ 22,830 | \$ 24,007 |
| COSTS AND EXPENSES | | | | |
| Cost of sales, buying and occupancy | 8,640 | 8,869 | 16,685 | 17,306 |
| Gross margin dollars | 3,122 | 3,391 | 6,145 | 6,701 |
| <i>Gross margin rate</i> | 26.5% | 27.7% | 26.9% | 27.9% |
| Selling and administrative | 2,694 | 2,802 | 5,509 | 5,446 |
| <i>Selling and administrative expense as a percentage of total revenues</i> | 22.9% | 22.9% | 24.1% | 22.7% |
| Depreciation and amortization | 247 | 262 | 495 | 524 |
| Gain on sales of assets | (6) | (5) | (38) | (10) |
| Total costs and expenses | 11,575 | 11,928 | 22,651 | 23,266 |
| Operating income | 187 | 332 | 179 | 741 |
| Interest and investment income | (20) | (42) | (31) | (82) |
| Interest expense | 65 | 71 | 131 | 144 |
| Other (income) loss | 1 | (12) | 2 | (17) |
| Income before income taxes and minority interest | 141 | 315 | 77 | 696 |
| Income tax expense | 56 | 128 | 28 | 276 |
| Minority interest | 20 | 14 | 40 | 24 |
| NET INCOME | \$ 65 | \$ 173 | \$ 9 | \$ 396 |

EARNINGS PER COMMON SHARE

| | | | | |
|--|---------|---------|---------|---------|
| Diluted earnings per share | \$ 0.50 | \$ 1.15 | \$ 0.07 | \$ 2.60 |
| Diluted weighted average common shares outstanding | 128.8 | 150.9 | 130.3 | 152.4 |

References to comparable store sales amounts within the following discussion include sales for all stores operating for a period of at least 12 full months, including remodeled and expanded stores, but excluding store relocations and format changes.

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SEARS HOLDINGS CORPORATION

13 and 26 Weeks Ended August 2, 2008 and August 4, 2007

Net Income and Earnings per Share Summary

For the second quarter of fiscal 2008, we recorded net income of \$65 million (\$0.50 per diluted share) as compared to net income of \$173 million (\$1.15 per diluted share) for the second quarter of fiscal 2007. For the first half of 2008, we recorded net income of \$9 million (\$0.07 per diluted share), as compared to net income of \$396 million (\$2.60 per diluted share) for the first half of fiscal 2007. Our second quarter and first half results in 2008 include the positive impact of the reversal of a \$62 million reserve because of the overturning of the previously disclosed February 2, 2007 adverse jury verdict relating to the redemption of certain Sears, Roebuck and Co. bonds in 2004 (see Note 12 for further information regarding this matter). This item had the impact of increasing our net income after tax for the second quarter and first half of fiscal 2008 by \$37 million (\$0.29 per diluted share) and \$39 million (\$0.30 per diluted share), respectively. Our second quarter and year-to-date income declined in fiscal 2008 primarily as a result of lower sales and reduced gross margins in our domestic operations.

13-week period ended August 2, 2008 compared to the 13-week period ended August 4, 2007

Comparable Store Sales and Total Revenues

Domestic comparable store sales declined 6.2% for the second quarter of fiscal 2008 as compared to the second quarter of fiscal 2007. Sears Domestic comparable store sales declined 6.7% for the second quarter of fiscal 2008 while Kmart comparable store sales declined 5.6% for the quarter. The comparable store sales declines at both Kmart and Sears Domestic continue to reflect increased competition and weakness in the general economy. Comparable store sales declined for the quarter across most major categories at both Kmart and Sears Domestic, but continue to be partially offset by increases in sales of consumer electronics, most notably at Sears Domestic. Comparable store sales declines continue to be driven by categories directly impacted by housing market conditions (including home appliances and, most notably, tools at Sears Domestic), and the increased costs of consumer staples, such as food and gas, which decrease consumers' discretionary spending.

For the second quarter in 2008, total revenues declined \$498 million, or 4.1%, to \$11.8 billion, as compared to \$12.3 billion for the second quarter of fiscal 2007. The second quarter decline primarily reflects the above-noted impact of lower domestic comparable store sales, partially offset by sales increases at Sears Canada of \$64 million, primarily reflecting the impact of favorable exchange rates, as the Canadian dollar strengthened from prior year levels.

Gross Margin

For the second quarter of fiscal 2008, we generated \$3.1 billion in total gross margin, as compared to \$3.4 billion in the second quarter of fiscal 2007. The total decline was made up of declines at both Kmart and Sears Domestic, partially offset by an increase at Sears Canada. The reductions at Kmart and Sears Domestic reflect the negative gross margin impact of lower overall sales, as well as a decline in our overall gross margin as a percentage of total revenues (our gross margin rate). As a percentage of total revenues, our gross margin rate declined 1.2% to 26.5% in the second quarter of fiscal 2008, as compared to 27.7% for the second quarter of fiscal 2007.

Reduced leverage of buying and occupancy costs, given lower overall sales levels in fiscal 2008, accounted for approximately 0.3% of the total 1.2% decline in our gross margin rate for the quarter. The remaining 0.9% decline was attributable to declines in gross margin rates across a number of merchandise categories at both Kmart and Sears Domestic. Sears Domestic's gross margin rate declined to 27.9% in the second quarter of fiscal 2008, as compared to 29.4% for the second quarter of fiscal 2007. Kmart's gross margin rate declined to 22.9% in the second quarter of fiscal 2008, as compared to 24.2% for the second quarter of fiscal 2007. The rate declines for both Sears Domestic and Kmart were due to increased markdown activity as a result of the intense competition for consumer business. As the home electronics category typically has a lower gross margin than

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13 and 26 Weeks Ended August 2, 2008 and August 4, 2007

other merchandise categories, the increase in home electronics sales, as well as a transition in electronics product offerings, contributed to the lower gross margin rate at Sears Domestic. The decline in Sears Domestic and Kmart gross margin rates was somewhat offset by an increase in the gross margin rate at Sears Canada.

Selling and Administrative Expenses

Our selling and administrative expenses as a percentage of total revenues (selling and administrative expense rate) were 22.9% for the second quarter of fiscal 2008 and 2007. The current year rate, in part, reflects the positive impact of the reversal of a \$62 million reserve because of a favorable verdict in connection with a pre-Merger legal matter concerning Sears' redemption of certain bonds in 2004 (see Note 12 for further information regarding this matter). Excluding this item, selling and administrative expenses decreased \$46 million as compared to the second quarter last year, and our selling and administrative expense rate would have been 23.4%. The selling and administrative expense rate increase is primarily a result of lower expense leverage given lower overall sales results. The decline in selling and administrative expenses of \$46 million mainly reflects a decrease in advertising, display and payroll expenses.

Operating Income

For the quarter, we reported operating income of \$187 million, as compared to operating income of \$332 million in the second quarter of fiscal 2007, mainly due to lower gross margin dollars generated at both Kmart and Sears Domestic, offset by the reversal of the legal matter reserve discussed previously.

Interest and Investment Income

We earned \$20 million in interest and investment income for the second quarter of fiscal 2008, as compared to \$42 million for the second quarter of fiscal 2007. Interest and investment income for the second quarter of fiscal 2008 included a pre-tax dividend of \$10 million received in connection with our investment in Sears Mexico. The second quarter decrease in fiscal 2008 was primarily due to lower levels of interest income due to reduced cash and cash equivalent balances.

Interest Expense

We incurred \$65 million in interest expense during the second quarter of fiscal 2008, as compared to \$71 million in the second quarter of last year. The reduction was attributable to lower average borrowings outstanding during the quarter.

Other Income / Loss

Other income / loss is primarily comprised of bankruptcy-related recoveries. A total of \$12 million in bankruptcy-related recoveries were recorded in the second quarter of fiscal 2007. Bankruptcy-related recoveries represent amounts collected from vendors who had received cash payment for pre-petition obligations. See Note 6 to the Condensed Consolidated Financial Statements for further information on bankruptcy claims resolution.

26-week period ended August 2, 2008 compared to the 26-week period ended August 4, 2007

Comparable Store Sales and Total Revenues

Domestic comparable store sales declined 7.4% for the first half of fiscal 2008 as compared to the first half of fiscal 2007. Sears Domestic comparable store sales declined 8.2% for the first half of fiscal 2008 while Kmart comparable store sales declined 6.3% for the first half of fiscal 2008. We experienced lower comparable store sales across most merchandise categories and formats at both Kmart and Sears Domestic for the first half of

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fiscal 2008. For the first half of fiscal 2008, declines continue to be driven by categories directly impacted by housing market conditions (including home appliance, lawn and garden, and most notably tools at Sears Domestic), and the increased costs of consumer staples, such as food and gas, which decrease consumers' discretionary spending. These declines continue to be partially offset by sales increases within home electronics, most notably at Sears Domestic.

For the first half of fiscal 2008, total revenues declined \$1.2 billion, or 4.9%, to \$22.8 billion, as compared to \$24.0 billion for the first half of fiscal 2007. The first half decline primarily reflects the above-noted impact of lower comparable store sales at Sears Domestic and Kmart, partially offset by sales increases at Sears Canada of \$227 million, primarily reflecting the effects of foreign currency exchange rates. Given that we do not expect any significant near-term improvement in the overall retail environment, we believe that our sales will likely continue to be pressured by the above-noted unfavorable economic factors for the balance of fiscal 2008.

Gross Margin

For the first half of fiscal 2008, we generated \$6.1 billion in total gross margin, as compared to \$6.7 billion in the first half of fiscal 2007. The total decline was made up of declines at Kmart and Sears Domestic of \$200 million and \$453 million, respectively, partially offset by an increase at Sears Canada of \$97 million. As noted above, the reductions reflect the negative gross margin impact of lower overall sales, as well as a decline in our domestic gross margin rate, somewhat offset by an increase in the gross margin rate at Sears Canada. As a percentage of total revenues, our gross margin rate declined by 100 basis points to 26.9% in the first half of fiscal 2008, as compared to 27.9% for the first half of fiscal 2007.

Reduced leverage of buying and occupancy costs, given lower overall sales levels in fiscal 2008, accounted for approximately 0.2% of the total decline in our gross margin rate for the first half. The remaining 0.8% decline was attributable to declines in gross margin rates across a number of merchandise categories at both Kmart and Sears Domestic, with the most significant overall decline being recorded at Sears Domestic. Sears Domestic's gross margin rate declined 140 basis points to 28.5% in the first half of fiscal 2008, as compared to 29.9% for the first half of fiscal 2007, while Kmart's gross margin rate declined 100 basis points to 23.1%. The rate declined within both segments due to increased markdown activity as a result of the intense competition for consumer business. Given that we do not expect any significant near-term improvement in the overall retail environment, which, in addition to the above noted economic factors, includes increasing commodity price pressures faced by our vendors, we believe that our margins will likely continue to be pressured for the balance of fiscal 2008.

Selling and Administrative Expenses

For the first half of fiscal 2008, our selling and administrative expense rate was 24.1% as compared to 22.7% for the first half of fiscal 2007. The current year rate, in part, reflects the positive impact of the reversal of a \$62 million reserve because of a favorable verdict in connection with a pre-Merger legal matter concerning Sears' redemption of certain bonds in 2004. The prior year rate, in part, reflects the net favorable impact of certain significant items recorded within selling and administrative expenses in fiscal 2007, including the \$30 million gain related to a legal settlement, \$27 million curtailment gain recorded in connection with changes made to Sears Canada's benefit plans and the \$18 million gain related to insurance recoveries for certain Sears property damaged by hurricanes during fiscal 2005. Excluding these items, selling and administrative expenses increased \$50 million as compared to first half last year.

The \$50 million increase in selling and administrative expense reflects higher marketing and display costs as well as an increase at Sears Canada of \$87 million (mainly related to the impact of foreign currency fluctuations). These increases were partially offset by a decrease in payroll expenses. The higher marketing costs are attributable to a reallocation of our annual marketing spend to the first half of 2008, and in particular to the first quarter of 2008, as compared to those allocated during the same period in fiscal 2007.

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SEARS HOLDINGS CORPORATION

13 and 26 Weeks Ended August 2, 2008 and August 4, 2007

Operating Income

For the first half of fiscal 2008, we reported operating income of \$179 million, as compared to operating income of \$741 million in the first half of fiscal 2007, mainly due to lower gross margin dollars generated at both Kmart and Sears Domestic. As noted above, in addition to the decline in gross margin we also had an increase in selling and administrative expenses for the first half of 2008. These items were partially offset by a decline in depreciation and amortization expense of \$29 million, primarily attributable to property and equipment becoming fully depreciated during the first half of the year, thereby decreasing our depreciable asset base.

Interest and Investment Income

We earned \$31 million in interest and investment income for the first half of fiscal 2008, as compared to \$82 million for the first half of fiscal 2007. Interest and investment income for the first half of fiscal 2008 is mainly comprised of a dividend of \$10 million from our cost method investment in Sears Mexico and interest income of \$16 million. Interest and investment income for the first half of fiscal 2007 was mainly comprised of a dividend of \$20 million from our cost method investment in Sears Mexico and interest income of \$73 million, partially offset by investment losses of \$21 million on total return swaps outstanding during the 26-week period ended August 4, 2007. There were no total return swaps outstanding as of or during the 26-week period ended August 2, 2008. The decrease in interest income in the first half of fiscal 2008 was primarily due to reduced cash and cash equivalent balances.

Interest Expense

We incurred \$131 million in interest expense during the first half of fiscal 2008, as compared to \$144 million in the first half of last year. The reduction was attributable to lower average borrowings outstanding during the first half of the year in 2008.

Other Income / Loss

Other income / loss is primarily comprised of bankruptcy-related recoveries. A total of \$18 million in bankruptcy-related recoveries were recorded in the first half of fiscal 2007. Bankruptcy-related recoveries represent amounts collected from vendors who had received cash payment for pre-petition obligations. See Note 6 to the Condensed Consolidated Financial Statements for further information on bankruptcy claims resolution.

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The following discussion of our business segment results is organized into three segments: Kmart, Sears Domestic and Sears Canada.

Kmart

Kmart results and key statistics were as follows:

| Kmart <i>millions, except number of stores</i> | 13 Weeks Ended | | 26 Weeks Ended | |
|---|---------------------------|---------------------------|---------------------------|---------------------------|
| | August 2, 2008 | August 4, 2007 | August 2, 2008 | August 4, 2007 |
| Merchandise sales and services | \$ 4,005 | \$ 4,228 | \$ 7,738 | \$ 8,243 |
| Cost of sales, buying and occupancy | 3,087 | 3,203 | 5,953 | 6,258 |
| Gross margin dollars | 918 | 1,025 | 1,785 | 1,985 |
| <i>Gross margin rate</i> | <i>22.9%</i> | <i>24.2%</i> | <i>23.1%</i> | <i>24.1%</i> |
| Selling and administrative | 863 | 870 | 1,719 | 1,710 |
| <i>Selling and administrative expense as a percentage of total revenues</i> | <i>21.5%</i> | <i>20.6%</i> | <i>22.2%</i> | <i>20.7%</i> |
| Depreciation and amortization | 34 | 27 | 67 | 53 |
| Gain on sales of assets | (1) | | (2) | (1) |
| Total costs and expenses | 3,983 | 4,100 | 7,737 | 8,020 |
| Operating income | \$ 22 | \$ 128 | \$ 1 | \$ 223 |
| Number of stores | | | 1,382 | 1,388 |

13-week period ended August 2, 2008 compared to the 13-week period ended August 4, 2007

Comparable Store Sales and Total Revenues

For the quarter, Kmart's comparable store sales and total sales declined 5.6% and 5.3%, respectively. Kmart experienced lower transaction volumes across most merchandise categories. For the quarter, comparable store sales declines were driven by declines recorded within soft home, hardware, including tools, jewelry, food and consumables, and drugstore. These declines were partially offset by comparable store sales increases in home entertainment. We believe the overall decline in comparable store sales reflects both increased competition, as well as the negative impact of certain external factors, as noted above in the discussion of consolidated results. The decline in the food and consumables category relates mainly to a shift in our promotional strategy in this category in the second quarter of fiscal 2008. The decline in total revenues as compared to the second quarter of fiscal 2007 primarily reflects the impact of lower comparable store sales.

Gross Margin

For the quarter, Kmart generated \$918 million in total gross margin in fiscal 2008, as compared to \$1.0 billion in the second quarter of fiscal 2007, with the decline reflecting the negative gross margin impact of lower overall sales, as well as a decline in Kmart's gross margin rate. For the quarter, Kmart's gross margin rate was 22.9% in fiscal 2008, as compared to 24.2% for the second quarter of fiscal 2007, a decline of 1.3%. Reduced leverage of buying and occupancy costs, given lower overall sales levels, accounted for approximately 0.5% of the total 1.3% decline, with the remaining 0.8% decline attributable to gross margin rate declines across a number of merchandise categories. As noted above, Kmart's gross margin rate decreases are mainly related to increased markdown activity taken to clear seasonal merchandise, as well as the intense competition for consumer business.

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SEARS HOLDINGS CORPORATION

13 and 26 Weeks Ended August 2, 2008 and August 4, 2007

Selling and Administrative Expenses

For the quarter, Kmart's selling and administrative expense rate was 21.5% in fiscal 2008, as compared to 20.6% for the second quarter of fiscal 2007. While total selling and administrative expenses decreased \$7 million as compared to the second quarter last year, the selling and administrative expense rate increased primarily as a result of lower expense leverage given lower overall sales results.

Operating Income

For the quarter, Kmart recorded operating income of \$22 million in fiscal 2008, as compared to operating income of \$128 million in the second quarter of fiscal 2007, a decline of \$106 million. As discussed above, the second quarter decline primarily reflects the negative gross margin impact of lower sales levels, as well as a decline in Kmart's gross margin rate for the second quarter.

26-week period ended August 2, 2008 compared to the 26-week period ended August 4, 2007

Comparable Store Sales and Total Revenues

For the first half of fiscal 2008, Kmart's comparable store sales and total sales declined 6.3% and 6.1%, respectively. Kmart experienced lower transaction volumes across most merchandise categories. For the first half of the year, comparable store sales declines were driven by declines within hardware, lawn and garden, jewelry, food and consumables and drugstore. These declines were partially offset by comparable store sales increases in home entertainment. We believe the overall decline in comparable store sales reflects both increased competition, as well as the negative impact of certain external factors, as noted above in the discussion of consolidated results. The decline in the food and consumables category relates mainly to a shift in our promotional strategy in this category in fiscal 2008.

The decline in total revenues as compared to the second quarter of fiscal 2007 primarily reflects the impact of lower comparable store sales. Given that we do not expect any significant near-term improvement in the overall retail environment, we believe that our sales will likely continue to be pressured by the above-noted unfavorable economic factors for the balance of fiscal 2008.

Gross Margin

For the first half of fiscal 2008, Kmart generated \$1.8 billion in total gross margin, as compared to \$2.0 billion in the first half of fiscal 2007, with the decline reflecting the negative gross margin impact of lower overall sales, as well as a decline in Kmart's gross margin rate. For the first half of fiscal 2008, Kmart's gross margin rate was 23.1%, as compared to 24.1% for the first half of fiscal 2007, a decline of 100 basis points.

Reduced leverage of buying and occupancy costs, given lower overall sales levels, accounted for approximately 0.5% of the total decline, with the remaining 0.5% decline attributable to gross margin rate declines across a number of merchandise categories. As noted above, Kmart's gross margin rate decreases are mainly related to increased markdown activity taken to clear seasonal merchandise, as well as the intense competition for consumer business. Similar to sales declines noted above, we believe that our margins will likely continue to be pressured by the above-noted unfavorable economic factors for the balance of fiscal 2008.

Selling and Administrative Expenses

For the first half of fiscal 2008, Kmart's selling and administrative expense rate was 22.2%, as compared to 20.7% for the first half of fiscal 2007. The selling and administrative expense rate for fiscal 2007 included a \$30 million legal settlement gain received in relation to a contract dispute. Excluding this gain, Kmart's selling and

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administrative expense rate was 21.1% for the first half of fiscal 2007. Total selling and administrative expenses increased \$9 million for the first half of the year, mainly as the result of the aforementioned legal settlement gain received in the first half of fiscal 2007. The current year selling and administrative rate increased, primarily reflecting lower expense leverage resulting from lower overall sales levels.

Operating Income

For the first half of fiscal 2008, Kmart recorded \$1 million of operating income, as compared to operating income of \$223 million in the first half of fiscal 2007, a decline of \$222 million. As discussed above, the first half decline primarily reflects the negative gross margin impact of lower sales levels, as well as a decline in Kmart's gross margin rate for the first half.

Sears Domestic

Sears Domestic results and key statistics were as follows:

| Sears Domestic <i>millions, except number of stores</i> | 13 Weeks Ended | | 26 Weeks Ended | |
|---|---------------------------|---------------------------|---------------------------|---------------------------|
| | August 2, 2008 | August 4, 2007 | August 2, 2008 | August 4, 2007 |
| Merchandise sales and services | \$ 6,367 | \$ 6,706 | \$ 12,467 | \$ 13,366 |
| Cost of sales, buying and occupancy | 4,590 | 4,736 | 8,919 | 9,365 |
| Gross margin dollars | 1,777 | 1,970 | 3,548 | 4,001 |
| <i>Gross margin rate</i> | 27.9% | 29.4% | 28.5% | 29.9% |
| Selling and administrative | 1,524 | 1,633 | 3,178 | 3,211 |
| <i>Selling and administrative expense as a percentage of total revenues</i> | 23.9% | 24.4% | 25.5% | 24.0% |
| Depreciation and amortization | 181 | 202 | 364 | 408 |
| Gain on sales of assets | (5) | (2) | (4) | (1) |
| Total costs and expenses | 6,290 | 6,569 | 12,457 | 12,983 |
| Operating income | \$ 77 | \$ 137 | \$ 10 | \$ 383 |
| Number of : | | | | |
| Full-line Stores ⁽¹⁾ | | | 933 | 934 |
| Specialty Stores | | | 1,177 | 1,111 |
| Total Domestic Sears Stores | | | 2,110 | 2,045 |

⁽¹⁾ The period ended August 2, 2008 includes 858 Full-line stores and 75 Sears Essentials/Grand stores;
The period ended August 4, 2007 includes 860 Full-line stores and 74 Sears Essentials/Grand stores

13-week period ended August 2, 2008 compared to the 13-week period ended August 4, 2007*Comparable Store Sales and Total Revenues*

For the quarter, Sears Domestic's comparable store sales and total sales declined 6.7% and 5.1%, respectively. Comparable store sales declines were driven by declines recorded in intimate apparel, jewelry, appliances, and most notably tools. As noted previously, comparable store sales continue to decline in categories directly impacted by housing market conditions and the increased costs of consumer staples, such as food and gas. Decreased sales performance within these areas was partially offset by comparable store sales increases within Sears Domestic's home

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electronics business for the second quarter of fiscal 2008, primarily reflecting continued market demand for flat-panel televisions. The decline in total revenues as compared to the second quarter of fiscal 2007 primarily reflects the impact of lower comparable store sales.

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SEARS HOLDINGS CORPORATION

13 and 26 Weeks Ended August 2, 2008 and August 4, 2007

Gross Margin

For the quarter, Sears Domestic generated \$1.8 billion in total gross margin in fiscal 2008, as compared to \$2.0 billion in the second quarter of fiscal 2007, with the decline primarily reflecting the negative margin impact of lower overall sales levels, as well as a decline in Sears Domestic's gross margin rate for the quarter. Sears Domestic's gross margin rate was 27.9% during the second quarter of 2008, as compared to 29.4% in the second quarter of fiscal 2007, a decline of 150 basis points.

Reduced leverage of buying and occupancy costs, given lower overall sales levels, accounted for approximately 0.2% of the total decline, with the remaining 1.3% decline attributable to gross margin rate declines across a number of merchandise categories. As noted above, gross margin rate decreases are mainly related to increased markdown activity taken to clear seasonal merchandise, as well as the intense competition for consumer business. Gross margin rate was also reduced as a result of a \$36 million increase in inventory reserves over the reserve for the comparable period last year primarily attributable to the reset of the Sears home electronics department and transition to newer products.

Selling and Administrative Expenses

For the quarter, Sears Domestic's selling and administrative expense rate was 23.9% in fiscal 2008, as compared to 24.4% for the second quarter of fiscal 2007. The current year rate, in part, reflects the positive impact of the reversal of a \$62 million reserve because of a favorable verdict in connection with a pre-Merger legal matter concerning Sears' redemption of certain bonds in 2004, as well as insurance proceeds of \$23 million related to a Sears, Roebuck and Co. matter from March 2000. Excluding these items, selling and administrative expenses decreased \$24 million as compared to the second quarter last year, and our selling and administrative expense rate would have been 25.3%. The selling and administrative expense rate increase is primarily a result of lower expense leverage given lower overall sales results. The decline in selling and administrative expenses for the second quarter of 2008 as compared to the second quarter of 2007 is primarily due to a decrease in advertising, display and payroll expenses.

Operating Income

For the second quarter in fiscal 2008, Sears Domestic recorded operating income of \$77 million, as compared to operating income of \$137 million in the second quarter of fiscal 2007, a decline of \$60 million. The decrease primarily reflects lower total gross margin dollars generated as a result of lower overall sales levels, partially offset by a decline in selling and administrative expenses, as well as a decline in depreciation and amortization expense of \$21 million. The decrease in depreciation and amortization expense is primarily attributable to property and equipment becoming fully depreciated during the quarter, thereby decreasing our depreciable asset base.

26-week period ended August 2, 2008 compared to the 26-week period ended August 4, 2007

Comparable Store Sales and Total Revenues

For the first half of fiscal 2008, Sears Domestic's comparable store sales and total sales declined 8.2% and 6.7%, respectively. Comparable store sales declines were driven by declines recorded in intimate apparel, jewelry, appliances, lawn and garden, and most notably tools. We believe these declines in comparable store sales are a result of the current housing market conditions and the increased costs of consumer staples, such as food and gas. Decreased sales performance within these areas was partially offset by comparable store sales increases within Sears Domestic's home electronics business for the first half of fiscal 2008, primarily reflecting continued market demand for flat-panel televisions.

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SEARS HOLDINGS CORPORATION

13 and 26 Weeks Ended August 2, 2008 and August 4, 2007

The decline in total revenues in the first half of 2008 as compared to the first half of fiscal 2007 primarily reflects the above-noted impact of lower comparable store sales. Given that we do not expect any significant near-term improvement in the overall retail environment, we believe that our sales will likely continue to be pressured by the above-noted unfavorable economic factors for the balance of fiscal 2008.

Gross Margin

For the first half of fiscal 2008, Sears Domestic generated \$3.5 billion in total gross margin, as compared to \$4.0 billion in the first half of fiscal 2007, with the decline primarily reflecting the negative margin impact of lower overall sales levels, as well as a decline in Sears Domestic's gross margin rate for the quarter. Sears Domestic's gross margin rate was 28.5% during the first half of 2008, as compared to 29.9% in the first half of fiscal 2007, a decline of 140 basis points.

Reduced leverage of buying and occupancy costs, given lower overall sales levels, accounted for approximately 0.1% of the total decline, with the remaining 1.3% decline attributable to gross margin rate declines across a number of merchandise categories. As noted previously, gross margin rate decreases are mainly related to increased markdown activity taken to clear seasonal merchandise, as well as the intense competition for consumer business. The gross margin rate decline for Sears Domestic is also partially due to an increase in lower margin home electronics sales, as previously noted. Similar to the sales declines noted above, we believe that our margins will likely continue to be pressured by the above-noted unfavorable economic factors for the balance of fiscal 2008.

Selling and Administrative Expenses

For the first half of fiscal 2008, Sears Domestic's selling and administrative expense rate was 25.5%, as compared to 24.0% for the first half of fiscal 2007. The current year rate, in part, reflects the positive impact of the reversal of a \$62 million reserve because of a favorable verdict in connection with a pre-Merger legal matter concerning Sears' redemption of certain bonds in 2004. The prior year rate includes a gain of \$18 million for insurance recoveries received on claims filed for certain property damaged by hurricanes during fiscal 2005. Excluding these items, selling and administrative expenses increased \$11 million in the first half of fiscal 2008 as compared to the same period in fiscal 2007. The increase in the selling and administrative expense rate for the first half of fiscal 2008 reflects the impact of lower expense leverage given lower overall sales results.

Operating Income

For the first half of fiscal 2008, Sears Domestic recorded operating income of \$10 million, as compared to operating income of \$383 million in the first half of fiscal 2007, a decline of \$373 million. The decrease primarily reflects lower total gross margin dollars generated as a result of lower overall sales levels and a decline in gross margin rate, partially offset by a \$33 million decrease in selling and administrative expenses and a \$44 million decline in depreciation and amortization expense. The decrease in depreciation and amortization expense is primarily attributable to property and equipment becoming fully depreciated during the first half of the year.

Sears Canada

Sears Canada, a consolidated, 70%-owned subsidiary of Sears, conducts similar retail operations as Sears Domestic. During the fourth quarter of 2007, Sears Canada changed its fiscal year end from the Saturday nearest December 31st to the Saturday nearest January 31st. This change has been retrospectively applied to prior year amounts as required by SFAS No. 154, Accounting Changes and Error Corrections A Replacement of APB Opinion No. 20 and SFAS No. 3. See Note 2 of Notes to Condensed Consolidated Financial Statements for further explanation of this change.

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Sears Canada results and key statistics were as follows:

| Sears Canada <i>millions, except number of stores</i> | 13 Weeks Ended | | 26 Weeks Ended | |
|---|---------------------------|---------------------------|---------------------------|---------------------------|
| | August 2, 2008 | August 4, 2007 | August 2, 2008 | August 4, 2007 |
| Merchandise sales and services | \$ 1,390 | \$ 1,326 | \$ 2,625 | \$ 2,398 |
| Cost of sales, buying and occupancy | 963 | 930 | 1,813 | 1,683 |
| Gross margin dollars | 427 | 396 | 812 | 715 |
| <i>Gross margin rate</i> | <i>30.7%</i> | <i>29.9%</i> | <i>30.9%</i> | <i>29.8%</i> |
| Selling and administrative | 307 | 299 | 612 | 525 |
| <i>Selling and administrative expense as a percentage of total revenues</i> | <i>22.1%</i> | <i>22.5%</i> | <i>23.3%</i> | <i>21.9%</i> |
| Depreciation and amortization | 32 | 33 | 64 | 63 |
| Gain on sales of assets | | (3) | (32) | (8) |
| Total costs and expenses | 1,302 | 1,259 | 2,457 | 2,263 |
| Operating income | \$ 88 | \$ 67 | \$ 168 | \$ 135 |
| Number of : | | | | |
| Full-line Stores | | | 122 | 123 |
| Specialty Stores | | | 260 | 253 |
| Total Sears Canada Stores | | | 382 | 376 |

13-week period ended August 2, 2008 compared to the 13-week period ended August 4, 2007*Total Revenues*

Sears Canada's total revenues increased 4.8% for the second quarter of fiscal 2008 as compared to the same period last year. The increase in total revenues primarily reflects the impact of favorable exchange rates, as the Canadian dollar strengthened over prior year levels in fiscal 2008. Excluding the impact of foreign-exchange rate changes, sales declined for the quarter by \$15 million Canadian.

Gross Margin

For the quarter, Sears Canada's gross margin rate was 30.7% in fiscal 2008, as compared to 29.9% in the second quarter of fiscal 2007. Total gross margin dollars increased \$31 million for the second quarter of fiscal 2008 as compared to the same period last year. Excluding the impact of foreign currency, gross margin increased \$8 million Canadian and was primarily due to improved inventory management, resulting in less shrinkage, during the second quarter of 2008.

Selling and Administrative Expenses

For the quarter, Sears Canada's selling and administrative expense rate was 22.1% in fiscal 2008, as compared to 22.5% in the second quarter of fiscal 2007. The selling and administrative expense rate decreased in U.S. dollar terms mainly as a result of increased expense leverage given increased sales in the second quarter of 2008. Excluding the impact of foreign currency, selling and administrative expenses decreased \$10 million Canadian.

Operating Income

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Sears Canada's operating income increased \$21 million for the second quarter of fiscal 2008 with the increase reflecting the above noted increases and decreases in sales, gross margin and selling and administrative expenses.

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Sears Canada's total revenues increased 9.5% to \$2.6 billion for the first half of fiscal 2008 as compared to the same period last year. The increase in total revenues primarily reflects the impact of favorable exchange rates, as the Canadian dollar continued to strengthen in fiscal 2008. Excluding the impact of foreign-exchange rate changes, sales declined for the first half of the year by \$21 million Canadian.

Gross Margin

For the first half, Sears Canada's gross margin rate was 30.9% in fiscal 2008, as compared to 29.8% in the first half of fiscal 2007. Total gross margin dollars increased \$97 million for the second quarter of fiscal 2008 as compared to the same period last year. Excluding the impact of foreign currency, gross margin increased \$23 million Canadian and was primarily due to improved inventory management, resulting in less shrinkage, during the first half of 2008.

Selling and Administrative Expenses

For the first half of fiscal 2008, Sears Canada's selling and administrative expense rate was 23.3%, as compared to 21.9% in the first half of fiscal 2007. For the first half, the selling and administrative expense rate in fiscal 2007 was favorably impacted by a \$27 million curtailment gain recorded in connection with changes made to Sears Canada's post-retirement benefit plans. In February 2007, Sears Canada announced amendments to its post-retirement programs including introduction of a defined contribution component to its pension plan and the discontinuation of retiree medical, dental and life benefits for those Sears Canada associates who will not have achieved eligibility for such benefits by December 31, 2008. Excluding the impact of this item, the selling and administrative expense rate was 23.0% for the first half of fiscal 2007.

Operating Income

Sears Canada's operating income increased \$33 million for the first half of fiscal 2008 with the increase reflecting the above noted increases and decreases in sales, gross margin and selling and administrative expenses. As noted above, selling and administrative expenses benefited from a curtailment gain of \$27 million in the first half of fiscal 2007. In addition, Sears Canada benefited from a \$32 million gain on the sale of its Calgary downtown full-line store during the first half of 2008.

ANALYSIS OF CONSOLIDATED FINANCIAL CONDITION**Cash and Cash Equivalents**

Our cash and cash equivalents include all highly liquid investments with original maturities of three months or less at the date of purchase. Our cash and cash equivalents balances as of August 2, 2008, August 4, 2007 and February 2, 2008 are detailed in the following table.

| <i>millions</i> | August 2, 2008 | August 4, 2007 | February 2, 2008 |
|--|---------------------------|---------------------------|-----------------------------|
| <u>Domestic</u> | | | |
| Cash and equivalents | \$ 579 | \$ 1,083 | \$ 595 |
| Cash posted as collateral | 14 | 799 | 29 |
| Credit card deposits in transit | 178 | 172 | 119 |
| Total domestic cash and cash equivalents | 771 | 2,054 | 743 |

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| | | | |
|---------------------------------|----------|----------|----------|
| Sears Canada | 763 | 580 | 879 |
| Total cash and cash equivalents | \$ 1,534 | \$ 2,634 | \$ 1,622 |

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SEARS HOLDINGS CORPORATION

13 and 26 Weeks Ended August 2, 2008 and August 4, 2007

We had cash and cash equivalents of \$1.5 billion at August 2, 2008 as compared to \$2.6 billion at August 4, 2007 and \$1.6 billion at February 2, 2008. During the first two quarters of 2008, significant uses of cash included share repurchases of \$477 million, capital expenditures of \$277 million and long-term debt repayments of \$179 million. These amounts were partially offset by an \$812 million increase in short-term borrowings, primarily through borrowing on our \$4 billion credit facility as further detailed in the Financing Activities section below.

At various times, we have posted cash collateral for certain outstanding letters of credit and self-insurance programs. Such cash collateral is classified within cash and cash equivalents given its ready availability to us as we have the ability to substitute letters of credit at any time for this cash collateral.

Credit card deposits in transit include deposits in-transit from banks for payments related to third-party credit card and debit card transactions.

We classify outstanding checks in excess of funds on deposit within other current liabilities and reduce cash and cash equivalents when these checks clear the bank on which they were drawn. Outstanding checks in excess of funds on deposit were \$261 million, \$330 million and \$405 million as of August 2, 2008, August 4, 2007 and February 2, 2008, respectively.

Operating Activities

Holdings used approximately \$2 million for operations during the first half of fiscal 2008. For the first half of fiscal 2007, our operations provided us with \$512 million. Our primary source of operating cash flows is the sale of goods and services to customers, while the primary use of cash in operations is to fund the purchase of merchandise inventories. The decrease in operating cash flows in the first half of fiscal 2008 as compared to the same period in the prior year is mainly a result of cash used for operating liabilities of \$563 million in fiscal 2008, including a reduction in outstanding checks of \$144 million, pension contributions of \$116 million and change in accrued liabilities for advertising of \$65 million.

Merchandise inventories at August 2, 2008 were \$9.8 billion, as compared to \$10.2 billion at August 4, 2007. Merchandise payables were \$3.5 billion at August 2, 2008, as compared to \$3.4 billion as of August 4, 2007. Domestic inventory declined from \$9.4 billion at August 4, 2007 to \$8.9 billion at August 2, 2008 reflecting the effectiveness of our efforts to control inventory levels. Sears Canada's inventory levels increased from \$801 million at August 4, 2007 to \$880 million at August 2, 2008. The increase in Sears Canada's inventory is partially due to the change in exchange rates. As we expect difficult economic conditions to persist in the near term, we intend to manage our inventories throughout the year with the goal of further reducing our domestic merchandise inventories to better align current levels with expected sales.

Investing Activities

For the first half of fiscal 2008, we used \$277 million of cash for capital expenditures as compared to \$278 million used during the first half of fiscal 2007. In addition, we received \$75 million of proceeds from sales of property and investments in the first half of fiscal 2008, which was mainly related to the sale of Sears Canada's Calgary downtown full-line store. In the first half of fiscal 2007, \$60 million of collateral was returned to us related to our investments in total return swaps. There were no total return swaps outstanding as of or during the period ended August 2, 2008.

Financing Activities

During the 26-week period ended August 2, 2008, we repurchased 6.0 million of our common shares at a total cost of \$477 million under our share repurchase program. As of August 2, 2008, we had \$206 million of remaining authorization under our common share repurchase program. The share repurchase program, authorized

Table of Contents**SEARS HOLDINGS CORPORATION****13 and 26 Weeks Ended August 2, 2008 and August 4, 2007**

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. During the 26-week period ended August 4, 2007, we repurchased 9.6 million of our common shares at a total cost of \$1.5 billion under our share repurchase program.

During the first half of fiscal 2008, we utilized a portion of the total availability under our \$4.0 billion Credit Agreement to meet seasonal working capital needs while, at the same time, continuing to invest in our stores and repurchase our stock. Accordingly, as of August 2, 2008, we had \$800 million in secured line of credit borrowings outstanding under the \$4.0 billion Credit Agreement. The entire \$800 million in Credit Agreement borrowings are expected to be repaid within the next twelve months, and therefore, have been classified within short-term borrowings on our condensed consolidated balance sheet as of August 2, 2008.

Our outstanding borrowings as of August 2, 2008, August 4, 2007 and February 2, 2008 were as follows:

| <i>millions</i> | August 2, 2008 | August 4, 2007 | February 2, 2008 |
|--|---------------------------|---------------------------|-----------------------------|
| Short-term borrowings: | | | |
| Unsecured commercial paper | \$ 174 | \$ 80 | \$ 145 |
| Secured borrowings | 800 | | 17 |
| Long-term debt, including current portion: | | | |
| Notes and debentures outstanding | 1,935 | 2,423 | 2,099 |
| Capitalized lease obligations | 705 | 774 | 749 |
| Total borrowings | \$ 3,614 | \$ 3,277 | \$ 3,010 |

Liquidity

Our primary need for liquidity is to fund seasonal working capital requirements of our retail businesses, capital expenditures and for general corporate purposes. We believe that these needs will be adequately funded by our operating cash flows, credit terms from vendors, current balances in cash and cash equivalents and borrowings under our revolving credit facilities. While we expect to use these facilities as our primary funding source, we may also access the public debt markets on an opportunistic basis. Additionally, we may from time to time consider selective strategic transactions to create value and improve performance, which may include acquisitions, dispositions, restructurings, joint ventures and partnerships. Transactions of these types may result in material proceeds or cash outlays. See our Annual Report on Form 10-K for the fiscal year ended February 2, 2008 for additional information regarding our sources of liquidity.

Debt Ratings

The ratings of our domestic debt securities as of August 2, 2008 appear in the table below:

| | Moody's Investors Service | Standard & Poor's Ratings Services | Fitch Ratings |
|----------------------------|--|---|--------------------------|
| Unsecured long-term debt | Ba2 | BB | BB |
| Unsecured commercial paper | NP | B-2 | B |

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SEARS HOLDINGS CORPORATION

13 and 26 Weeks Ended August 2, 2008 and August 4, 2007

Credit Agreement

We have a \$4.0 billion, five-year credit agreement (the *Credit Agreement*) in place as a funding source for general corporate purposes, which includes a \$1.5 billion letter of credit sublimit. The Credit Agreement, which has an expiration date of March 2010, is a revolving credit facility under which SRAC and Kmart Corporation are the borrowers. The Credit Agreement is guaranteed by Holdings and certain of our direct and indirect subsidiaries and is secured by a first lien on our domestic inventory, credit card accounts receivable and the proceeds thereof. Availability under the Credit Agreement is determined pursuant to a borrowing base formula, based on domestic inventory levels, subject to certain limitations. As of August 2, 2008, we had \$800 million of borrowings and \$1.0 billion of letters of credit outstanding under the Credit Agreement with \$2.2 billion of availability remaining under the Credit Agreement. The \$800 million in borrowings, borrowed in the first half of fiscal 2008, are classified within short-term borrowings on our condensed consolidated balance sheet as of August 2, 2008 as we intend to repay the entire amount within the next 12 months. The Credit Agreement does not contain provisions that would restrict borrowings or letter of credit issuances based on material adverse changes or credit ratings.

The majority of the letters of credit outstanding under the Credit Agreement, and Letter of Credit Agreement discussed below, are used to provide collateral for our insurance programs.

Letter of Credit Agreement

In July 2008, we amended our secured letter of credit agreement with Bank of America, N.A. (the *LC Agreement*). As amended, the LC Agreement provides for a commitment amount of up to \$5 million and is scheduled to expire in July 2009. The LC Agreement continues to provide solely for the issuance of letters of credit and does not provide for direct borrowings. At August 2, 2008, \$2 million in letters of credit were outstanding under the LC Agreement and we had \$2 million posted as collateral under the LC Agreement.

Orchard Supply Hardware LLC (OSH LLC) Credit Agreement

In fiscal 2005, our subsidiary 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 sublimit. 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 accounts and credit card accounts receivable, subject to certain limitations. As of August 2, 2008, there were no borrowings outstanding under the OSH LLC Facility and \$2 million of letters of credit outstanding.

Recent Accounting Pronouncements

In December 2007, the FASB issued SFAS No. 141(R), *Business Combinations* which revised SFAS No. 141, *Business Combinations*. SFAS No. 141(R) is effective for fiscal years beginning on or after December 15, 2008, with early adoption prohibited. SFAS No. 141(R) will have a significant impact on the accounting for transaction costs and 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 a previously acquired entity's 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 have not yet assessed the impact this statement will have on our financial statements.

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13 and 26 Weeks Ended August 2, 2008 and August 4, 2007

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements. See Note 4 for further discussion regarding our adoption of SFAS No. 157 in the first quarter of 2008.

In September 2006, the FASB issued SFAS No. 158, Employer's Accounting for Defined Benefit Pension and Other Postretirement Plans, which changes the recognition and disclosure provisions and measurement date requirements for an employer's accounting for defined benefit pension and other postretirement plans. The recognition and disclosure provisions require an employer to (1) recognize the funded status of a benefit plan measured as the difference between plan assets at fair value and the benefit obligation in its statement of financial position, (2) recognize as a component of other comprehensive income (OCI), net of tax, the gains or losses and prior service costs or credits that arise during the period but are not recognized as components of net periodic benefit cost, and (3) disclose in the notes to financial statements certain additional information. SFAS No. 158 does not change the amounts recognized in the income statement as net periodic benefit cost. As required by SFAS No. 158, we adopted the recognition and disclosure provisions of the Statement as of February 3, 2007, and accordingly recognized the funded status of our defined benefit pension and other postretirement plans and provided the required additional disclosures. The adoption of these provisions of SFAS No. 158 did not have any material impact on our consolidated results of operations or cash flows.

As required under the Statement, we will adopt the measurement-date requirements of SFAS No. 158 effective fiscal 2008. Under the measurement-date requirements, an employer is required to measure defined benefit plan assets and obligations as of the date of the employer's fiscal year end. We currently measure our plan assets and obligations as of December 31. We will adopt the change in measurement date by re-measuring plan assets and benefit obligations as of our fiscal year end in fiscal 2008, pursuant to the transition requirements of SFAS No. 158. We are currently evaluating the impact, if any, the adoption of the measurement-date requirements of SFAS No. 158 will have on our financial statements.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities. See Note 4 for further discussion regarding our adoption of SFAS No. 159 in the first quarter of 2008.

In December 2007, the FASB issued SFAS No. 160, Noncontrolling Interests in Consolidated Financial Statements, an amendment of ARB No. 51. SFAS No. 160 is effective for fiscal years beginning on or after December 15, 2008, with early adoption prohibited. Before SFAS No. 160 was issued, limited guidance existed for reporting noncontrolling interests and many companies reported such interest as a liability in its balance sheet under the heading Minority Interest. SFAS No. 160 requires companies to report noncontrolling interests of consolidated subsidiaries as a component of equity in the consolidated statement of financial position. As a result, upon adoption of this Statement, Holdings will reclassify its noncontrolling interest in Sears Canada and OSH (which represents 30% and 19.9% of the subsidiaries' ownership, respectively) from its current classification within the long-term liabilities section of Holdings' condensed consolidated balance sheet to classification within the shareholders' equity section.

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. SFAS No. 161 expands the disclosure requirements of SFAS No. 133 to require entities to make qualitative disclosures regarding objectives and strategies for using derivatives, quantitative disclosures regarding fair value amounts of and gains and losses on derivative instruments, and disclosures regarding credit-risk-related contingent features in derivative instruments. SFAS No. 161 is effective for fiscal years beginning after November 15, 2008 and we plan to adopt this standard beginning in the first quarter of fiscal 2009. As this statement relates only to disclosure requirements, we do not expect it to have a material impact on our financial condition or operating results.

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SEARS HOLDINGS CORPORATION

13 and 26 Weeks Ended August 2, 2008 and August 4, 2007

In May 2008, the FASB issued SFAS No. 162, The Hierarchy of Generally Accepted Accounting Principles. SFAS No. 162 identifies the sources of accounting principles and the framework for selecting the principles used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles in the United States. SFAS No. 162 is effective 60 days following the SEC's approval of the Public Company Accounting Oversight Board amendments to Statement of Auditing Standards Section 411, The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles. We do not expect this statement to have a material impact on our financial condition or operating results.

CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING INFORMATION

Certain statements made in this Quarterly Report on Form 10-Q and in other public announcements by us contain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements are subject to risks and uncertainties that may cause our actual results, performance or achievements to be materially different from any future results, performance or achievements expressed or implied by these forward-looking statements. Forward-looking statements include information concerning our future financial performance, business strategy, plans, goals and objectives. Statements preceded or followed by, or that otherwise include, the words believes, expects, anticipates, intends, estimates, plans, forecast, is likely to and similar expressions or future or conditional verbs such as will, could are generally forward-looking in nature and not historical facts. Such statements are based upon the current beliefs and expectations of Holdings' management and are subject to significant risks and uncertainties. Actual results may differ materially from those set forth in the forward-looking statements.

The following factors, among others, could cause actual results to differ from those set forth in the forward-looking statements: our ability to offer merchandise and services that our customers want, including our proprietary brand products; our ability to successfully implement initiatives to improve inventory management and other capabilities; competitive conditions in the retail and related services industries; the impact of seasonal buying patterns, including seasonal fluctuations due to weather conditions, which are difficult to forecast with certainty; general economic conditions and normal business uncertainty, changes in consumer confidence, tastes, preferences and spending, including the impact of fuel costs and spending patterns, the availability and level of consumer debt, and unanticipated increases in our costs; our dependence on sources outside the United States for significant amounts of our merchandise; our extensive reliance on computer systems to process transactions, summarize results and manage our business; our reliance on third parties to provide us with services in connection with the administration of certain aspects of our business; our ability to properly implement and realize the expected benefits from our new organizational structure and operating model; our ability to attract, motivate and retain key executives and other associates; the outcome of pending and/or future legal proceedings, including product liability claims and bankruptcy claims, including proceedings with respect to which the parties have reached a preliminary settlement; and our ability to successfully invest available capital.

Certain of these and other factors are discussed in more detail in our filings with the Securities and Exchange Commission and the Annual Report on Form 10-K of Sears Holdings Corporation for the fiscal year ended February 2, 2008, which may be accessed through the Commission's website at www.sec.gov.

While we believe that our forecasts and assumptions are reasonable, we caution that actual results may differ materially. We intend the forward-looking statements to speak only as of the time made and does not undertake to update or revise them as more information becomes available.

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SEARS HOLDINGS CORPORATION

13 and 26 Weeks Ended August 2, 2008 and August 4, 2007

Item 3. Quantitative and Qualitative Disclosures about Market Risk

The nature of market risks faced by us at August 2, 2008 is the same as disclosed in our Annual Report on Form 10-K for the year ended February 2, 2008.

Interest Rate Risk

We manage interest rate risk through the use of fixed and variable-rate funding and interest rate derivatives. As of August 2, 2008, we had interest rate derivatives with a notional amount of \$120 million, nominal fair value and a weighted average remaining life of 0.4 years. All debt securities and interest-rate derivative instruments are considered non-trading. As of August 2, 2008, 36% of our debt portfolio was variable rate. Based on the size of this variable rate debt portfolio at August 2, 2008, which totaled approximately \$1.3 billion, an immediate 100 basis point change in interest rates would have affected annual pretax funding costs by \$13 million. These estimates do not take into account the effect on income resulting from invested cash or the returns on assets being funded. These estimates also assume that the variable rate funding portfolio remains constant for an annual period and that the interest rate change occurs at the beginning of the period.

Foreign Currency Risk

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 2, 2008.

Sears Canada mitigates the risk of currency fluctuations on offshore merchandise purchases denominated in U.S. currency by purchasing U.S. dollar denominated forward contracts for a portion of its expected requirements at the time of placement. As of August 2, 2008, the value of these contracts is not material to Holdings' financial condition or results of operations.

Counterparties

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. In certain cases, counterparty risk is also managed through the use of collateral in the form of cash or U.S. government securities.

Item 4. Controls and Procedures

Our management, with the participation of our principal executive officer and principal financial officers, conducted an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act), as of the end of the period covered by this report (the Evaluation Date). Based on this evaluation, the principal executive officer and principal financial officers concluded that, as of the Evaluation Date, our disclosure controls and procedures were effective in ensuring that information required to be disclosed by us in the reports that we file or submit under the Exchange Act (i) is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms and (ii) is accumulated and communicated to our management, including our principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure.

In addition, based on that evaluation, no changes in our internal control over financial reporting have occurred during our last fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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Item 103 of SEC Regulation S-K requires that we disclose legal proceedings to which the Company and a governmental authority is a party and that arise under laws dealing with the discharge of materials into the environment or the protection of the environment, if the proceeding reasonably involves potential monetary sanctions of \$100,000 or more. Disclosure also is required as to any such proceedings known by us to be contemplated by governmental authorities. In that connection, we note that we have received an administrative subpoena from the District Attorney of the County of Ventura, California, seeking information and documents primarily concerning our handling of hazardous waste in Ventura County and in California generally. We are cooperating with California state and county authorities in connection with this matter. In addition, we are a party to administrative actions brought by the California Air Resources Board (CARB) that allege that Kmart sold certain non-food items (windshield wiper fluid and portable fuel containers) that do not comply with applicable regulations. The parties are currently negotiating toward a resolution of this matter.

See Part I, Item 1, Financial Statements Notes to Condensed Consolidated Financial Statements, Note 6 Claims Resolution, and Note 12 Legal Proceedings, for additional information regarding legal proceedings, which information is incorporated herein by this reference.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

The following table provides information about shares of common stock we acquired during the second quarter of fiscal 2008. During the 13 weeks ended August 2, 2008, we repurchased 5.6 million of our common shares at a total cost of \$437 million under our common share repurchase program. As of August 2, 2008, we had \$206 million of remaining authorization under the program.

| | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Program⁽¹⁾ | Average Price Paid per Share for Publicly Announced Program | Approximate Dollar Value of Shares that May Yet Be Purchased Under the Program |
|--------------------------------|---|---|---|--|---|
| May 4, 2008 to May 31, 2008 | 239,158 | \$ 84.50 | 239,158 | \$ 84.50 | |
| June 1, 2008 to July 5, 2008 | 4,444,138 | 79.19 | 4,444,138 | 79.19 | |
| July 6, 2008 to August 2, 2008 | 906,322 | 71.77 | 906,322 | 71.77 | |
| Total | 5,589,618 | \$ 78.22 | 5,589,618 | \$ 78.22 | \$ 206,000,000 |

⁽¹⁾ Our common share repurchase program was initially announced on September 14, 2005 with a total authorization by our Board of Directors of up to \$500 million. Subsequently, we announced that our Board of Directors authorized the repurchase of up to an additional \$500 million of common stock on each of October 14, 2005, April 5, 2006 and September 12, 2006, \$1.0 billion of common stock on July 10, 2007, \$1.5 billion of common stock on August 13, 2007, and \$500 million of common stock on May 29, 2008 for a total authorization since inception of the program of \$5.0 billion. The program has no stated expiration date.

Item 4. Submission of Matters to a Vote of Security Holders

See Part II, Item 4, Submission of Matters to a Vote of Security Holders in our Quarterly Report on Form 10-Q for the quarter ended May 3, 2008 regarding the matters submitted to a vote at our annual meeting of stockholders held on May 5, 2008, which information is incorporated herein by this reference.

Item 6. Exhibits

(a) Exhibits.

An Exhibit Index has been filed as part of this Report on Page E-1.

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SEARS HOLDINGS CORPORATION

SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

August 29, 2008

SEARS HOLDINGS CORPORATION

(Registrant)

By

/s/ WILLIAM K. PHELAN
William K. Phelan

Senior Vice President, Controller and Treasurer

(Principal Accounting Officer and duly

authorized officer of Registrant)

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SEARS HOLDINGS CORPORATION

EXHIBIT INDEX

- 3.1 Restated Certificate of Incorporation (incorporated by reference to Exhibit 3.1 to Registrant's Current Report on Form 8-K, dated March 24, 2005, filed on March 24, 2005 (File No. 000-51217)).
- 3.2 Restated By-Laws (incorporated by reference to Exhibit 3.2 to Registrant's Current Report on Form 8-K, dated March 24, 2005, filed on March 24, 2005 (File No. 000-51217)).
- 10.1 Amendment to Letter from Registrant to J. Miles Reidy relating to employment dated June 27, 2008 (incorporated by reference to Exhibit 10.1 to Registrant's Current Report on Form 8-K, dated June 25, 2008, filed on June 27, 2008 (File No. 000-51217)).
- *31.1 Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- *31.2 Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- *32 Certification of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

* Filed herewith