SEARS HOLDINGS CORP
Form 10-Q
May 22, 2014

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-Q

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED MAY 3, 2014

OR

o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

Commission file number 000-51217
SEARS HOLDINGS CORPORATION
(Exact name of registrant as specified in its charter)

DELAWARE	20-1920798
(State of Incorporation)	(I.R.S. Employer Identification No.)
3333 BEVERLY ROAD, HOFFMAN ESTATES, ILLINOIS	60179
(Address of principal executive offices)	(Zip Code)

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.
Yes x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).
Yes x No ¨

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

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

As of May 16, 2014, the registrant had 106,439,687 common shares, $0.01 par value, outstanding.

SEARS HOLDINGS CORPORATION
INDEX TO QUARTERLY REPORT ON FORM 10-Q
13 Weeks Ended May 3, 2014 and May 4, 2013

SEARS HOLDINGS CORPORATION
Condensed Consolidated Statements of Operations
(Unaudited)
PART I. FINANCIAL INFORMATION
Item 1. Financial Statements

millions, except per share data	13 Weeks Ended May 3, 2014	13 Weeks Ended May 4, 2013
REVENUES		
Merchandise sales and services[1]	$7,879	$8,452
COSTS AND EXPENSES		
Cost of sales, buying and occupancy[1]	6,051	6,296
Selling and administrative	2,089	2,218
Depreciation and amortization	155	191
Impairment charges	5	8
Gain on sales of assets	(46)	(14)
Total costs and expenses	8,254	8,699
Operating loss	(375)	(247)
Interest expense	(71)	(61)
Interest and investment income	4	7
Other loss	(3)	—
Loss before income taxes	(445)	(301)
Income tax benefit	3	9
Net loss	(442)	(292)
Loss attributable to noncontrolling interests	40	13
NET LOSS ATTRIBUTABLE TO HOLDINGS' SHAREHOLDERS	$(402)	$(279)
NET LOSS PER COMMON SHARE ATTRIBUTABLE TO HOLDINGS' SHAREHOLDERS		
Basic loss per share	$(3.79)	$(2.63)
Diluted loss per share	$(3.79)	$(2.63)
Basic weighted average common shares outstanding	106.2	106.0
Diluted weighted average common shares outstanding	106.2	106.0

[1] Includes merchandise sales to Sears Hometown and Outlet Stores, Inc. ("SHO") of $358 million and $369 million for the 13 weeks ended May 3, 2014 and May 4, 2013, respectively. Pursuant to the terms of the separation, merchandise is sold to SHO at cost.

See accompanying notes.

SEARS HOLDINGS CORPORATION
Condensed Consolidated Statements of Comprehensive Loss
(Unaudited)

millions	13 Weeks Ended May 3, 2014	13 Weeks Ended May 4, 2013
Net loss	$(442)	$(292)
Other comprehensive income		
Pension and postretirement adjustments, net of tax	30	46
Deferred loss on derivatives, net of tax	(1)	—
Currency translation adjustments, net of tax	11	(7)
Total other comprehensive income	40	39
Comprehensive loss	(402)	(253)
Comprehensive loss attributable to noncontrolling interests	34	14
Comprehensive loss attributable to Holdings' shareholders	$(368)	$(239)

See accompanying notes.

SEARS HOLDINGS CORPORATION
Condensed Consolidated Balance Sheets
(Unaudited)

millions	May 3, 2014	May 4, 2013	February 1, 2014
ASSETS			
Current assets			
Cash and cash equivalents	$831	$471	$1,028
Restricted cash	11	10	10
Accounts receivable(1)	562	608	553
Merchandise inventories	6,726	7,900	7,034
Prepaid expenses and other current assets	397	462	334
Total current assets	8,527	9,451	8,959
Property and equipment, net	5,190	5,910	5,394
Goodwill	269	379	379
Trade names and other intangible assets	2,312	2,871	2,850
Other assets	632	785	679
TOTAL ASSETS	$16,930	$19,396	$18,261
LIABILITIES			
Current liabilities			
Short-term borrowings(2)	$1,230	$1,754	$1,332
Current portion of long-term debt and capitalized lease obligations	78	72	83
Merchandise payables	2,612	2,862	2,496
Other current liabilities	2,284	2,403	2,527
Unearned revenues	889	922	900
Other taxes	435	440	460
Short-term deferred tax liabilities	484	382	387
Total current liabilities	8,012	8,835	8,185
Long-term debt and capitalized lease obligations(3)	2,821	1,929	2,834
Pension and postretirement benefits	1,837	2,638	1,942
Other long-term liabilities	1,998	2,107	2,008
Long-term deferred tax liabilities	800	966	1,109
Total Liabilities	15,468	16,475	16,078
Commitments and contingencies			
EQUITY			
Total Equity	1,462	2,921	2,183
TOTAL LIABILITIES AND EQUITY	$16,930	$19,396	$18,261

(1) Includes $86 million, $89 million and $68 million at May 3, 2014, May 4, 2013 and February 1, 2014, respectively, of net amounts receivable from SHO.

(2) Includes $150 million and $305 million of unsecured commercial paper held by ESL and its affiliates at May 3, 2014 and May 4, 2013, respectively. ESL and its affiliates held none of our commercial paper at February 1, 2014.

(3) Includes $205 million of senior secured notes held by ESL and its affiliates at May 3, 2014, and $95 million at both May 4, 2013, and February 1, 2014, and $3 million of subsidiary notes held by ESL and its affiliates at May 3, 2014, May 4, 2013, and February 1, 2014.

See accompanying notes.

SEARS HOLDINGS CORPORATION
Condensed Consolidated Statements of Cash Flows
(Unaudited)

millions	13 Weeks Ended May 3, 2014	13 Weeks Ended May 4, 2013
CASH FLOWS FROM OPERATING ACTIVITIES		
Net loss	$(442)	$(292)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	155	191
Impairment charges	5	8
Gain on sales of assets	(46)	(14)
Pension and postretirement plan contributions	(102)	(89)
Settlement of Canadian dollar hedges	1	—
Change in operating assets and liabilities (net of acquisitions and dispositions):		
Deferred income taxes	(25)	(1)
Merchandise inventories	(37)	(350)
Merchandise payables	153	105
Income and other taxes	(92)	(60)
Mark-to-market adjustments and settlements on Sears Canada derivative instruments	5	—
Other operating assets	(44)	18
Other operating liabilities	(91)	(229)
Net cash used in operating activities	(560)	(713)
CASH FLOWS FROM INVESTING ACTIVITIES		
Proceeds from sales of property and investments	79	5
Net increase in investments and restricted cash	—	(1)
Purchases of property and equipment	(72)	(60)
Net cash provided by (used in) investing activities	7	(56)
CASH FLOWS FROM FINANCING ACTIVITIES		
Proceeds from debt issuances	—	1
Repayments of long-term debt	(20)	(28)
Increase (decrease) in short-term borrowings, primarily 90 days or less	(102)	660
Lands' End, Inc. pre-separation funding	515	—
Separation of Lands' End, Inc.	(31)	—
Debt issuance costs	(11)	—
Net cash provided by financing activities	351	633
Effect of exchange rate changes on cash and cash equivalents	5	(2)
NET DECREASE IN CASH AND CASH EQUIVALENTS	(197)	(138)
CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR	1,028	609
CASH AND CASH EQUIVALENTS, END OF PERIOD	$831	$471
Supplemental Cash Flow Data:		
Income taxes paid, net of refunds	$76	$16
Cash interest paid	84	68
Unpaid liability to acquire equipment and software	24	26

See accompanying notes.

SEARS HOLDINGS CORPORATION
Condensed Consolidated Statements of Equity
(Unaudited)

	Equity Attributable to Holdings' Shareholders							
millions	Number of Shares	Common Stock	Treasury Stock	Capital in Excess of Par Value	Retained Earnings (Deficit)	Accumulated Other Comprehensive Income (Loss)	Noncontrolling Interests	Total
Balance at February 2, 2013	106	$ 1	$ (5,970)	$ 9,298	$ 885	$ (1,459)	$ 417	$ 3,172
Comprehensive loss								
Net loss	—	—	—	—	(279)	—	(13)	(292)
Pension and postretirement adjustments, net of tax	—	—	—	—	—	44	2	46
Currency translation adjustments, net of tax	—	—	—	—	—	(4)	(3)	(7)
Total Comprehensive Loss								(253)
Stock awards	—	—	(1)	2	—	—	—	1
Associate stock purchase	—	—	1	—	—	—	—	1
Balance at May 4, 2013	106	$ 1	$ (5,970)	$ 9,300	$ 606	$ (1,419)	$ 403	$ 2,921
Balance at February 1, 2014	106	$ 1	$ (5,963)	$ 9,298	$ (480)	$ (1,117)	$ 444	$ 2,183
Comprehensive loss								
Net loss	—	—	—	—	(402)	—	(40)	(442)
Pension and postretirement adjustments, net of tax	—	—	—	—	—	29	1	30
Deferred loss on derivatives, net of tax	—	—	—	—	—	(1)	—	(1)
Currency translation adjustments, net of tax	—	—	—	—	—	6	5	11
Total Comprehensive Loss								(402)
Stock awards	—	—	—	1	—	—	—	1
Separation of Lands' End, Inc.	—	—	—	(323)	—	2	—	(321)
Associate stock purchase	—	—	1	—	—	—	—	1
Balance at May 3, 2014	106	$ 1	$ (5,962)	$ 8,976	$ (882)	$ (1,081)	$ 410	$ 1,462

See accompanying notes.

SEARS HOLDINGS CORPORATION
Notes to Condensed Consolidated Financial Statements
(Unaudited)

NOTE 1 – BASIS OF PRESENTATION

Sears Holdings Corporation ("Holdings") is the parent company of Kmart Holding Corporation ("Kmart") and Sears, Roebuck and Co. ("Sears"). Holdings (together with its subsidiaries, "we," "us," "our," or the "Company") was formed as a Delaware corporation in 2004 in connection with the merger of Kmart and Sears (the "Merger"), on March 24, 2005. We are an integrated retailer with 1,924 full-line and specialty retail stores in the United States, operating through Kmart and Sears, and 439 full-line and specialty retail stores in Canada operating through Sears Canada Inc. ("Canada"), a 51%-owned subsidiary. We have three reportable segments: Kmart, Sears Domestic and Sears Canada.

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. 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 1, 2014.

Depreciation Expense

Depreciation expense included within depreciation and amortization expense reported on the Condensed Consolidated Statements of Operations was $150 million and $181 million for the 13-week periods ended May 3, 2014 and May 4, 2013, respectively.

Separation of Lands' End, Inc.

On April 4, 2014, we completed the separation of our Lands' End business through a spin-off transaction. The separation was structured to be tax free to our U.S. shareholders for U.S. federal income tax purposes. Prior to the separation, Lands' End, Inc. ("Lands' End") entered into an asset-based senior secured revolving credit facility, which provides for maximum borrowings of approximately $175 million with a letter of credit sub-limit, and a senior secured term loan facility of approximately $515 million. The proceeds of the term loan facility were used to fund a $500 million dividend to Holdings and pay fees and expenses associated with the foregoing facilities. We accounted for this spin-off in accordance with accounting standards applicable to spin-off transactions. Accordingly, we classified the carrying value of net assets of $323 million contributed to Lands' End as a reduction of capital in excess of par value in the Condensed Consolidated Statement of Equity for the period ended May 3, 2014.

Additionally, as a result of Mr. Lampert's role as our Chairman and Chief Executive Officer, and Chairman and Chief Executive Officer of ESL Investments, Inc. (together with its affiliated funds, "ESL"), and the continuing arrangements between Holdings and Lands' End (as further described in Note 14), Holdings has determined that it has significant influence over Lands' End. Accordingly, the operating results for Lands' End through the date of the spin-off are presented within the consolidated continuing operations of Holdings and the Sears Domestic segment in the accompanying Condensed Consolidated Financial Statements.

In connection with the separation, Holdings and certain of its subsidiaries entered into various agreements with Lands' End under the terms described in Note 14.

SEARS HOLDINGS CORPORATION
Notes to Condensed Consolidated Financial Statements — (Continued)
(Unaudited)

Changes in the carrying amount of goodwill by segment, which reflects the impact related to the Lands' End spin-off, were as follows:

millions	Sears Domestic
Balance, February 1, 2014:	
Goodwill	$379
2014 activity:	
Separation of Lands' End, Inc.	(110)
Balance, May 3, 2014	$269

Changes in the carrying amount of trade names and other intangible assets by segment, which reflects the impact related to the Lands' End spin-off, were as follows:

millions	Sears Domestic	Total
Balance, February 1, 2014:		
Trade names and intangible assets	$2,651	$2,850
2014 activity:		
Separation of Lands' End, Inc.	(531)	(531)
Amortization expense	(5)	(7)
Balance, May 3, 2014	$2,115	$2,312

NOTE 2 – BORROWINGS

Total borrowings were as follows:

millions	May 3, 2014	May 4, 2013	February 1, 2014
Short-term borrowings:			
Unsecured commercial paper	$159	$377	$9
Secured borrowings	1,071	1,377	1,323
Long-term debt, including current portion:			
Notes and debentures outstanding	2,569	1,582	2,571
Capitalized lease obligations	330	419	346
Total borrowings	$4,129	$3,755	$4,249

The fair value of long-term debt, excluding capitalized lease obligations, was $2.4 billion at May 3, 2014, $1.5 billion at May 4, 2013 and $2.3 billion at February 1, 2014. The fair value of our debt was estimated based on quoted market prices for the same or similar issues or on current rates offered to us for debt of the same remaining maturities. Our long-term debt instruments are valued using Level 2 measurements as defined in Note 4 to the Condensed Consolidated Financial Statements.

Debt Repurchase Authorization

In 2005, our Finance Committee of the Board of Directors authorized the repurchase, subject to market conditions and other factors, of up to $500 million of our outstanding indebtedness in open market or privately negotiated transactions. Our wholly owned finance subsidiary, Sears Roebuck Acceptance Corp. ("SRAC"), has repurchased $215 million of its outstanding notes. In 2011, Sears Holdings repurchased $10 million of senior secured notes. The unused balance of this authorization is $275 million.

SEARS HOLDINGS CORPORATION
Notes to Condensed Consolidated Financial Statements — (Continued)
(Unaudited)

Unsecured Commercial Paper

We borrow through the commercial paper markets. At May 3, 2014, May 4, 2013 and February 1, 2014, we had outstanding commercial paper borrowings of $159 million, $377 million and $9 million, respectively. ESL held $150 million and $305 million, respectively, of our commercial paper at May 3, 2014 and May 4, 2013, including $86 million and $178 million, respectively, held by Edward S. Lampert. ESL held none of our commercial paper at February 1, 2014, including any held by Edward S. Lampert. See Note 14 for further discussion of these borrowings.

Domestic Credit Agreement

During the first quarter of 2011, Sears Roebuck Acceptance Corp. ("SRAC"), Kmart Corporation (together with SRAC, the "Borrowers") and Holdings entered into an amended credit agreement (the "Domestic Credit Agreement"). The Domestic Credit Agreement provides for a $3.275 billion asset-based revolving credit facility (the "Revolving Facility") with a $1.5 billion letter of credit sub-limit. On October 2, 2013, Holdings and the Borrowers entered into a First Amendment (the "Amendment") to the Domestic Credit Agreement with a syndicate of lenders. Pursuant to the Amendment, the Borrowers borrowed $1.0 billion under a new senior secured term loan facility (the "Term Loan"). Advances under the Domestic Credit Agreement bear interest at a rate equal to, at the election of the Borrowers, either the London Interbank Offered Rate ("LIBOR") or a base rate, in either case plus an applicable margin. The Domestic Credit Agreement's interest rates for LIBOR-based borrowings vary based on leverage in the range of LIBOR plus 2.0% to 2.5%. Interest rates for base rate-based borrowings vary based on leverage in the range of the applicable base rate plus 1.0% to 1.5%. Commitment fees are in a range of 0.375% to 0.625% based on usage. The Revolving Facility is in place as a funding source for general corporate purposes and is secured by a first lien on most of our domestic inventory and credit card and pharmacy receivables, and is subject to a borrowing base formula to determine availability. The Revolving Facility permits aggregate second lien indebtedness of up to $2.0 billion, of which $1.2 billion in second lien notes were outstanding at May 3, 2014, resulting in $760 million of permitted second lien indebtedness, subject to limitations imposed by a borrowing base requirement under the indenture that governs our 6 5/8% senior secured notes due 2018. The Revolving Facility is expected to expire in April 2016.

The Term Loan bears interest at a rate equal to, at the election of the Borrowers, either (1) LIBOR (subject to a 1.00% LIBOR floor) or (2) the highest of (x) the prime rate of the bank acting as agent of the syndicate of lenders, (y) the federal funds rate plus 0.50% and (z) the one-month LIBOR rate plus 1.00% (the highest of (x), (y) and (z), the "Base Rate"), plus an applicable margin for LIBOR loans of 4.50% and for Base Rate loans of 3.50%. Beginning February 2, 2014, the Borrowers are required to repay the Term Loan in quarterly installments of $2.5 million, with the remainder of the Term Loan maturing June 30, 2018. Beginning with the fiscal year ending January 2015, the Borrowers are also required to make certain mandatory repayments of the Term Loan from excess cash flow (as defined in the Domestic Credit Agreement). The Term Loan may be prepaid in whole or part without penalty, other than a 1.00% prepayment premium if the Borrowers enter into certain repricing transactions with respect to the Term Loan within one year. The Term Loan is secured by the same collateral as the Revolving Facility on a pari passu basis with the Revolving Facility, and is guaranteed by the same subsidiaries of the Company that guarantee the Revolving Facility.

The Domestic Credit Agreement limits our ability to make restricted payments, including dividends and share repurchases, subject to specified exceptions that are available if, in each case, no event of default under the credit facility exists immediately before or after giving effect to the restricted payment. These include exceptions that require that projected availability under the credit facility, as defined, is at least 15% and an exception that requires that the restricted payment is funded from cash on hand and not from borrowings under the credit facility. The Domestic Credit Agreement also imposes various other requirements, which take effect if availability falls below designated thresholds, including a cash dominion requirement and a requirement that the fixed charge ratio at the last day of any quarter be not less than 1.0 to 1.0.

At May 3, 2014, May 4, 2013 and February 1, 2014, we had $1.1 billion, $1.4 billion and $1.3 billion, respectively, of Revolving Facility borrowings and $656 million, $747 million and $661 million, respectively, of letters of credit outstanding under the Revolving Facility. At May 3, 2014 and February 1, 2014, the amount available to borrow under the Revolving Facility was $752 million and $549 million, respectively, which reflects the effect of the

SEARS HOLDINGS CORPORATION
Notes to Condensed Consolidated Financial Statements — (Continued)
(Unaudited)

springing fixed charge coverage ratio covenant and the borrowing base limitation. At May 4, 2013, the amount available to borrow was $823 million, which reflects the effect of the springing fixed charge coverage ratio covenant, while the borrowing base requirement had no effect on availability. The majority of the letters of credit outstanding are used to provide collateral for our insurance programs. At both May 3, 2014 and February 1, 2014 we had $1.0 billion of borrowings under the Term Loan.

Senior Secured Notes

In October 2010, we sold $1.0 billion aggregate principal amount of senior secured notes (the "Notes"), which bear interest at 6 5/8% per annum and mature on October 15, 2018. Concurrent with the closing of the sale of the Notes, the Company sold $250 million aggregate principal amount of Notes to the Company's domestic pension plan in a private placement, of which approximately $110 million remains in the domestic pension plan. The Notes are guaranteed by certain subsidiaries of the Company and are secured by a security interest in certain assets consisting primarily of domestic inventory and credit card receivables (the "Collateral"). The lien that secures the Notes is junior in priority to the lien on such assets that secures obligations under the Domestic Credit Agreement, as well as certain other first priority lien obligations. The Company used the net proceeds of this offering to repay borrowings outstanding under a previous domestic credit agreement on the settlement date and to fund the working capital requirements of our retail businesses, capital expenditures and for general corporate purposes. The indenture under which the Notes were issued contains restrictive covenants that, among other things, (1) limit the ability of the Company and certain of its domestic subsidiaries to create liens and enter into sale and leaseback transactions and (2) limit the ability of the Company to consolidate with or merge into, or sell other than for cash or lease all or substantially all of its assets to, another person. The indenture also provides for certain events of default, which, if any were to occur, would permit or require the principal and accrued and unpaid interest on all the then outstanding notes to be due and payable immediately. Generally, the Company is required to offer to repurchase all outstanding Notes at a purchase price equal to 101% of the principal amount if the borrowing base (as calculated pursuant to the indenture) falls below the principal value of the notes plus any other indebtedness for borrowed money that is secured by liens on the Collateral for two consecutive quarters or upon the occurrence of certain change of control triggering events. The Company may call the Notes at a premium based on the "Treasury Rate" as defined in the indenture, plus 50 basis points. On September 6, 2011, we completed our offer to exchange the Notes held by nonaffiliates for a new issue of substantially identical notes registered under the Securities Act of 1933, as amended.

Sears Canada Credit Agreement

In September 2010, Sears Canada entered into a five-year, $800 million Canadian senior secured revolving credit facility (the "Sears Canada Facility"). The Sears Canada Facility is available for Sears Canada's general corporate purposes and is secured by a first lien on inventory and credit card receivables. Availability under the Sears Canada Facility is determined pursuant to a borrowing base formula based on inventory and credit card receivables, subject to certain limitations. At May 3, 2014, May 4, 2013 and February 1, 2014, we had no borrowings outstanding under the Sears Canada Facility. Availability under this agreement was approximately $433 million ($475 million Canadian), $602 million ($607 million Canadian) and $336 million ($374 million Canadian), respectively, at May 3, 2014, May 4, 2013 and February 1, 2014. The current availability may be reduced by reserves currently estimated by the Company to be approximately $179 million, which may be applied by the lenders at their discretion pursuant to the Credit Facility agreement. As a result of judicial developments relating to the priorities of pension liability relative to certain secured obligations, Sears Canada has executed an amendment to the Sears Canada Credit Facility which would provide additional security to lenders, with respect to the Company's unfunded pension liability by pledging certain real estate assets as collateral thereby partially reducing the potential reserve amounts by up to $137 million the lenders could apply. The potential additional reserve amount may increase or decrease in the future based on estimated net pension liabilities.

SEARS HOLDINGS CORPORATION
Notes to Condensed Consolidated Financial Statements — (Continued)
(Unaudited)

Wholly owned Insurance Subsidiary and Intercompany Securities

We have numerous types of insurable risks, including workers' compensation, product and general liability, automobile, warranty, asbestos and environmental claims and the extended service contracts we sell to our customers. In addition, we provide credit insurance to third party creditors of the Company to mitigate their credit risk with the Company. The associated risks are managed through Holdings' wholly owned insurance subsidiary, Sears Reinsurance Company Ltd. ("Sears Re"), a Bermuda Class 3 insurer.

In accordance with applicable insurance regulations, Sears Re holds marketable securities to support the insurance coverage it provides. Sears has utilized two securitization structures to issue specific securities in which Sears Re has invested its capital to fund its insurance obligations. In November 2003, Sears formed a Real Estate Mortgage Investment Conduit, or REMIC. The real estate associated with 125 Full-line stores was contributed to indirect wholly owned subsidiaries of Sears, and then leased back to Sears. The contributed stores were mortgaged and the REMIC issued to wholly owned subsidiaries of Sears (including Sears Re) $1.3 billion (par value) of securities (the "REMIC Securities") that are secured by the mortgages and collateral assignments of the store leases. Payments to the holders on the REMIC Securities are funded by the lease payments. In May 2006, a subsidiary of Holdings contributed the rights to use the Kenmore, Craftsman and DieHard trademarks in the U.S. and its possessions and territories to KCD IP, LLC, an indirect wholly owned subsidiary of Holdings. KCD IP, LLC has licensed the use of the trademarks to subsidiaries of Holdings, including Sears and Kmart. Asset-backed securities with a par value of $1.8 billion (the "KCD Securities") were issued by KCD IP, LLC and subsequently purchased by Sears Re, the collateral for which includes the trademark rights and royalty income. Payments to the holders on the KCD Securities are funded by the royalty payments. The issuers of the REMIC Securities and KCD Securities and the owners of these real estate and trademark assets are bankruptcy remote, special purpose entities that are indirect wholly owned subsidiaries of Holdings. Cash flows received from rental streams and licensing fee streams paid by Sears, Kmart, other affiliates and third parties, are used for the payment of fees and interest on these securities. In the fourth quarter of fiscal 2013, Holdings contributed all of the outstanding capital stock of Sears Re to SRe Holding Corporation, a direct wholly owned subsidiary of Holdings. Sears Re thereafter reduced its excess statutory capital through the distribution of all REMIC Securities held by it to SRe Holding Corporation. Since the inception of the REMIC and KCD IP, LLC, the REMIC Securities and the KCD Securities have been entirely held by our wholly owned consolidated subsidiaries. At May 3, 2014, May 4, 2013 and February 1, 2014, the net book value of the securitized trademark rights was approximately $1.0 billion. The net book value of the securitized real estate assets was approximately $0.7 billion at May 3, 2014, May 4, 2013 and February 1, 2014.

Trade Creditor Matters

We have ongoing discussions concerning our liquidity and financial position with the vendor community and third parties that offer various credit protection services to our vendors. The topics discussed have included such areas as pricing, payment terms and ongoing business arrangements. As of the date of this report, we have not experienced any significant disruption in our access to merchandise or our operations.

NOTE 3 – DERIVATIVE FINANCIAL INSTRUMENTS

We primarily use derivatives as a risk management tool to decrease our exposure to fluctuations in the foreign currency market, and do not use derivative financial instruments for trading or speculative purposes. We are exposed to fluctuations in foreign currency exchange rates as a result of our net investment in Sears Canada. Further, Sears Canada is exposed to fluctuations in foreign currency exchange rates due to inventory purchase contracts denominated in U.S. dollars. The recorded amounts and corresponding gains on the hedging activity were not material at May 3, 2014 or for the 13-week period ended May 3, 2014.

Hedges of Net Investment in Sears Canada

During the first quarter of 2014, we entered into foreign currency forward contracts with a total Canadian notional value of $143 million, and with a weighted-average remaining life of 0.2 years at May 3, 2014. These contracts were designated and qualify as hedges of the foreign currency exposure of our net investment in Sears Canada.

For derivatives that were designated as hedges of our net investment in Sears Canada, we assess effectiveness based on changes in forward currency exchange rates. Changes in forward rates on the derivatives are recorded in the

SEARS HOLDINGS CORPORATION
Notes to Condensed Consolidated Financial Statements — (Continued)
(Unaudited)

currency translation adjustments line in accumulated other comprehensive loss and will remain there until we substantially liquidate or sell our holdings in Sears Canada.

We settled foreign currency forward contracts during the 13-week period ended May 3, 2014 and received a net amount of $1 million relative to these contract settlements. As hedge accounting was applied to these contracts, an offsetting amount was recorded as a component of other comprehensive loss.

Sears Canada Hedges of Merchandise Purchases

At May 3, 2014, Sears Canada had $64 million notional amount of foreign exchange forward contracts. These forward contracts are used to reduce the foreign exchange risk with respect to U.S. dollar denominated assets and liabilities and purchases of goods or services.

Sears Canada has merchandise purchase contracts denominated in U.S. currency. The merchandise purchase contracts are considered embedded derivatives under relevant accounting rules.

We record mark-to-market adjustments for the fair value of forward contracts and embedded derivatives at the end of each period. Changes in the fair value of any derivatives that are not designated as hedges are recorded in earnings each period. Sears Canada mitigates the risk of foreign currency exchange rates by entering into foreign exchange forward contracts. Since the Company's functional currency is the U.S. dollar, we are not directly exposed to the risk of exchange rate changes due to Sears Canada's contracts, and therefore we do not account for these instruments as a hedge of our foreign currency exposure risk.

Counterparty Credit Risk

We actively manage the risk of nonpayment by our derivative counterparties by limiting our exposure to individual counterparties based on credit ratings, value at risk and maturities. The counterparties to these instruments are major financial institutions with investment grade credit ratings or better at May 3, 2014, May 4, 2013 and February 1, 2014.

NOTE 4 – FAIR VALUE OF FINANCIAL ASSETS AND LIABILITIES

We determine fair value of financial assets and liabilities based on the following fair value hierarchy, which prioritizes the inputs to valuation techniques used to measure fair value into three levels:

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

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

Level 3 inputs – unobservable inputs for the asset or liability.

Accounts receivable, merchandise payables, short-term borrowings, accrued liabilities, cash and domestic cash equivalents are reflected in the Condensed Consolidated Balance Sheets at cost, which approximates fair value due to the short-term nature of these instruments. The fair value of our long-term debt is disclosed in Note 2 to the Condensed Consolidated Financial Statements. The following tables provide the fair value measurement amounts for other financial assets and liabilities recorded in our Condensed Consolidated Balance Sheets at fair value at May 3, 2014, May 4, 2013 and February 1, 2014:

SEARS HOLDINGS CORPORATION
Notes to Condensed Consolidated Financial Statements — (Continued)
(Unaudited)

millions	Total Fair Value Amounts at May 3, 2014	Level 1	Level 2	Level 3
Cash equivalents[1]	$172	$172	$—	$—
Restricted cash[2]	11	11	—	—
Foreign currency derivative assets[3]	2	—	2	—
Total	$185	$183	$2	$—

millions	Total Fair Value Amounts at May 4, 2013	Level 1	Level 2	Level 3
Cash equivalents[1]	$35	$35	$—	$—
Restricted cash[2]	10	10	—	—
Total	$45	$45	$—	$—

millions	Total Fair Value Amounts at February 1, 2014	Level 1	Level 2	Level 3
Cash equivalents[1]	$346	$346	$—	$—
Restricted cash[2]	10	10	—	—
Foreign currency derivative assets[3]	8	—	8	—
Total	$364	$356	$8	$—

(1) Included within Cash and cash equivalents in our Condensed Consolidated Balance Sheets.
(2) Included within Restricted cash in our Condensed Consolidated Balance Sheets.
(3) Included within Prepaid expenses and other current assets in our Condensed Consolidated Balance Sheets.

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.

NOTE 5 – SEARS CANADA

Sears Holdings Ownership of Sears Canada

At May 3, 2014, May 4, 2013 and February 1, 2014, Sears Holdings was the beneficial holder of approximately 52 million, or 51% of the common shares of Sears Canada.

Sears Canada Share Repurchases

During the second quarter of 2013, Sears Canada renewed its Normal Course Issuer Bid with the Toronto Stock Exchange that permits it to purchase for cancellation up to 5% of its issued and outstanding common shares, representing approximately 5.1 million common shares. The purchase authorization expires on May 23, 2014, or on such earlier date as Sears Canada may complete its purchases pursuant to the Normal Course Issuer Bid. There were no share purchases during the 13-week periods ended May 3, 2014 and May 4, 2013.

SEARS HOLDINGS CORPORATION
Notes to Condensed Consolidated Financial Statements — (Continued)
(Unaudited)

Update on our Interest in Sears Canada

On May 14, 2014, we announced that we are exploring strategic alternatives for our 51% interest in Sears Canada, which has a current market value of approximately $730 million as of May 20, 2014, including a potential sale of our interest or Sears Canada as a whole. In connection with these efforts, we engaged BofA Merrill Lynch.

Sears Canada's Board of Directors has advised us that Sears Canada's board and management intend to cooperate fully with us in this process to achieve value for all shareholders.

NOTE 6 – STORE CLOSING CHARGES, IMPAIRMENTS AND REAL ESTATE TRANSACTIONS

In accordance with accounting standards governing costs associated with exit or disposal activities, expenses related to future rent payments for which we no longer intend to receive any economic benefit are accrued for when we cease to use the leased space and have been reduced for any income that we believe can be realized through sub-leasing the leased space. During the first quarter of 2014, we closed 29 stores in our Kmart segment and 13 stores in our Sears Domestic segment we previously announced would close, and recorded charges for the related lease obligations of $0.3 million for five of these stores in our Kmart segment and $1 million for seven of these stores in our Sears Domestic segment. During the first quarter of 2013, we closed four stores we previously announced would close and recorded charges of $1 million at Kmart for the related lease obligations.

We expect to record additional charges of approximately $15 million during the remainder of 2014 related to stores we had previously made the decision to close.

We made the decision to close 14 stores in our Kmart segment and four stores in our Sears Domestic segment during the first quarter of 2014, and 13 stores in our Kmart segment and six stores in our Sears Domestic segment during the first quarter of 2013.

Store closing costs and severance recorded for the 13-week periods ended May 3, 2014 and May 4, 2013 were as follows:

millions	Markdowns[1]	Severance Costs[2]	Lease Termination Costs[2]	Other Charges[2]	Impairment and Accelerated Depreciation[3]	Total Store Closing Costs
Kmart	$5	$1	$—	$3	$ —	$9
Sears Domestic	2	—	(2)	—	5	5
Sears Canada	—	5	5	—	—	10
Total for the 13-week period ended May 3, 2014	$7	$6	$3	$3	$ 5	$24
Kmart	$5	$1	$(1)	$3	$ 1	$9
Sears Domestic	3	1	(3)	2	8	11
Sears Canada	—	2	—	—	—	2
Total for the 13-week period ended May 4, 2013	$8	$4	$(4)	$5	$ 9	$22

(1) Recorded within Cost of sales, buying and occupancy on the Condensed Consolidated Statements of Operations.

(2) Recorded within Selling and administrative on the Condensed Consolidated Statements of Operations. Lease termination costs are net of estimated sublease income, and include the reversal of closed store reserves for which the lease agreement has been terminated and the reversal of deferred rent balances related to closed stores.

(3) Costs for the 13-week period ended May 3, 2014 are recorded within Impairment charges on the Condensed Consolidated Statement of Operations. Costs for the 13-week period ended May 4, 2013 include $8 million recorded within Impairment charges and $1 million recorded within Depreciation and amortization on the Condensed Consolidated Statements of Operations.

13

SEARS HOLDINGS CORPORATION
Notes to Condensed Consolidated Financial Statements — (Continued)
(Unaudited)

Store closing cost accruals of $180 million, $169 million and $199 million at May 3, 2014, May 4, 2013 and February 1, 2014, respectively, were as follows:

millions	Severance Costs	Lease Termination Costs	Other Charges	Total
Balance at May 4, 2013	$26	$127	$16	$169
Store closing costs	55	7	15	77
Store closing capital lease obligations	—	2	—	2
Payments/utilizations	(18)	(17)	(14)	(49)
Balance at February 1, 2014	63	119	17	199
Store closing costs	6	6	3	15
Payments/utilizations	(20)	(5)	(9)	(34)
Balance at May 3, 2014	$49	$120	$11	$180

Real Estate Transactions

During the first quarter of 2014, we recorded gains on the sales of assets of $46 million in connection with real estate transactions, which included a gain of $13 million recognized on the sale of a distribution facility in our Sears Domestic segment for which we received $16 million of cash proceeds. Also, during the first quarter of 2014, we entered into an agreement for the surrender and early termination of one Sears Full-line store lease for which we received $40 million of cash proceeds. The gain will be deferred until the lease termination agreement is effective.

NOTE 7 – EQUITY

Accumulated Other Comprehensive Loss

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

millions	May 3, 2014	May 4, 2013	February 1, 2014
Pension and postretirement adjustments (net of tax of $(327), $(442) and $(328), respectively)	$(1,007)	$(1,364	