MEMORANDUM

TO: McIntire Investment Institute Managers
FROM: Alex Persson, Commerce 2009
DATE: 11/27/07
SUBJECT: Sears Holdings Corp.

Business Description

Sears Holding Corp, the parent company of K-Mart and Sears, was created by the March 2005 merger of K-mart and Sears, Roebuck and Co. ESL Investments, headed by investor Eddie Lampert, has a 45% stake in the company. It is the nation’s 4th largest retailer with revenue of over $50 billion in revenue. Sears Holdings’ brand include: Lands End, Joe Boxer, Craftsman, Kenmore, and Martha Stewart Everyday. However, the company’s strength is not entirely derived from its brands and retail operations. Analysts have long speculated that Sears Holdings Co. will become another Berkshire-Hathaway, with interests in many undervalued stocks that have the potential for high returns. With a free cash flow of $2.5 billion, Sears Holdings has the potential to make big moves in the upcoming months.

Financial Information

<table>
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<tr>
<th>($ in mil)</th>
<th>Feb-07</th>
<th>Jan-06</th>
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<tbody>
<tr>
<td>Revenue</td>
<td>$53,012</td>
<td>$49,124</td>
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<tr>
<td>Expenses</td>
<td>$60,489</td>
<td>$47,000</td>
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<tr>
<td>EBIT</td>
<td>$2,623</td>
<td>$2,124</td>
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<tr>
<td>Net Income</td>
<td>$1,490</td>
<td>$868</td>
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- Cash and Cash Equivalents: $2631 mil
- Cash Per Share: $10.42
- Free Cash Flow Per Share: $5.72
- Return on Assets: 4.9%
- Return on Equity: 12.1%
- Share Price (11/23/07): 112.56
- Shares Outstanding: 150 mil.
- Market Cap: 16,068
- 52-week range: 106.83-195.16
- Price/Earnings: 14.3
- EPS: 9.19
Investment Summary

I believe that Sears Holdings Corp (NYSE: SHLD) is an attractive long position for the McIntire Investment Institute for the following reasons:

- Weak forecasted retail sales have lowered earnings expectations but have lead to discounted share price.
- Target and Simon have openly expressed interest in expanding by purchasing stores instead of building.
- Sears is focusing on building its brands and improving customer service in order to increase profitability.
- Management has a successful track record
- Financial analysis reveals a large increase in EBITDA from selling stores.

A gloomy outlook on retail holiday sales has contributed to decline of SHLD stock price

The 25% drop in share price of Sears Holdings has largely been attributed to weak holiday forecasts as well as press releases announcing lower estimated earnings. Low consumer confidence, signs of stress in labor market, and high crude prices lead to a gloomy outlook for this year’s holiday shopping season. The Reuters/University of Michigan consumer confidence reading for November was 76.1, down from 80.9 in October. Apart from the short-lived dip in sentiment that followed Hurricane Katrina in 2005, it was the weakest since 1992. The market groups Sears Holdings along with many other retailers who have forecasted lower earnings due to a weak holiday outlook. However, Sears Holdings’ power comes from its vast portfolio of prime retail and high-end brands. At a share price of $112 per share, Sears Holdings is grossly undervalued. Many analysts have priced Sears Holdings at $175 per share but recent uncertainty in retail, as well as recent uncertainty in the future of Sears Holdings have left investors cautious. An analyst at Carlson Capital LLC, based out of Dallas, Texas, has projected a share price of over $200 for Sears Holdings.

Conditions are favorable for liquidation of Sears Holdings property

Target, Inc. and Simon Malls, in their letters to shareholders, have stated that they are interested in expanding. Specifically, Target, Inc. has outlined a 25% increase in stores over the upcoming years. They have also stated that it is less expensive to purchase retail space than to build. This information gives Sears Holdings tremendous power and is the reason for Barron’s recent article that stated that the Sears Holdings stock has the potential to reach $300 per share if some of its prime real estate was sold off. In addition, Lampert has continually stated that his interest is not in growing the company, but increasing profits. Chairman Eddie Lampert is a hedge fund manager whose main concerns is with providing high returns, and thus he will not hesitate to sell off stores if it will provide higher returns than growing the retail chain. From speaking with a leading commercial real estate company, there is a large market for Sears Holdings’ property.
Furthermore, a declining dollar has led foreign investors to express interest in acquiring property in the United States.

**Sears Holdings Chairman Eddie Lampert has stated that his goal is to increase profits, not to grow the company.**

As of August 2007, Sears Holdings had approximately 3,800 stores broken down in to 1,400 K-mart stores and 2,400 Sears full-line and specialty stores. Eddie Lampert has expressed interest in converting K-mart stores in to higher end, and more profitable, Sears stores. On November 17th 2007, a newly renovated store opened its doors with a Sears logo instead of a K-mart logo. These Sears stores have strong brands such as Lands End and Kenmore, and Sears Holdings has expressed interest in expanding their brand selection. This is evident by their recent acquisition of 14% of Restoration Hardware which can add strength to their home furnishings department. In addition, acquiring Restoration Hardware would provide high quality home furnishings at low price since Sears Holdings would own the supplier of these high quality products. According to Brad Belz, an executive at Macy’s East, the future of retail is in high end merchandise. By converting K-mart stores in to Sears stores, and by providing high end brands such as Lands End, Sears Holdings is heading in the direction of increased profits and increased return on assets.

**Sears Holdings management has a proven track record of success**

Sears Holdings is run by Chairman of Sears Holdings Eddie Lampert and CEO/President Ailwyn Lewis. ESL Investments, headed by Eddie Lampert, has enjoyed average annual returns of 25% during the fund’s 19 year history. In addition, his cost-cutting techniques and aggressive focus on increasing profit margins led to the successful turn around of AutoZone (AZO). When Sears Holdings was created, shareholders enjoyed a dramatic increase in share price, hitting an all-time high in April at more than $195 per share. CEO Ailwyn Lewis joined Sears Holding in September 2005 and has been with the company since. Before joining SHLD, he was President of YUM! Brands as well as a director for The Walt Disney Company. Mr. Lewis has a proven track record of success in his past positions and contributed heavily to the early success of Sears Holdings.

**Conservative financial modeling shows that sale of assets can result in a share price of at least $181 per share.**

By subtraction rent expense and adding cash proceeds from the sale of property, SHLD is valued using OpCo/PropCo Valuation at a minimum of $181 per share. Using a rental yield of approximately 5%, it is possibly to calculate a new EBITDA and from that, a new enterprise value. Dividing enterprise value by outstanding stocks gave me new values for SHLD’s share price. Using book value, I estimated the share price to be $171.
Conservative estimates gave me a share price of $181 and best estimates gave me a share price of $272. It is clear that the current share price of $112 is drastically low for SHLD.

Risks

- Sears Holdings profits are tied to other investments that ESL Investments has their hands in. Current uncertainty in the market may hurt ESL Investment’s ability to restructure Sears.
- Currently, Sears is seen as a poor retailer with declining same-store sales and declining profits. This is evidenced by the drastic decline in stock price over the past few months. If Chairman Eddie Lampert does not turn things around, Sears’ value will continue to plummet.
- A weak housing market may translate in to difficulty selling off stores if Sears Holdings decides to sell off real estate. In addition, selling all $8 billion of real estate may not be entirely possible.
- In addition, a weak housing market can translate in to low demand for home appliances and home services. Sears is the nation’s largest provider of home services and revenue from home services contributes significantly to Sears Holdings’ bottom line.
- A bidding war may erupt between SHLD and Catterson Partners over Restoration Hardware. Sears Holdings currently have a 14% stake in Restoration Hardware (RSTO) and has had private discussions with management regarding an acquisition of RSTO. A bidding war would drive the price up and end up costing Sears Holdings millions.

Conclusion

Whichever route Chairman Eddie Lampert and CEO Ailwyn Lewis decide to take, it is clear that SHLD is undervalued at the current share price. The price has declined because of weak forecasted earnings and a bleak outlook on retailers. Consumer confidence is at an all-time low and this has translated in to a deflated stock price. However, as stated above, SHLD’s power comes from its properties and brands. Other retailers see their properties and brands as core to their business and cannot part with them. However, because SHLD is held by institutions who are concerned with high returns, SHLD can afford to part with property because Chairman Eddie Lampert is not concerned with growing the Sears image. While Sears Holdings is interested in acquiring Restoration Hardware to spruce up its stores, it is also acquiring Restoration Hardware because it is an undervalued company that provides high quality goods. By having a hedge fund perspective of SHLD, Mr. Lampert is able to treat Sears Holdings differently than all other retailers. This will translate in to maneuvers that will increase Sears Holdings profits and value to shareholders.
Recent News

- SHLD will announce 3Q Earnings on November 29, 2007.
- Restoration Hardware will consider all buyout offers until December 13, 2007.
- Black Friday saw an unexpected amount of shoppers, lowering concerns of weak holiday sales.

Value Added Research Contact List

Saunders Ketcham, CB Richard Ellis.
- Discussed feasibility of liquidating Sears Holding property
- Discussed market and potential buyers of commercial real estate

Brad Belz, Macy’s East
- Discussed future of retail industry. Sears and Macy’s are in very similar positions because of recent mergers and influx of stores.

Henric Persson, Carlson Capital LLC
- Discussed value of SHLD’s property
- Speculated on rumors about other acquisitions SHLD might pursue.
- Gave details on the RSTO acquisition.

Thomas Kircher, A.G. Edwards
- Discussed ideas about whether SHLD’s share price will bottom out in the upcoming days.

Investor Relations, Target, Inc.
- Discussed Target’s outline to expand its stores.