

SEARS HOLDINGS CORP
Form 10-K
March 15, 2006

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**United States
Securities And Exchange Commission**
Washington, D.C. 20549

FORM 10-K

**For Annual and Transition Reports pursuant to
Section 13 or 15(d) of the Securities Exchange Act of 1934**

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

For the Fiscal Year Ended January 28, 2006

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**

Securities registered pursuant to Section 12(b) of the Act:

Title of each class

Name of Each Exchange on Which Registered

None

Securities registered pursuant to Section 12(g) of the Act:

Common Shares, par value \$0.01 per share

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes No

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.

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Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of the Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer (as defined in Exchange Act Rule 12b-2).

Large accelerated filer Accelerated filer Non-accelerated filer

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

On February 25, 2006, the Registrant had 158,997,881 common shares outstanding. The aggregate market value (based on the closing price of the Registrant's common shares as reported in a summary of composite transactions in *The Wall Street Journal* for stocks quoted on the NASDAQ National Market) of the Registrant's common shares owned by non-affiliates (which are assumed, solely for the purpose of this calculation, to be stockholders other than (i) directors and executive officers of the Registrant and (ii) any person known by the Registrant to beneficially own five percent or more of the Registrant's common shares), as of July 30, 2005 was approximately \$15 billion.

Documents Incorporated By Reference

Part III of this Form 10-K incorporates by reference certain information from the Registrant's proxy statement relating to its Annual Meeting of Stockholders to be held on April 12, 2006 (the "2006 Proxy Statement"), which will be filed with the Securities and Exchange Commission within 120 days after the end of the fiscal year to which this Form 10-K relates.

PART I

Item 1. Business

General

Sears Holdings Corporation ("Holdings" or the "Company") is the parent company of Kmart Holding Corporation ("Kmart") and Sears, Roebuck and Co. ("Sears"). Holdings was formed as a Delaware corporation in 2004 in connection with the merger of Kmart and Sears (the "Merger"). The Merger, completed on March 24, 2005, combined two of America's oldest existing retail entities, both with origins dating to the late 1800s. The Company is a broadline retailer with approximately 2,300 full-line and 1,100 specialty retail stores in the United States operating through Kmart and Sears and approximately 370 full-line and specialty retail stores in Canada operating through Sears Canada Inc. ("Sears Canada"), a 54%-owned subsidiary.

The Merger

The Merger has provided Holdings with an opportunity to significantly improve the earnings and cash flow performance of both Kmart and Sears given the scale of the combined entity. The Merger has also provided a means for leveraging the historical strengths of Kmart and Sears with the goal of making the Company's products, brands and service offerings more responsive to the needs of customers, thereby building long-term, value-added customer relationships.

Sears has a long-standing reputation for offering customers a wide variety of merchandise and related services, with a particular emphasis on a number of strong proprietary brands such as Kenmore, Craftsman, Diehard and Lands' End. Historically, Sears conducted its business primarily using a mall-based format. At the time of the Merger, Sears operated 874 domestic full-line stores mainly located in such on-mall locations. In response to off-mall competitor growth, Sears commenced a strategy prior to the Merger to increase the number of its off-mall stores in order to expand distribution points for its brands, merchandise and services. Kmart, on the other hand, historically used large format, off-mall locations in selling a selection of general merchandise goods. At the time of the Merger, Kmart operated approximately 1,400 off-mall stores and sought to further improve its operational performance by pursuing opportunities to offer customers a differentiated high-quality product selection to distinguish itself from competitors.

With Kmart's approximately 1,400 off-mall locations, Holdings is in a position to offer a greater number of customers an opportunity to purchase Sears products and services outside of Sears' traditional mall-based stores. This increase in distribution points brought about by the Merger provides a more rapid and lower-cost store base growth than Sears would have been able to accomplish on its own. At the same time, the addition of Sears-owned brands and services, including Sears' credit products, to Kmart stores enhances the selection and value proposition offered to Kmart customers and helps to differentiate Kmart from its general merchandise competitors. Furthermore, its combined store base of approximately 2,300 full-line stores places Holdings in a position to compete on a scale larger than that of many of its national competitors.

The scale of the combined enterprise has also generated significant opportunities for realizing cost synergies across a number of areas, including merchandise and non-merchandise purchasing, delivery and distribution and within other selling, general and administrative expense areas. While the Company will continue to operate both the Sears and Kmart store formats in the foreseeable future, many of the functions supporting these formats have been integrated. This integration will continue.

From an accounting perspective, the Merger has been treated as a purchase business combination, with Kmart acquiring Sears. In identifying Kmart as the acquiring entity, the companies took into account the relative share ownership of the Company after the Merger, the composition of the governing body of the combined entity and the designation of certain senior management positions.

Accordingly, the historical financial statements of Kmart serve as the historical financial statements of Holdings, the registrant.

In connection with the Merger, Kmart shareholders received one share of Holdings common stock for each Kmart share owned. In all, approximately 94.9 million shares of Holdings common stock were issued in exchange for all outstanding common stock of Kmart. Sears shareholders were issued an aggregate of 62.2 million shares of Holdings common stock at a total value of approximately \$6.5 billion (based on the average closing price of \$104.33 of Kmart's common stock during the period from November 15, 2004 through November 19, 2004, two business days before and after the date the Merger was announced). In addition, approximately \$5.4 billion in cash was paid in consideration for (i) all outstanding shares of common stock of Sears, based upon the proration provisions of the agreement pursuant to which the Merger was effected, and (ii) all outstanding stock options of Sears. Including transaction costs of approximately \$18 million, the total consideration paid was approximately \$11.9 billion.

Additional information concerning the Merger is contained in Note 2 of Notes to Consolidated Financial Statements.

Bankruptcy of Kmart Corporation

Kmart Corporation (the "Predecessor Company") is a predecessor operating company of Kmart (the "Successor Company"). In January 2002, the Predecessor Company and 37 of its U.S. subsidiaries (collectively, the "Debtors") filed voluntary petitions for reorganization under Chapter 11 of the federal bankruptcy laws ("Chapter 11"). The Debtors decided to seek bankruptcy reorganization based upon a rapid decline in their liquidity resulting from below-plan sales and earnings performance in the fourth quarter of fiscal 2001, the evaporation of the surety bond market, an erosion of supplier confidence, intense competition and unsuccessful sales and marketing initiatives, as well as the continued recession and capital market volatility in existence at that time. The Predecessor Company utilized Chapter 11 to strengthen its balance sheet and reduce debt, focus its store portfolio on the most productive locations and terminate leases for closed stores, develop a more efficient organization and lower overall operating costs.

On May 6, 2003 (the "Effective Date"), the Predecessor Company emerged from reorganization proceedings under Chapter 11 pursuant to the terms of an Amended Joint Plan of Reorganization (the "Plan of Reorganization") and related amended Disclosure Statement. This Plan received formal endorsement of the statutory creditors' committee and, as modified, was confirmed by the U.S. Bankruptcy Court in April 2003. The Predecessor Company is presently an indirect wholly-owned subsidiary of Holdings.

Sale of Sears Canada's Credit and Financial Services Business

On November 15, 2005, Sears Canada completed the sale of substantially all of the assets and liabilities of its Credit and Financial Services operations to JPMorgan Chase & Co. ("JPMorgan Chase") for approximately \$2.0 billion in cash proceeds net of securitized receivables and other related costs and taxes. In addition, Sears Canada and JPMorgan Chase concurrently entered into a long-term marketing and servicing alliance with an initial term of ten years. Sears Canada used a substantial portion of the proceeds generated from this sale to fund an extraordinary cash dividend and a tax-free return of stated capital to shareholders of record on December 16, 2005. Holdings, as beneficial owner of approximately 54% of the outstanding common stock of Sears Canada, received \$877 million in after-tax proceeds from this distribution. Additional information concerning the sale is contained in Note 4 of Notes to Consolidated Financial Statements.

Sears Canada Take-Over Bid

In December 2005, Holdings announced its intention to acquire the remaining 46% interest in Sears Canada that it does not already own. The Company commenced a take-over bid for the remaining interest in Sears Canada on February 9, 2006. The Company has offered C\$16.86 (Canadian dollars) per share, or approximately C\$835 million (\$720 million U.S. dollars), for the minority interest. The take-over bid is open for acceptance until March 17, 2006. The Company believes that 100% ownership of Sears Canada would allow Sears Canada to be able to compete with the other Canadian retailers and the Canadian operations of major U.S. retailers.

In December 2005, the Company entered into a lock-up agreement with Natcan Investment Management, Inc. ("Natcan"), pursuant to which Natcan agreed to tender all Sears Canada common shares (representing approximately 9% of the outstanding common shares of Sears Canada) that it owns or controls in response to the Company's take-over bid, at a price of C\$16.86 per share. This agreement obligates the Company to spend approximately \$141 million to purchase the Natcan shares.

Real Estate Transactions

In the normal course of business, the Company considers opportunities to purchase leased operating properties, as well as offers to sell owned, or assign leased, operating and non-operating properties. These transactions may, individually or in the aggregate, result in material proceeds or outlays of cash. In addition, the Company reviews leases that will expire in the short term in order to determine the appropriate action to take with respect to them.

Further information concerning the Company's real estate transactions is contained in Note 16 of Notes to Consolidated Financial Statements.

Business Segments

Holdings has integrated many Kmart and Sears store-support functions to more efficiently serve both formats; however, for purposes of reviewing operating performance and making asset-allocation decisions, senior management has continued to utilize principally the reporting structures that existed independently for Kmart and Sears prior to the Merger. As a result, the following discussion of the Company's business segments is organized into three segments: Kmart, Sears Domestic and Sears Canada.

Financial information, including revenues, operating income and total assets for each of these business segments is contained in Note 21 of Notes to Consolidated Financial Statements. Information regarding the components of revenue for Holdings is included in Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations."

Kmart

As of January 28, 2006, Holdings operated a total of 1,416 Kmart stores across 49 states, Guam, Puerto Rico, and the U.S. Virgin Islands. This store count included 1,361 discount stores, averaging 92,000 square feet, and 55 Super Centers, averaging 165,000 square feet. Most Kmart stores are one-floor, free-standing units that carry a wide assortment of general merchandise, including products sold under such well-known labels as Jaelyn Smith, Joe Boxer, and Martha Stewart Everyday. Subsequent to the Merger, the Company began selling certain Sears brand products and services within certain Kmart stores. As of January 28, 2006, approximately 100 Kmart stores were selling an assortment of Sears brand products, mainly within home appliances and tools. Approximately 1,100 Kmart stores also contain in-store pharmacies. The Super Centers generally operate 24-hours a day and combine a full-service grocery along with the general merchandise selection of a discount store. Kmart also sells its products through its kmart.com website.

Sears Domestic

As of January 28, 2006, Sears Domestic operations consisted of the following:

Full-line Stores 866 Full-line stores located across all 50 states and Puerto Rico, primarily mall-based locations averaging 132,000 square feet. Full-line stores offer a wide array of products across many merchandise categories, including home appliances, consumer electronics, tools, fitness and lawn and garden equipment, certain automotive services and products such as tires and batteries, home fashion products, as well as apparel, footwear and accessories for the whole family, including Lands' End merchandise. Also, as of January 28, 2006, the Company operated a total of 58 Sears Essentials and Sears Grand stores located in 22 states, primarily free-standing units averaging 122,000 square feet and offering health and beauty, pantry, household products and toys in addition to the offerings of the typical mall-based store. In February 2006, management decided that, on a go-forward basis, Sears Essentials and Sears Grand stores will all be operated under the Sears Grand name. Management expects to begin the conversion to the Sears Grand nameplate in the first half of fiscal 2006. Sears also extends the availability of its product selection through the use of its sears.com website, which offers a more limited assortment of home, apparel and accessory merchandise and provides customers the option of buying through the internet and picking up their merchandise in Sears Full-line stores.

Specialty Stores 1,128 specialty stores located across all 50 states and Puerto Rico, located primarily in free-standing, off-mall locations or high-traffic neighborhood shopping centers, and including the operations of:

809 Dealer Stores Primarily independently-owned stores, predominantly located in smaller communities and averaging 8,900 square feet offering appliances, consumer electronics, lawn and garden equipment, hardware and automotive batteries. Dealer stores carry proprietary Sears brands, such as Craftsman, Kenmore and DieHard, as well as a wide assortment of national brands.

147 Sears Hardware Stores and 84 Orchard Supply Hardware Stores Neighborhood hardware stores averaging 37,000 square feet that carry Craftsman tools and lawn and garden equipment, a wide assortment of national brands and other home improvement products. Approximately 120 locations also offer a limited selection of home appliances.

16 The Great Indoors Stores Home decorating and remodeling superstores, averaging 143,000 square feet, dedicated to the four main rooms of the house: kitchen, bedroom, bathroom and great room.

50 Outlet Stores Locations offering overstock and/or distressed appliances, consumer electronics and lawn and garden equipment at a discount.

Commercial Sales This business primarily targets home builders, remodelers and property managers for appliance purchases.

Direct to Customer The Direct to Customer business includes the direct merchant business of Lands' End, Inc. ("Lands' End"). Lands' End is a leading direct merchant of traditionally-styled casual clothing, accessories and footwear for men, women and children, as well as home products and soft luggage. These products are offered through multiple selling channels including Landsend.com, one of the leading apparel websites, as well as catalog mailings, international businesses and 17 Lands' End retail stores. These retail stores, averaging 7,700 square feet, offer Lands' End merchandise primarily from catalog and internet channel overstocks. Direct to Customer also includes direct marketing of Sears goods through specialty catalogs.

Home Services Product Repair Services, the nation's largest product repair service provider, is a key element in the Company's active relationship with more than 46 million households. With over 10,000 service technicians making over 13 million service calls annually, this business delivers a broad range of retail-related residential and commercial services across all 50 states and Puerto Rico under the Sears Parts & Repair Services and A&E Factory Service brand names. Commercial and residential customers can obtain parts and repair services for all major brands of products within the home appliances, lawn and garden equipment, consumer electronics, floorcare products, and heating and cooling systems categories. Smaller items for repair can be brought into Sears Parts & Repair Centers located throughout the United States or to any Sears Full-line store. This business also offers protection agreements, product installation services and Kenmore and Carrier residential heating and cooling systems. Home Services also includes home improvement services (primarily siding, windows, cabinet refacing, kitchen remodeling, HVAC and carpet cleaning) provided through Sears Home Improvement Services.

Sears Canada

Sears Canada, a consolidated, 54%-owned subsidiary of Sears, conducts retail operations in Canada similar to those conducted by Sears Domestic, with a greater emphasis on apparel and other softlines than in the U.S. stores. In addition, Sears Canada conducted credit operations prior to the November 15, 2005 sale of its Credit and Financial Services operations to JPMorgan Chase.

As of January 28, 2006, Sears Canada operated a total of 123 full-line stores, 252 specialty stores (49 furniture and appliance stores, 159 dealer stores operated under independent local ownership, five appliances and mattresses stores, 28 Corbeil stores and 11 outlet stores), 50 floor covering stores, approximately 2,116 catalog pick-up locations and 112 travel offices. Sears Canada also conducts business over the internet through its website, sears.ca.

Trademarks, Trade Names and Licenses

The "KMART®" and "SEARS®" trade names, service marks and trademarks, used by the Company both in the United States and internationally, are material to the Company's retail and other related businesses.

The Company sells proprietary branded merchandise under a number of brand names that are important to its operations. The Company's KENMORE®, CRAFTSMAN®, DIEHARD® and LANDS' END® brands are among the most recognized proprietary brands in retailing. These marks are the subject of numerous United States and foreign trademark registrations. Other well-recognized Company trademarks and service marks include THE GREAT INDOORS®, OSH®, CANYON RIVER BLUES®, COVINGTON®, and ATHLETECH®. The Company also has the right to sell an exclusive line of Martha Stewart Everyday® products in its Kmart locations over the next four years, as well as within Sears Canada stores through August 2008.

Seasonality

The retail business is seasonal in nature, and the Company generates a high proportion of its revenues and operating cash flows during the fourth quarter of its fiscal year, which includes the holiday season. As a result, the Company's overall profitability is heavily impacted by its fourth quarter operating results. Additionally, in preparation for the fourth quarter holiday season, the Company significantly increases its merchandise inventory levels, which have traditionally been financed from operating cash flows and credit terms received from vendors. Fourth quarter reported revenues accounted for 33% of total reported revenues in fiscal 2005.

Competition

The Company's business is subject to highly competitive conditions. The Company competes with a wide variety of retailers, including other department stores, discounters, home improvement stores, consumer electronics dealers, auto parts and auto service providers, specialty retailers, wholesale clubs and many other competitors operating on a national, regional or local level along with internet and catalog businesses, which handle similar lines of merchandise. Wal-Mart, Target, Kohl's, JC Penney, Home Depot, Lowe's and Best Buy are some of the major competitors with which the Company competes. Home Depot, Lowe's and Best Buy are major competitors in relation to the Company's home appliance business, which accounted for approximately 15% of the Company's fiscal 2005 reported revenues. Sears Canada competes in Canada with Hudson's Bay Company and U.S.-based competitors, including those mentioned above, that are expanding into Canada. Success in this competitive marketplace is based on factors such as price, convenience, product assortment and quality, and service, including availability of retail-related services such as access to credit, product delivery, repair and installation.

Employees

As of January 28, 2006, the Company had approximately 317,000 employees in the United States and U.S. territories, and approximately 38,000 employees in Canada through Sears Canada including, in each case, part-time employees.

Our Website; Availability of SEC Reports and Other Information

The Company's corporate website is located at www.searsholdings.com. The Company's Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and any amendments to these reports are available, free of charge, through the SEC filings portion of the Investor Information section of the Company's website as soon as reasonably practicable after they are electronically filed with or furnished to the Securities and Exchange Commission.

The Corporate Governance Guidelines of the Company's Board of Directors, the charters of the Audit, Compensation, Finance and Nominating and Governance Committees of the Board of Directors, the Company's Code of Conduct and the Board of Directors Code of Conduct are available on the Corporate Governance section of www.searsholdings.com. References to the Company's website address do not constitute incorporation by reference of the information contained on the website, and the information contained on the website is not part of this document.

Item 1A. Risk Factors

References to "us", "we" and "our" refer to the Company. The following risk factors could adversely affect our business, results of operations and financial condition. The risks and uncertainties described below are not the only ones we face. Additional risks and uncertainties not presently known to us may also negatively impact us.

If we fail to offer merchandise and services that our customers want, our sales may be limited, which would reduce our revenues and profits.

In order for our business to be successful, we must identify, obtain supplies of, and offer to our customers attractive, innovative and high-quality merchandise on a continuous basis. Our products and services must satisfy the desires of our customers, whose preferences may change in the future. If we misjudge either the demand for products and services we sell or our customers' purchasing habits and tastes, we may be faced with excess inventories of some products and missed opportunities for products and services we chose not to offer. In addition, our sales may decline or we may be required to sell the merchandise we have obtained at lower prices. This would have a negative effect on our business and results of operations.

If we do not successfully manage our inventory levels, our operating results will be adversely affected.

We must maintain sufficient inventory levels to operate our business successfully. However, we also must guard against accumulating excess inventory as we seek to minimize out-of-stock levels across all product categories and to maintain in-stock levels. We obtain a significant portion of our inventory from vendors located outside the United States. These vendors often require lengthy advance notice of our requirements in order to be able to supply products in the quantities we request. This usually requires us to order merchandise, and enter into purchase order contracts for the purchase and manufacture of such merchandise, well in advance of the time these products will be offered for sale. As a result, we may experience difficulty in responding to a changing retail environment, which makes us vulnerable to changes in price. If we do not accurately anticipate the future demand for a particular product or the time it will take to obtain new inventory, our inventory levels will not be appropriate and our results of operations may be negatively impacted.

If we are unable to compete effectively in the highly competitive retail industry, our business and results of operations could be materially adversely affected.

The retail industry is highly competitive with few barriers to entry. We compete with a wide variety of retailers including other department stores, discounters, home improvement stores, consumer electronics dealers, auto parts and auto service providers, specialty retailers, wholesale clubs and many other competitors operating on a national, regional or local level. Internet and catalog businesses which handle similar lines of merchandise also compete with us. In this competitive marketplace, success is based on factors such as price, product assortment and quality, service, and convenience.

Our success depends on our ability to differentiate ourselves from our competitors with respect to shopping convenience, a quality assortment of available merchandise and superior customer service. We must also successfully respond to our customers' changing tastes. The performance of our competitors, as well as changes in their pricing policies, marketing activities, new store openings and other business strategies, could have a material adverse effect on our business, financial condition and results of operations.

Our failure to successfully integrate Kmart and Sears may cause us to fail to realize cost savings and other benefits, which could adversely affect our future results.

We may fail to successfully complete the integration of Kmart and Sears and, as a result, may fail to realize synergies, cost savings and other benefits expected from the Merger. The eventual success of the Merger depends, in part, on our ability to realize the anticipated growth opportunities and cost savings from combining the businesses of Kmart and Sears. In particular, expanding the offering and distribution of proprietary brands may impact the value of those brands and lead to cannibalization of sales from either Sears or Kmart. In addition, we may be unable to successfully differentiate product offerings at our various locations. If we do not achieve these benefits, our results of operations could be materially adversely affected.

Also, we may fail to achieve sufficient cost savings through the integration of purchasing functions, supply chain, administrative and other operational activities. Furthermore, we must achieve these savings without adversely affecting our revenues. If we are not able to successfully achieve these objectives, the anticipated benefits of the Merger may not be realized fully or at all, or it may take longer to realize them than expected, and our results of operations could be materially adversely affected.

Due to the seasonality of our business, our annual operating results would be adversely affected if our fourth quarter results fail to meet our expectations.

Our business is seasonal, with a high proportion of revenues and operating cash flows being generated during the fourth quarter of our fiscal year, which includes the holiday season. As a result, our fourth quarter operating results significantly impact our annual operating results. Our fourth quarter operating results may fluctuate significantly, based on many factors, including holiday spending patterns and weather conditions.

Our comparable store sales may fluctuate for a variety of reasons, which could adversely affect our results of operations.

Our business is sensitive to customers' spending patterns, which in turn are subject to prevailing economic conditions. Our comparable store sales and results of operations have fluctuated in the past, and we expect them to continue to fluctuate in the future. A variety of other factors affect our comparable store sales and financial performance, including:

actions by our competitors, including opening of new stores in our existing markets,

seasonal fluctuations due to weather conditions,

changes in our merchandise strategy and mix,

changes in population and other demographics, and

timing of our promotional events.

Accordingly, our results for any one fiscal quarter are not necessarily indicative of the results to be expected for any other quarter, and comparable store sales for any particular future period may decrease. For more information on our results of operations, see "Management's Discussion and Analysis of Financial Condition and Results of Operations" in Item 7 of this Form 10-K.

We rely on foreign sources for significant amounts of our merchandise, and our business may therefore be negatively affected by the risks associated with international trade.

We depend on a large number of products produced in foreign markets. We face risks associated with the delivery of merchandise originating outside the United States, including:

potential economic and political instability in countries where our suppliers are located,

increases in shipping costs,

transportation delays and interruptions,

adverse fluctuations in currency exchange rates, and

changes in U.S. and foreign laws affecting the importation and taxation of goods, including duties, tariffs and quotas, or changes in the enforcement of those laws.

A decline in general economic conditions, consumer spending levels and other conditions could lead to reduced consumer demand for our merchandise thereby reducing our revenues and gross margins.

Many economic and other factors outside our control, including consumer confidence, consumer spending levels, employment levels, prevailing interest rates, housing starts and remodels, and consumer debt levels, as well as fuel costs and the availability of consumer credit, affect consumer spending habits. In addition, disposable income levels may influence consumer purchasing patterns. A general slowdown in the United States economy or an uncertain economic outlook could adversely affect consumer spending habits and our operating results.

The domestic and international political situation also affects consumer confidence. The threat, outbreak or escalation of terrorism, military conflicts or other hostilities could lead to a decrease in consumer spending. Any of these events and factors could cause us to increase inventory markdowns and promotional expenses, thereby reducing our gross margins and operating results.

We rely extensively on computer systems to process transactions, summarize results and manage our business. Disruptions in these systems could harm our ability to run our business.

Given the number of individual transactions we have each year, it is critical that we maintain uninterrupted operation of our computer and communications hardware and software systems. Our primary computer systems and operations are located at our corporate headquarters in Hoffman Estates, Illinois and our facilities in Troy, Michigan. In addition, each of our stores is connected to our computerized inventory management and other systems. Our systems are subject to damage or interruption from power outages, computer and telecommunications failures, computer viruses, security breaches, catastrophic events such as fires, tornadoes and hurricanes, and usage errors by our employees. If our systems are damaged or cease to function properly, we may have to make a significant investment to fix or replace them, and we may suffer interruptions in our operations in the interim. Any material interruption in our computer operations may have a material adverse effect on our business or results of operations.

The loss of key personnel may disrupt our business and adversely affect our financial results.

We depend on the contributions of our senior management team, including Aylwin B. Lewis (Chief Executive Officer and President) and other key employees, for our future success. Although certain executives, including Mr. Lewis, have employment agreements with us, changes in our senior management and any future departures of key employees may disrupt our business and materially adversely affect our results of operations.

Affiliates of our Chairman, whose interests may be different than your interests, exert substantial influence over our company.

Affiliates of Edward S. Lampert, the Chairman of our Board of Directors, beneficially own approximately 41% of the outstanding shares of our common stock. These affiliates are controlled, directly or indirectly, by Mr. Lampert. Accordingly, these affiliates, and thus Mr. Lampert, have substantial influence over many if not all actions to be taken or approved by our stockholders, including the election of directors and any transactions involving a change of control.

The interests of these affiliates, which have investments in other companies, may from time to time diverge from the interests of our other stockholders, particularly with regard to new investment opportunities. This substantial influence may have the effect of discouraging offers to acquire our company because the consummation of any such acquisition would likely require the consent of these affiliates.

We may be subject to product liability claims if people or property are harmed by the products we sell.

Some of the products we sell may expose us to product liability claims relating to personal injury, death, or property damage caused by such products, and may require us to take actions such as product recalls. Although we maintain liability insurance, we cannot be certain that our coverage will be adequate for liabilities actually incurred or that insurance will continue to be available to us on economically reasonable terms, or at all.

We may be subject to periodic litigation and other regulatory proceedings. These proceedings may be affected by changes in laws and government regulations or changes in the enforcement thereof.

From time to time we may be involved in lawsuits and regulatory actions relating to our business. Due to the inherent uncertainties of litigation and regulatory proceedings, we cannot accurately predict the ultimate outcome of any such proceedings. An unfavorable outcome could have a material adverse impact on our business, financial condition and results of operations. In addition, regardless of the outcome of any litigation or regulatory proceedings, these proceedings could result in substantial costs and may require that we devote substantial resources to defend our company. Further, changes in governmental regulations both in the United States and in the other countries where we operate could have adverse effects on our business and subject us to additional regulatory actions. For a description of current legal proceedings, see Item 3, "Legal Proceedings" in this Form 10-K.

Item 1B. Unresolved Staff Comments

None.

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Item 2. Properties

The following table summarizes the locations of the Company's Kmart and Sears Domestic stores as of January 28, 2006:

State/Territory	Kmart		Sears Domestic		
	Discount Stores	Super Centers	Full-line Mall Stores	Sears Grand/ Essentials	Specialty Stores
Alabama	26		13	3	32
Alaska			3		3
Arizona	18	2	14	1	12
Arkansas	6		7		30
California	107	1	81	10	131
Colorado	17	4	13	2	18
Connecticut	7		8	1	10
Delaware	6		4		4
District of Columbia					
Florida	98		56	10	25
Georgia	38	1	22		37
Hawaii	7		6		1
Idaho	8		6		7
Illinois	60	4	38	6	52
Indiana	38	5	21	2	34
Iowa	24		12		13
Kansas	13		10		21
Kentucky	30		11	1	24
Louisiana	11		13		19
Maine	6		6		10
Maryland	23		19	1	8
Massachusetts	19		21	1	8
Michigan	79	7	27	3	39
Minnesota	32		12		35
Mississippi	6		9		20
Missouri	28		14	1	42
Montana	10		3		7
Nebraska	8		5		10
Nevada	9	2	4	1	6
New Hampshire	6		6	3	8
New Jersey	37		20	5	20
New Mexico	15		7		11
New York	60	1	48		35
North Carolina	43	4	27		36
North Dakota	7		4		4
Ohio	75	11	42		52
Oklahoma	9		11		20
Oregon	14		9		19
Pennsylvania	100	2	45	2	38
Rhode Island	1		2		2
South Carolina	27	1	14	1	18
South Dakota	9		2		7
Tennessee	33	3	24	1	26
Texas	19	1	60	1	81
Utah	18		5	1	5
Vermont	3		2		6
Virginia	40	4	23	1	19
Washington	21		23		12
West Virginia	16	1	8		7
Wisconsin	38		15		32

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	Kmart		Sears Domestic		
Wyoming	9		2		6
Puerto Rico	22	1	9		6
U.S. Virgin Islands	4				
Guam	1				
Totals	1,361	55	866	58	1,128

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	Kmart		Sears Domestic			Sears Canada		Total
	Discount Stores	Super Centers	Full-line Mall Stores	Sears Grand/Essentials	Specialty Stores	Full-line Stores	Specialty Stores	
Stores as of January 28, 2006								
Owned	134	34	516	15	44	17	2	762
Leased	1,227	21	350	43	275	106	91	2,113
Independently-owned and operated stores					809		159	968
Totals	1,361	55	866	58	1,128	123	252	3,843

In addition, as of January 28, 2006, the Company had 42 domestic supply chain distribution centers, of which 14 are owned and 28 are leased for terms ranging from one to 15 years. Of the total, 15 primarily support Kmart locations and the remaining 27 primarily support Sears stores. In addition, the Company had 651 domestic store warehouses, customer call centers and service facilities, most of which are leased for terms ranging from one to 10 years or are part of other facilities included in the above table.

The Company's principal executive offices are located on a 200-acre site owned by the Company at the Prairie Stone office park in Hoffman Estates, Illinois. The complex consists of six interconnected office buildings totaling approximately two million gross square feet of office space.

In December 2005, the Company sold the former Kmart headquarters building in Troy, Michigan. The Company still owns an 86,000 square foot office building in Troy, Michigan which houses the Company's data center.

As of January 28, 2006, Sears Canada operated a total of 123 full-line stores, 252 specialty stores (49 furniture and appliance stores, 159 dealer stores operated under independent local ownership, five appliances and mattresses stores, 28 Corbeil stores and 11 outlet stores), 50 floor covering stores, approximately 2,116 catalog pick-up locations and 112 travel offices.

A description of the Company's leasing arrangements appears in Note 17 of Notes to Consolidated Financial Statements.

Item 3. Legal Proceedings

See Part II, Item 8, "Financial Statements and Supplementary Data" "Notes to Consolidated Financial Statements", Note 11 "Emergence from Chapter 11 Bankruptcy Protection and Fresh-Start Accounting," and Note 22 "Legal Proceedings", for information regarding legal proceedings, which information is incorporated herein by this reference.

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

None.

Item 4A. Executive Officers of the Registrant

The following table and information sets forth the names of the executive officers of the Company, their current positions and offices with the Company, the date they first became executive officers of the Company, their current ages, and their principal employment during the past five years.

Name	Position	Date First Became an Executive Officer	Age
Aylwin B. Lewis	Chief Executive Officer and President	2005*	51
Alan J. Lacy	Vice Chairman	2005*	52
Karen A. Austin	Executive Vice President, Chief Information Officer	2005*	44
Kristine K. Crow	Senior Vice President/General Manager, Financial Services	2005*	46
William C. Crowley	Executive Vice President, Chief Financial and Administrative Officer	2005*	48
Mark C. Good	Executive Vice President and General Manager, Home Services	2005*	49
William R. Harker	Vice President, Acting General Counsel and Corporate Secretary	2006	33
W. Bruce Johnson	Executive Vice President, Supply Chain and Operations	2005*	54
Daniel F. Laughlin	Senior Vice President, Merchandising	2005	55
Robert D. Luse	Senior Vice President, Human Resources	2005*	43
Maureen A. McGuire	Executive Vice President, Chief Marketing Officer	2005	54
William K. Phelan	Vice President, Controller and Chief Accounting Officer	2005*	43
Peter J. Whitsett	Senior Vice President, Merchandising	2005	40
Corwin M. Yulinsky	Executive Vice President, Strategy and Customer Insight	2005	51

*

Became an executive officer of Holdings upon the completion of the Merger on March 24, 2005.

Mr. Lewis became Chief Executive Officer and President in October 2005, after serving as the Chief Executive Officer and President of Kmart and Sears Retail as well as President of Holdings from March 2005 until September 2005. He was previously a director and the Chief Executive Officer and President of Kmart from October 2004 to March 2005. Prior to joining Kmart in October 2004, Mr. Lewis was President, Chief Multi-Branding and Operating Officer of YUM! Brands, Inc. (franchisor and licensor of quick-service restaurants) from 2000 until October 2004.

Mr. Lacy was previously Chief Executive Officer and Vice Chairman of the Company from March 2005 to September 2005. He served as Chairman of the Board, Chief Executive Officer and President of Sears from December 2000 until March 2005.

Ms. Austin became Executive Vice President, Chief Information Officer in February 2006 and was Senior Vice President and Chief Information Officer prior thereto. She was Senior Vice President,

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Chief Information Officer of Kmart from April 2002 to March 2005. She previously served as its Vice President, IT Applications from 2001 to 2002.

Ms. Crow became Senior Vice President, Financial Services of Sears in May 2004. From December 2000 to April 2004, she was Vice President, Customer Relationship Management for Sears.

Mr. Crowley was previously Senior Vice President, Finance of Kmart, and had served as an officer of Kmart since 2003. Mr. Crowley is also the President and Chief Operating Officer of ESL Investments, Inc., a private investment firm, and has served in that capacity since 1999.

Mr. Good was previously Executive Vice President and General Manager, Home Services (formerly Product Repair Services) of Sears from August 1999 to March 2005, when he assumed the same role with Sears Holdings.

Mr. Harker joined the Company as Vice President and Chief Counsel in September 2005. He became Acting General Counsel and Corporate Secretary in January 2006. Prior to joining Sears Holdings, he practiced corporate law with the law firm of Wachtell, Lipton, Rosen and Katz from September 2000 to August 2005.

Mr. Johnson was previously Kmart's Senior Vice President, Supply Chain and Operations. He joined Kmart in October 2003, after serving as Director, Organization and Systems for Carrefour S.A. from March 1998 to October 2003.

Mr. Laughlin was elected Senior Vice President, Merchandising in December 2005. Previously, he served as Sears' Senior Vice President/General Merchandise Manager, Sears Home, from October 2003 to December 2005, Senior Vice President/General Manager, Home Stores from May 2003 to September 2003, and Vice President/General Merchandise Manager, Tools and Paint prior thereto.

Mr. Luse joined Sears as Vice President, HR Retail and Related Services in 2001.

Ms. McGuire joined the Company as Executive Vice President and Chief Marketing Officer in October 2005. Prior to joining Sears Holdings, she spent over 30 years at International Business Machines Corporation, most recently as Vice President, Worldwide Strategy and Marketing, IBM Systems and Technology Group from January 2005 to September 2005. Previously she served as IBM's Vice President, Worldwide Marketing and Strategy, IBM Global Services from August 2003 to January 2005 and Vice President, Worldwide Market Management and Integrated Marketing Communications from 1995 to August 2003.

Mr. Phelan was elected Vice President and Controller of Sears Holdings effective March 2005. From December 2000 to March 2005 he served as Assistant Controller of Sears.

Mr. Whitsett was elected Senior Vice President, Kmart Merchandising Officer in July 2005. He joined Kmart in 1999 as Director, Merchandise Planning & Replenishment and has served in a variety of positions, including Divisional Vice President, Merchandise Planning from 2000 to 2003, Divisional Vice President, Merchandising Consumables in 2003, Vice President/General Merchandise Manager, Drug Store and Food from 2003 to 2004, and Vice President/General Merchandise Manager from 2004 to 2005.

Mr. Yulinsky joined the Company as Executive Vice President, Strategy and Customer Insight in October 2005. Previously, he was a leader of the Financial Institutions and Marketing/CRM practice at McKinsey and Co., a consulting firm, from August 1999 to October 2005.

The Company's Code of Conduct applies to all employees, including the Company's principal executive officer, principal financial officer and principal accounting officer. The Code of Conduct is available on the "Corporate Governance" portion of the Company's corporate website at searsholdings.com. The Company intends to disclose on this website any amendment to, or waiver of, a provision of its Code of Conduct that applies to any of those three officers of the Company.

PART II

Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

Holdings common stock is quoted on The NASDAQ Stock Market under the ticker symbol SHLD. There were approximately 25,000 registered stockholders of Holdings common stock as of January 28, 2006.

The common stock of Holdings began trading on March 28, 2005, the first trading day after the consummation of the Merger. Prior to that date, Kmart's common stock was quoted on The NASDAQ Stock Market, under the ticker symbol KMRT. The quarterly high and low sales prices for Holdings' common stock (for the 2005 fiscal year) and for Kmart's common stock (for the 2004 fiscal year) are set forth below.

		2005			
		Sears Holdings			
		First Quarter ⁽¹⁾	Second Quarter	Third Quarter	Fourth Quarter
Common stock price					
High		\$ 149.50	\$ 163.50	\$ 155.90	\$ 127.66
Low		125.90	133.24	113.30	111.64
		2004			
		Kmart			
		First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Common stock price					
High		\$ 48.50	\$ 84.50	\$ 93.18	\$ 119.69
Low		26.10	40.66	61.76	84.51

⁽¹⁾ During the first quarter of 2005, Kmart's common stock traded from January 27, 2005 until March 23, 2005, during which its high price was \$133.85 and its low price was \$89.37.

Neither Holdings nor Kmart paid dividends on common stock in the last two fiscal years.

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Equity Compensation Plan Information

The following table reflects information about securities authorized for issuance under the Company's equity compensation plans as of January 28, 2006.

Plan Category	(a) Number of securities to be issued upon exercise of outstanding options, warrants and rights	(b) Weighted-average exercise price of outstanding options, warrants and rights	(c) Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a))
Equity compensation plans approved by security holders ⁽¹⁾	350,000	\$ 112.90	
Equity compensation plans not approved by security holders			