Equity Research

November 19, 2004

Kmart & Sears: Wal-Mart Ate My Lunch…

Sears Holding Corp. ($104.99)
Target Price: $91
Rating: Underweight

Current Market Price:	$ 104.99
52 Wk Range	$ 22.41 - $106.30
Market Cap	$ 9.36 bn
Trailing P/E	9.78
Forward P/E	16.38
Return on Assets	16.45
Return on Equity	45.84

Current Market Price:	$ 52.95
52 Wk Range	$ 31.21 - $56.06
Market Cap	$ 11.01 bn
Trailing P/E	4.97
Forward P/E	24.2
Return on Assets	9.59
Return on Equity	47.43

An over-valued turnaround store with limited potential for success:

We are underweight Sears Holding Corp.'s equity (the name given to the $11bn combination of Kmart Holding Corp. and Sears Roebuck & Co). When we first started writing our report on Kmart two weeks ago, we were bearish Kmart at its trading levels given the tough operating environment for retailers in general, and the growing margin pressure from Wal-Mart. On a stand-alone basis, we would also have been underweight Sears Roebuck. On November 17, Kmart and Sears made a surprise announcement that the two companies planned on merging. Under the terms of the deal, Kmart shareholders will receive one share of Sears Holding for each of their shares. Sears investors will receive 0.5 shares of the new company (or $50 in cash) for each of their shares. The $50 price represents a 10.6% premium over Sears' closing share price on November 16.

Company Description: Kmart Corporation is a discount retailer operating through 1,511 Kmart discount stores and Supercenters with locations in 49 states, Puerto Rico, the United States Virgin Islands and Guam, as of January 28, 2004, and through an e-commerce shopping site, www.kmart.com. The Company has one operating segment that consists of its retail business. Its general merchandise retail operations are located in 286 of the 331 metropolitan statistical areas in the United States. Its 60 Kmart Supercenters combine a full grocery, deli and bakery, along with the general merchandise selection of a Kmart discount store. The brands that the Company markets include Martha Stewart Everyday, Joe Boxer, Jaclyn Smith, Sesame Street and Thalia Sodi, among others. On January 22, 2002, Kmart and 37 of its United States subsidiaries filed voluntary petitions for reorganization under Chapter 11 of the United States Bankruptcy Code. In May 2003, the Company emerged from Chapter 11 protection. (Source: Yahoo Finance)

Company Description: Sears, Roebuck and Co. is a multi-line retailer that offers an array of merchandise and related services. The Company operates principally in the United States, Puerto Rico and Canada. During the fiscal year ended January 3, 2004 (fiscal 2003), Sears was organized into three domestic segments: Retail and Related Services, Credit and Financial Products and Corporate and Other; and one international segment: Sears Canada. The Retail and Related Services segment consists of merchandise sales and related services, including service contracts, delivery and product installation and repair services. The Credit and Financial Products segment managed the Company's domestic portfolio of Sears Card and MasterCard receivables. This business was sold on November 3, 2003. The Corporate and Other segment includes the operations of Sears Home Improvement Services. The Sears Canada segment includes similar retail, credit and corporate operations conducted by Sears Canada, a 54.4%-owned subsidiary. (Source: Yahoo Finance)

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Please refer to important disclosure information on page 27.

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VALUATION MEASURES

	Sears	K-Mart
Market Cap (intraday):	11.01B	9.36B
Enterprise Value (24-Nov-04)[3]:	13.91B	7.13B
Trailing P/E (ttm, intraday):	4.97	9.78
Forward P/E (fye 3-Jan-06)[1]:	24.2	16.38
PEG Ratio (5 yr expected)[1]:	5.82	1.81
Price/Sales (ttm):	0.3	0.46
Price/Book (mrq):	2.03	3.04
Enterprise Value/Revenue (ttm)[3]:	0.37	0.35
Enterprise Value/EBITDA (ttm)[3]:	9.81	3.7

FINANCIAL HIGHLIGHTS

	Sears	K-Mart
Fiscal Year		
Fiscal Year Ends:	3-Jan	28-Jan
Most Recent Quarter (mrq):	30-Sep-04	31-Oct-04
Profitability		
Profit Margin (ttm):	7.45%	5.37%
Operating Margin (ttm):	0.23%	9.30%
Management Effectiveness		
Return on Assets (ttm):	9.59%	16.45%
Return on Equity (ttm):	47.43%	45.84%
Income Statement		
Revenue (ttm):	37.12B	20.12B
Revenue Per Share (ttm):	164.776	199.876
Revenue Growth (lfy)[3]:	-0.60%	N/A
Gross Profit (ttm)[2]:	14.89B	5.41B
EBITDA (ttm):	1.42B	1.93B
Net Income Avl to Common (ttm):	2.72B	1.08B
Diluted EPS (ttm):	10.704	10.738
Earnings Growth (lfy)[3]:	146.90%	N/A
Balance Sheet		
Total Cash (mrq):	2.73B	2.56B
Total Cash Per Share (mrq):	13.22	28.75
Total Debt (mrq)[2]:	5.68B	393.00M
Total Debt/Equity (mrq):	1.048	0.128
Current Ratio (mrq):	1.277	3.15
Book Value Per Share (mrq):	26.098	34.300999
Cash Flow Statement		
From Operations (ttm)[3]:	-969.00M	2.19B
Free Cashflow (ttm)[3]:	-1.90B	2.01B

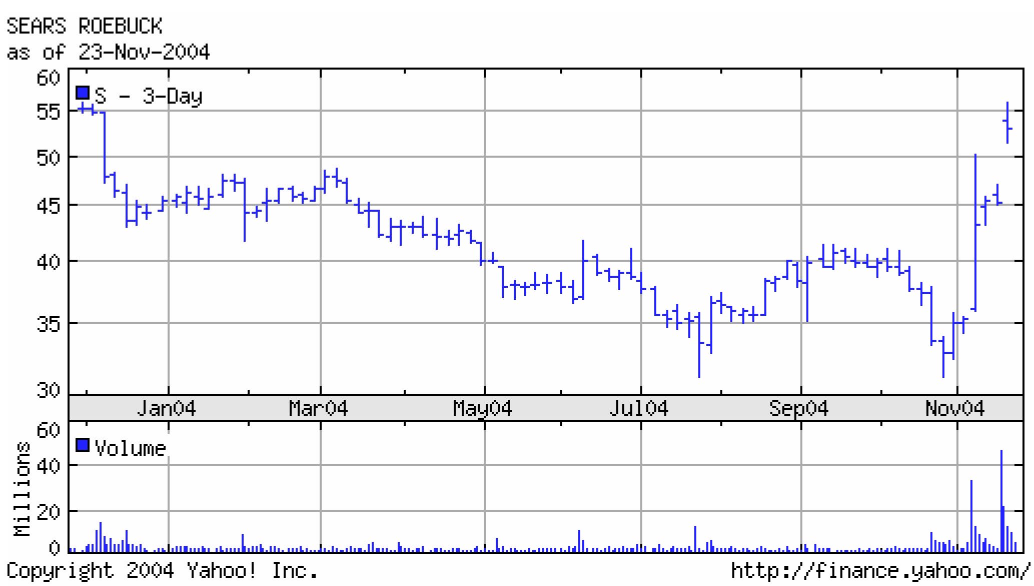
TRADING INFORMATION

	Sears	K-Mart
Stock Price History		
Beta:	0.614	N/A
52-Week Change:	-3.37%	265.20%
52-Week Change (relative to	-14.52%	223.05%
52-Week High (1-Dec-03):	56.06	119.69
52-Week Low (25-Oct-04):	31.21	22.41
50-Day Moving Average:	40.41	91.89
200-Day Moving Average:	40.2	64.93
Share Statistics		
Average Volume (3 month):	4,584,636	2,556,090
Average Volume (10 day):	11,623,000	7,377,000
Shares Outstanding:	206.82M	89.18M
Float:	205.90M	37.50M
% Held by Insiders:	0.44%	57.95%
% Held by Institutions:	69.64%	74.06%
Shares Short (as of 8-Nov-04	12.65M	9.19M
Daily Volume (as of 8-Nov-04	N/A	N/A
Short Ratio (as of 8-Nov-04):	2.153	6.429
Short % of Float (as of 8-Nov	6.14%	24.50%
Shares Short (prior month):	15.50M	9.46M
Dividends & Splits		
Annual Dividend:	0.92	N/A
Dividend Yield:	1.74%	0.00%
Dividend Date:	3-Jan-05	5-Jun-87
Ex-Dividend Date:	26-Nov-04	8-Jun-87
Last Split Factor (new per old	2:01	N/A
Last Split Date:	18-Jul-77	N/A

Source: Yahoo Finance

Kmart Stock Price: 12-month Performance

Sears Stock Price: 12-month Performance



K-Mart Major Holders

BREAKDOWN

% of Shares Held by All Insider and 5% Owners:	58%
% of Shares Held by Institutional & Mutual Fund Owner	74%
% of Float Held by Institutional & Mutual Fund Owners:	176%
Number of Institutions Holding Shares:	10

TOP INSIDER & RULE 144 HOLDERS

Holder	Shares	Reported
ESL INVESTMENTS INC	73,140,756	24-Aug-04
TISCH, THOMAS J.	1,079,302	6-May-03
KELLY, JANET LANGFORD	34,218	3-Sep-03
DONLON, JAMES D.	21,552	2-Jan-04
GOODMAN, JOHN	21,552	2-Jan-04

TOP INSTITUTIONAL HOLDERS

Holder	Shares	% Out	Value*	Reported
Third Avenue Management, LLC	4,481,520	5	$321,773,136	30-Jun-04
RBS Partners, L.P.	41,480,635	46.27	$2,978,309,593	30-Jun-04
Atticus Capital, L.L.C.	3,182,072	3.55	$228,472,769	30-Jun-04
Perry Corp.	2,450,100	2.73	$175,917,180	30-Jun-04
Trafelet & Company, LLC	1,362,500	1.52	$97,827,500	30-Jun-04
Barclays Bank Plc	1,040,514	1.16	$74,708,905	30-Jun-04
Goldman Sachs Group Inc	972,864	1.09	$69,851,635	30-Jun-04
Zander Capital Management, LLC	860,401	0.96	$61,776,791	30-Jun-04
Vanguard Group, Inc. (The)	843,499	0.94	$73,780,858	30-Sep-04
JGD Management Corporation	710,686	0.79	$51,027,254	30-Jun-04

TOP MUTUAL FUND HOLDERS

Holder	Shares	% Out	Value*	Reported
Third Avenue Value Fund, Inc.	1,492,913	1.67	$115,596,251	31-Jul-04
Vanguard Total Stock Market Index Fund	323,090	0.36	$23,197,862	30-Jun-04
College Retirement Equities Fund-Stock Account	314,194	0.35	$22,559,129	30-Jun-04
Vanguard Extended Market Index Fund	225,099	0.25	$16,162,108	30-Jun-04
Vanguard Mid-Cap Index Fund	152,381	0.17	$10,940,955	30-Jun-04
Aegon/Transamerica Ser-Third Avenue Value	109,600	0.12	$7,869,280	30-Jun-04
MET Investors Ser Tr-Third Avenue Small Cap Value	100,400	0.11	$7,208,720	30-Jun-04
Third Avenue Variable Series Trust Fund	99,600	0.11	$7,151,280	30-Jun-04
Diversified Investors Aggressive Equity Portfolio	87,000	0.1	$6,246,600	30-Jun-04
CDC Nvest Star Advisers Fund	78,425	0.09	$5,630,915	30-Jun-04

Sears Major Holders

BREAKDOWN

% of Shares Held by All Insider and 5% Owners:	0%
% of Shares Held by Institutional & Mutual Fund Owners:	70%
% of Float Held by Institutional & Mutual Fund Owners:	70%
Number of Institutions Holding Shares:	10

TOP INSIDER & RULE 144 HOLDERS

Holder	Shares	Reported
KP I PARTNERS LP	31,100,000	30-Jun-03
ESL INVESTMENTS INC	31,100,000	1-Jul-04
LACY, ALAN J.	109,006	20-Aug-04
CARTY, DON	50,000	31-Mar-03
PADILLA, LUIS A.	50,000	20-Sep-04

TOP INSTITUTIONAL HOLDERS

Holder	Shares	% Out	Value*	Reported
Hotchkis & Wiley Capital Management, LLC	14,332,648	6.9	$541,200,797	30-Jun-04
Barclays Bank Plc	7,098,850	3.42	$268,052,580	30-Jun-04
Vanguard Group, Inc. (The)	4,220,294	2.03	$168,178,715	30-Sep-04
Axa	4,188,164	2.02	$158,145,075	30-Jun-04
RBS Partners, L.P.	31,100,000	14.98	$1,174,336,018	30-Jun-04
State Street Corporation	23,498,071	11.32	$887,287,175	30-Jun-04
Deutsche Bank Aktiengesellschaft	3,478,210	1.68	$131,337,211	30-Jun-04
Equinox Capital Management	3,447,845	1.66	$137,396,623	30-Sep-04
Goldman Sachs Group Inc	2,716,769	1.31	$102,585,199	30-Jun-04
LSV Asset Management	2,654,050	1.28	$100,216,929	30-Jun-04

TOP MUTUAL FUND HOLDERS

Holder	Shares	% Out	Value*	Reported
Vanguard/Windsor II	3,928,700	1.89	$144,104,711	31-Jul-04
Hotchkis and Wiley Mid-Cap Value Fund	2,109,500	1.02	$79,654,721	30-Jun-04
Vanguard 500 Index Fund	1,977,537	0.95	$74,671,798	30-Jun-04
College Retirement Equities Fund-Stock Account	1,188,182	0.57	$44,865,753	30-Jun-04
SPDR Trust Series 1	1,108,223	0.53	$48,462,590	30-Sep-03
Fidelity Equity-Income Fund	1,032,700	0.5	$37,879,434	31-Jul-04
Vanguard Institutional Index Fund-Institutional Index Fd	860,785	0.41	$32,503,242	30-Jun-04
Hotchkis and Wiley Large Cap Value Fund	780,000	0.38	$29,452,800	30-Jun-04
Vanguard Total Stock Market Index Fund	763,216	0.37	$28,819,036	30-Jun-04
American Skandia Tr-Hotchkiss & Wiley Large Cap Value	762,600	0.37	$28,795,776	30-Jun-04

I. Overview

… Institutional ownership is preponderant, signaling the firms' value as stable retail holdings.

Insider ownership is significant for Kmart, not surprising given ESL's huge stake and the company's restructuring history. Insider ownership is negligible, however, for Sears. Institutional ownership is preponderant for both companies, signaling the firms' value as stable retail holdings. For the purpose of writing this report, we will assume that the merger deal will work out, although we want to draw attention to the possibility, however remote, that another bidder (such as Vornado Realty Trust) might try to stir the pot by topping Kmart's bid.

Eddie Lampert (of ESL Investments and chairman of Kmart) will run the combined group along with Aylwin Lewis (recently appointed chief executive of Kmart) and Alan Lacy (chief executive of Sears). Sears Holding, which will be the third-largest US retailer after Wal-Mart and Home Depot, will be headquartered in Hoffman Estates, Illinois, at Sears' current home-base. Investors sent the stocks of both companies soaring upon news of the merger plan. Sears Holding, with $55bn in annual revenues still lags far behind Wal-Mart Stores, with $280bn in annual revenues.[1]

Combining two struggling retailers with dismal sales does not necessarily produce a winner …

Combining two struggling retailers with dismal sales does not necessarily produce a winner; the aphorism of "two wrongs do not add up to a right" comes to mind. Speculation is rife that Lampert wants to turn the combined entity into a Berkshire Hathaway-like investment vehicle.[2] When investors buy Sears Holding's equity, investors are not really investing in the combined retailer as much as they are investing in Eddie Lampert's business acumen. If one thinks that Lampert is the second coming of Warren Buffett, then buying the stock at current valuation levels makes sense. Eddie is a great trader, no doubt, but he has yet to earn his spurs as the honcho of a major going concern. Our view is that for an investor looking for stable returns, the risk of owning Sears Holding's equity is not worth it.

In the long-run, we see Eddie consolidating Sears Holding, divesting underperforming stores, accruing tax-shielded cash from the retail operations using $3.8bn in deferred tax assets,[3] and eventually spinning off the going concern to a strategic player like Target or the European retailing giant Carrefour.[4]

In a sign that the fixed-income market is not pleased with the merger, S&P warned that the company could end up with a junk rating when the deal is finalized. Moody's has lowered its rating on Sears' debt to a low investment grade ranking of Baa2. Credit default swap spreads on Sears widened some 20 basis points on the announcement.[5]

II. Background

Many investors are confused about why Lampert would engineer such a takeover for cash-rich Kmart, which could have had its pick of investment opportunities. Eddie is often referred to as the next Warren Buffett,[6] whose successful investment technique of buying solid, dull, and undervalued companies is one that the 42 year-old Lampert has closely followed. Lampert bought his initial stake in AutoZone Inc., the struggling auto-parts retailer, in 1997. By 1999, Eddie had a seat on AutoZone's board and eventually brought in a new management team and boosted cash flow. The result was improved earnings and a fourfold surge in the company's stock price.[7]

… why…engineer such a takeover for cash-rich Kmart, which could have had its pick of investment opportunities?

Eddie brought Kmart out of Chapter 11 bankruptcy proceedings on May 6, 2003 with its long-term prime leases intact. Kmart had filed voluntary petitions for reorganization under Chapter 11 of the US Bankruptcy Code on January 22, 2002; the company was forced into bankruptcy mainly by fierce competition from Wal-Mart. Kmart's bankruptcy restructuring was an all equity deal. The equity stake was wiped out and all of the debt outstanding was converted to new equity in the restructured entity; nothing would have been left over for the creditors had the deal not been an all-equity transaction.[8]

Eddie led an aggressive strategy of closing or selling about 600 stores. This aggressive cost-cutting and asset divestiture strategy has been the main driver of Kmart's speedy financial turnaround. Since coming out of bankruptcy, Kmart's stock has more than quadrupled in value. Before the merger announcement, the consensus estimate was for Kmart shares to hit $110/share by the end of the year, which happened shortly after the merger news hit the tape.[9]

Kmart has not been plowing its cash flow back into its operations and thus has not been able to sustain any substantial growth on an operational basis. Kmart's inventories and fixed assets are in bad shape and subject to shrinkage.[10] Kmart's earnings to date have benefited from deferred tax assets that came from writing down assets before the bankruptcy and taking the losses through the process. Aside from this limited source of capital, there is not a lot of potential upside in the Kmart story.

III. Issues and Concerns

At Kmart, customers' household incomes are typically $25,000 and below. Kmart was the first discounter to use exclusive brands. Over the past few years, the company's stable of exclusive brands has expanded to include Jaclyn Smith, Sesame Street, Kathy Ireland, Martha Stewart Everyday, and most recently, Joe Boxer. The latter two lines have been wins for the retailer, as both have raised the profile of its stores and attracted new customers.[11] With the merger, there will be difficulties in synchronizing Kmart and Sears with regards to merchandising and planning. There are no guarantees that cross-selling between the stores (i.e. bringing Craftsman tools into Kmart or Martha Stewart-branded goods into Sears) will drive business.[12]

We view competition [from Wal-Mart and Target], however, as an unavoidable part of doing business in the retail space.

Lampert, Lewis and Lacy plan on squeezing suppliers as the combined Sears Holding entity buys $40bn a year in merchandise. Sears Holding also plans on lowering costs by streamlining its back-office operations. The new company is expected to have annual savings, or "synergies," of $500 million over the next three years. Whether these ambitious goals can be achieved remains to be seen.[13]

Aylwin Lewis, formerly of Yum! Brands, has extensive experience in the restaurant business although he has no prior experience with retail.[14] Aylwin's expertise might not translate over to running Sears Holding Corp, especially in the face of unrelenting competition from Target and Wal-Mart. Aylwin's strong operations background, however, could help Sears Holding focus on cutting costs and overlapping functions between Kmart and Sears stores.[15]

The potential for Sears to improve sales by expanding into some of the stand-alone or off-mall locations occupied by Kmart is substantial.

Sears Holding is purportedly not going to compete head-to-head with Wal-Mart and Target. We view this competition, however, as an unavoidable part of doing business in the retail space. Kmart and Sears have to generate more consumer traffic; the stock will drop if they do not. Christmas sales will be crucial in determining Sears Holding's value as a going concern.[16] An increased focus on branded goods will help generate more traffic.

Sears' sales have remained weak. Comps were down 4% in the domestic business and the company experienced particularly weak demand in August and September due in part to unseasonably cool weather. Further markdowns were needed in apparel to clear seasonal slower moving inventory.[17]

Selling off underperforming real estate and tucking away retained earnings appear to be Lampert's main source of free capital. Kmart's leases constitute the bulk of Kmart's value as same-store sales and other retail metrics have been declining steadily. Eddie had sold 45 stores to Sears for $524.5 million and a further 18 stores to Home Depot for $271 million before the merger announcement.[18]

Geographically, Kmart stores are concentrated in urban areas with a heavy African-American and Hispanic presence. Sears stores are also located primarily in urban areas, and so growth prospects will be limited. According to UBS retail analyst Gary Balter, 64% of Sears' full-line stores are within one mile of a Kmart store, and 68% of Target and Wal-Mart stores are within one mile of a Kmart or Sears' store. Kmart and Sears' overlap could lead to some cannibalization and possible brand deterioration.[19]

The potential for Sears to improve sales by expanding into some of the stand-alone or off-mall locations occupied by Kmart is substantial. Talking about Sears, Alan Lacy declared that "Off-mall growth is our number one strategic position…We have an opportunity to significantly accelerate" that strategy. Eddie Lampert believes that converting some Kmart stores into Sears' stores would boost sales among suburban shoppers who bypass Kmart for Wal-Mart and Target. There are over 1,500 Kmart stores in off-mall locations in high traffic areas. Sears' strategy to move off-mall highlights a trend that some mall-based retailers are starting to adopt in order to stay competitive. Sears had already started moving in this direction prior to the merger announcement with the build-out of a few Sears Grand stores. Sears' desire to move off-mall, where many Kmart properties are, was most likely one of the main driving forces behind the merger.[20]

… we certainly see a transformation of Sears Holding into an investment vehicle as a likely strategy, which would not necessarily be good news for investors …

At its stores inside malls, Sears, not unlike JC Penney, has been losing traffic to more exclusive boutiques and branded stores. By moving toward having more stand-alone stores, Sears could boost its product offerings and benefit from reduced competition. According to Darrell Rigby, head of the global retail practice at Bain & Company, a growing segment of consumers is less interested in going to malls. Mall traffic has been declining steadily as more people shop off the mall. One of the reasons is that malls are less convenient than big-box stores where customers can park closer to the entrance. Mr. Rigby continued "As Sears has built off-mall stores they have found it is not cannibalizing their existing stores nearly as much as they expected…it is a different customer base who go there for different purchasing occasions; they are going there more frequently because of the mix of merchandise."[21]

Looking at Kmart's cash position, we certainly see a transformation of Sears Holding into an investment vehicle as a likely strategy, which would not necessarily be good news for investors looking to buy retail stock. In the event that Eddie Lampert elects not to pursue this course, there has not been a lot of clarity on exit strategies for his investment. Lampert's role in the merger is fueling speculation about how the merged company will unlock value in its real-estate holdings. Estimates of Sears' real estate value remain a little exaggerated. It is very likely that groups of underperforming stores (both Sears' and Kmart's) will likely be sold to fund off mall expansion for Sears Holding and to build a mountain of cash for Lampert's investment vehicle.

Kmart and Sears' corporate cultures will have to be merged, posing additional challenges for the combined retailer. Sears, founded in 1886, is one of America's most well-established shopping institutions. Although its products are often discounted, the retailer is not a pure discounter like Wal-Mart, Target or Kmart. Sears puts a premium on customer service and its staff having very high levels of product knowledge whereas service does not play as big a role at Kmart. The emphasis at Kmart is on a convenient shopping experience as opposed to product knowledge. Over the past year, Kmart has been trying to sell more branded products, while Sears has been adding more soft goods to its stores, which will help make the cultural fusion a little easier.[22]

Regarding inventory, Kmart and Sears have not made any moves toward matching Wal-Mart's steady progression toward scan-based trading (using checkout scan technology to pressure manufacturers to own each product until it is sold, therefore shedding billions of dollars worth of inventory from the balance sheet).[23] This will further put Sears Holding at a disadvantage vis-à-vis Wal-Mart.

Eddie Lampert will likely use Sears Holding as an investment vehicle. Kmart is currently sitting on $4 billion of cash and not much of it has been dedicated to retail. It is likely that Lampert will use Sears Holding to generate even more cash. Lampert might buy Toys 'R Us (or their Babies 'R Us unit) to add to his real estate portfolio and enhance Sears Holding's scale and value as a going concern.[24]

At some point, however, it is likely that Lampert will look for a buyer for the going concern. Target or Carrefour could be potential strategic buyers of Sears Holding's retail business. Vornado would be a likely buyer of Sears Holding's divested real-estate properties. Retail is a terrible industry to be in, mainly because the industry is very badly financed. Between 1978 and 1992, an inordinate number of retailers went insolvent and had to reorganize. For every Wal-Mart, there was a Federated Department Stores or an Ames. Moreover, the Wal-Mart phenomenon has caused all kinds of permanent revolutions in the retail space making it harder to compete.[25] Owning retailers only makes sense, from an investment vehicle's standpoint, in order to build a tremendous cash surplus.

In terms of retail, cash-rich specialty retailers which cater to a niche, such as Sharper Image, appear to be well-positioned to tough it out for a while longer. And so, we would not be altogether surprised if Lampert decided to transform Sears Holding into a niche player in retail, focusing on branded appliance goods, apparel brands, and catalogue sales instead of simply providing all sorts of goods at a lower price than the next retailer.

We do not want to discount the legacy/ego effect; Lampert can truly earn his rightful place in the pantheon of great American business legends if he can cobble together a success story out of two relative failures.

At some point, however, it is likely that Lampert will look for a buyer for the going concern.

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IV. Valuation

Using an APV (adjusted present value) discounted cash flow model and using Kmart's share price as a proxy for Sears Holding Corp.'s share price, we arrive at a theoretical share price of $91.08 for Sears Holding Corp. The theoretical price is well below the $104.99 price level that the surviving Sears Holding Corp.'s equity is currently trading at (we use Kmart's price in this analysis since it will be the surviving entity, even if it will not retain its name).[26]

Our analysis of the firm's comparables from a multiples perspective further supports our view that the share price is currently overvalued. On a comparables basis, we regard Sears Holding Corp. as fairly valued at best. As an aggregated entity, Sears Holding Corporation trades more like a mall retailer than a free-standing growth retailer. Traditional department stores trade in the 6-8x FV/EBITDA range, whereas "off-the-mall" retailers trade in the 10-12x range. Sears Holding falls firmly in the department store camp with a 7x range. Despite Sears' concerted efforts to move away from its historic role as primarily a mall anchor-store and the inclusion of Kmart's predominantly free-standing locations to the combined company's empire, we feel that the successor company does not yet justify the same multiple as successful "off-the-mall" retailers like Wal-Mart, Best Buy, and Home Depot.

… the break-up value of the combined entity's real assets [are] about $70 per-share, well below the current trading value.

Looking at the results, Sears and Kmart, as stand-alone entities, appear to be reasonably priced on a Price-to-Earnings basis. Incorporating growth into the analysis, however, paints a different picture. Looking at the firms' PEG ratios, Kmart and Sears both appear to be materially more expensive than discount retailers Target and Wal-Mart, and again are trading much closer to department stores like May and Saks. Kmart's PEG ratio of 1.81 and Sears' ratio of 5.82 dwarf Target's 1.33 and Wal-Mart's 1.45.

We ran a "sum-of-the-parts" analysis (please refer to page 26) where we looked at the break-up value of the combined entity's real assets and found it to be worth about $70 per-share, well below the firm's current trading value. The market clearly attaches a premium to the firm's value as a going concern. We also ran a base case scenario for the combined entity (please refer to pages 23-25), stripping away the effects of any promised synergies stemming from the merger. The result of the base-case analysis is an APV value of $81.23.

On a technical basis, our total APV valuation of $91.08 falls into line with our technical analysis of the firm's share price. There appears to be an upper resistance level in the mid-to-high 90's and we doubt that the company will stay above it for long, although it has been trading well above that level with the frenzied merger rally. Once the euphoria fizzles out, we see Sears Holding Corp.'s share price (represented by Kmart's share price) settling back down into the low 90's range.

We are underweight Sears Holding Corp. at current trading levels and would switch to an overweight position only if the share price dips below $88/share, which is unlikely in the near term given that there appears to be a lower resistance band at the $90 level.

We would switch to an overweight position only if the share price dips below $88/share …

Comparables:

Department Store v. Off-Mall Analysis

Successor Company	FV/EBITDA
Sears, Roebuck, & Co.	7x LTM

Traditional Department Stores	FV/EBITDA
Dillard's	5.9
Federated	5.9
J.C. Penney	8.4
May	7.7
Nordstrom	7.3
Saks Inc.	6.8
"On-the-mall Average"	7.0
Range	6-8x

Off-the-Mall Retailers	FV/EBITDA
Best Buy	9.6
Costco	12.1
Home Depot	10.9
Lowe's	10.7
Target	11.2
Wal-Mart	12.7
"Off-the-mall Average"	10.7
Range	10-12x

Source: JP Morgan Securities ("K-Mart and Sears to Merge - Additional Thoughts," 11/17/2004).

We prepared a more comprehensive comparable analysis, evaluating earnings multiples for a pool of the same retailers as the department store vs. off-mall analysis.

Comps Analysis

	KMRT	S	TGT	WMT	FD	DDS	MAY	SKS	Industry
Market Cap:	9.31B	11.02B	46.94B	234.91B	9.81B	2.19B	8.61B	1.92B	3.27B
Employ-ees:	158,000	249,000	328,000	1,500,000	111,000	53,598	58,000	29,640	25.91K
Rev. Growth (ttm):	N/A	-0.60%	9.70%	4.90%	-1.10%	-4.50%	-1.10%	2.40%	4.90%
Revenue (ttm):	20.12B	37.12B	47.22B	280.36B	15.61B	7.77B	13.90B	6.34B	6.34B
Gross Margin (ttm):	25.40%	29.47%	31.69%	22.77%	40.57%	32.93%	30.12%	38.27%	34.38%
EBITDA (ttm):	1.93B	1.42B	4.95B	20.74B	2.10B	538.03M	1.93B	185.08M	439.04M
Oper. Margins (ttm):	9.30%	0.23%	6.56%	5.90%	8.93%	1.23%	6.96%	2.92%	1.97%
Net Income (ttm):	1.08B	2.72B	1.93B	9.82B	708.00M	60.21M	599.00M	50.08M	180.90M
EPS (ttm):	10.738	10.704	2.104	2.291	3.875	0.712	1.978	0.335	1.92
PE (ttm):	9.73	4.98	24.7	24.17	14.66	36.59	14.93	41.13	20.56
PEG (ttm):	1.81	5.82	1.33	1.45	1.32	5.5	1.81	2.15	1.32
PS (ttm):	0.46	0.3	0.99	0.84	0.63	0.28	0.62	0.29	0.52

S = Sears, Roebuck and Co
TGT = Target Corp
WMT = Wal-Mart Stores Inc
DDS = Dillard's Inc
MAY = May Department Stores Co
SKS = Saks Inc
Industry = Retail (Department & Discount)

Source: Y! Finance

Because of ESL's proclivity for using leverage to maximize investments, we expect that with Eddie Lampert at the helm, Sears Holding Corp. will make more frequent use of debt to finance the turnaround effort, which will become even more capital intensive now that Lampert must repair two wounded retailers with assets from the same balance sheet. Consequently, we used APV as our primary methodology for deriving a fundamental valuation. Applying an APV calculation to our pro forma financials for the combined companies provides us with a theoretical value of $91.08.

Adjusted Present Value Calculations

Valuation Date:	11/19/2004
Trading Price (closing):	52.95

Cost of Equity Calculation:
Equity Risk Premium = 7% per Ibbotson Associates SBBI
Risk-free rate = 4.115% (10-year Bond [UST4.25 11/15/14] at close 11/18/04)
Beta = 1.48% (Sear's Adjusted Beta per Bloomberg)
Equity Discount Rate R(e) = [Beta * RP] + R(f)]
R(e) = 14.5%

Cost of Debt:
Cost of Debt K(d) = 7.168% (6.668 = yield on S6.25 05/01/09 on 11/18/04 + 1.5% penalty for K-Mart credit)
K(d) = 7.17%

Terminal Value Calculation:
Terminal Value = Final Cash Flow / (rate equity - growth)
TV = CF Yr 2010/ (R(e) - g)
TV = $2518/ (14.5% - 2%)
TV = $ 20,184

Cash Flows	2004	2005	2006	2007	2008	2009	TV
EBIT	2,041	1,525	1,177	1,176	1,165	1,147	
- Taxes (100% Equity Scenario)	612	458	353	353	350	344	
+ Depreciation	935	976	1,018	1,063	1,109	1,158	
- Delta Working Cap Required	58	(11)	28	67	105	142	
- CapEx	17	39	40	40	40	41	
All Equity Cash Flows	2,289	2,015	1,775	1,779	1,780	1,777	20,184
Discount Factor (r = 14.5%)	1.00	0.87	0.76	0.67	0.58	0.51	0.51
Discounted Value	2,289	1,760	1,354	1,186	1,036	904	10,267

Total Discounted Value =	**$ 18,797.12**
Share Oustanding (mm) =	**213**
Theoretic Value Equity Cash Flows =	**$ 88.25**

Tax Shield:

Cash Flow from Tax Shield						
Tax Rate	30.0%	30.0%	30.0%	35.0%	35.0%	35.0%
D	4,446	4,686	4,940	5,207	5,490	5,787
Kd *	7.17%	7.20%	7.24%	7.28%	7.31%	7.35%
CF(tax shield)	96	101	107	133	140	149
Discount Factor (r = 5.67%)	1.00	0.93	0.87	0.81	0.76	0.71
Discounted Value	96	95	93	108	107	105

Total Discounted Value =	**$ 603.09**
Share Oustanding (mm) =	**213**
Theoretic Value Equity Cash Flows =	**$ 2.83**

Total Theoretical Value =	**$ 91.08**

* We increase Kd in future periods to enumerate the impact that increasing the firm's leverage will have on the firm's perceived credit quality and hence on its cost of debt financing.
* The average maturity of S bonds is 2009 and this is company's second largest bond issue.

… we incorporated our beliefs for synergies that appear attainable from the merger when aggregating our results.

Financial Projections:

In preparing the pro forma financial statements which underlie this APV valuation, we separately analyzed Kmart and Sears and disparate going entities because, in the immediate future at least, Sears and Kmart remain very distinct operating agents. We believe that the most effective approach to valuing the combined company at the moment is to continue to approach the two divisions separately in terms of forecasting. Accordingly, we prepared pro forma forecasts for each retailer individually and then incorporated our beliefs for synergies that appear attainable from the merger when aggregating our results.

Underlying this comprehensive approach are our projections for the growth prospects of each company as stand-alone entities and the trajectories of Kmart and Sears. Here we highlight some key items:

Income Statement Items:

- For each company, we separately decomposed top-line revenue growth into: (1) geographic expansion (new stores); and (2) same store sales (SSS) growth (increased sales volume at existing stores).
    - Sears' new store growth is expected to remain slow in the short term. The company has issued guidance for flat same store sales for the rest of the year and we find this concerning. Until the company has demonstrated success toward transforming itself, we feel that it will continue to have difficulty boosting SSS and have used a low 1.5% growth rate in our forward-looking analysis.
    - We have the Sears' new store growth moving at a slightly faster 2.25% because of the company's recent efforts toward (and stated desire to continue) expanding into new free standing locations through building or acquisition.
    - Kmart has been shedding less profitable stores (including the sale of several to Sears last year); we have built into our analysis the expectation that they will continue this process, transferring stores to Sears' centers while slightly improving SSS growth by about 0.5% annually to reflect the survival effect of paring out weaker stores.
    - We are increasing the provision for un-collectibles as we believe that credit quality of the customer base will deteriorate as the spending power of the customer base

declines (per the analysis in our industry report, coupled with the possibility that Sears attempts to expand its financing unit to include Kmart customers).

- Sears' gross margins, which we calculate as a percentage of sales, have been improving as the company has done a good job improving its cost structure in recent years. We feel that both entities' margins will continue to improve slightly as the combined company enjoys lower COGS from increased buyer power associated with its new scale and through the realization of further operating efficiencies with Kmart's national distribution network. We project a 0.2% discount year-on-year in COGS over the 2005-2007 time period. Additionally, we project a 0.5% discount in SAG expenses over the same period.

Balance Sheet Items:

- We established a minimum portion of liquid assets to be retained as cash for operations. Excess cash flows are also retained in the company's cash balance, commensurate with its recent affinity for building up its cash coffers and a historical precedent of limited use of non-operating investments.

- We view inventories as an important de facto element of fixed assets for retailers and feel that inventory levels will be especially important for Kmart; we are treating Kmart's inventory as a fixed asset.

- We have forecasted for the successor company to increase its use of debt financing as it attempts to construct a rather epic turnaround effort. Because of ESL's proclivity for using leverage to maximize investments, we expect Sears Holding Corp. will make more frequent use of debt to finance the turnaround endeavor, which will become even more capital intensive now that Lampert must repair two wounded retailers with the same balance sheet. We have increased conventional debt and capital leases by 5% annually until 2009. We have also gradually adjusted the company's cost of debt (Kd) upward throughout the analysis to account for the increased return that fixed income investors will require as the company ramps up its leverage.

We have forecasted for the successor company to increase its use of debt financing as it attempts to construct a rather epic turnaround effort.

- We increase accounts payable to again enumerate our belief that the combined entity will enjoy greater buyer power and enjoy some of the better financing terms for inventory currently being negotiated by Wal-Mart and Target.

- We base our CapEx requirements on an expected growth in square footage and base our forecast of the company's cost per square foot of new store space on recent transaction prices scaled upward to account for the company's shift toward opening free-standing stores where they will have to pay for certain amenities which are normally shared in mall space.

The $81.23 base case scenario value represents where the merged company would trade should the planned synergies…somehow not materialize.

Base Case Scenario:

In order to compare our merger-based APV valuation with a non-merger based APV benchmark, we prepared a base case scenario for the combined entity (please refer to pages 23-25), stripping each operating company's income statement of any positive effects stemming from the merger. The result of the base-case analysis is an APV value of $81.23, roughly $10 below our theoretic price of $91.08 which includes all of the synergies we expect the company to realize following the merger. The $81.23 base case scenario value represents where the merged company would trade should the planned synergies associated with the merger somehow not materialize.

Equity Research

Pro Forma Income Statement: Successor Company

$ millions	2004	2005	2006	2007	2008	2009
REVENUES:						
K-Mart Contribution to Revenues	$ 21,515	$ 21,623	$ 21,731	$ 21,839	$ 21,949	$ 22,058
Sears Contribution to Revenues	42,527	43,982	45,490	47,052	48,672	50,349
Total Revenues	64,042	65,604	67,220	68,892	70,620	72,407
COSTS AND EXPENSES:						
K-Mart Cost of Goods Sold	16,708	16,935	16,969	17,002	17,036	17,070
Sears Cost of Goods Sold	27,392	28,715	30,100	31,161	32,258	33,391
Total Cost of sales	44,100	45,650	47,069	48,163	49,294	50,461
GROSS PROFIT:						
K-Mart Gross Profit	4,807	4,688	4,762	4,837	4,913	4,989
Sears Gross Profit	15,135	15,267	15,389	15,891	16,414	16,957
Total Gross Profit	19,942	19,955	20,151	20,728	21,326	21,946
OPERATING EXPENSES:						
K-Mart Selling and Administrative, Depreciation, & Other Operating Expenses	4,386	4,396	4,399	4,402	4,406	4,412
Sears Selling and Administrative, Depreciation, & Other Operating Expenses	13,478	14,005	14,556	15,134	15,740	16,374
Total Operating Expenses	17,863	18,401	18,956	19,536	20,146	20,786
OPERATING INCOME:						
K-Mart Contribution to Operating Income	421	292	363	436	506	577
Sears Contribution to Operating Income	1,657	1,262	833	757	674	583
Total Cost of sales	2,078	1,554	1,196	1,193	1,180	1,160
Other Income	37	28	19	17	15	13
EBIT	2,041	1,525	1,177	1,176	1,165	1,147
Interest Expense	1,110	1,203	1,304	1,413	1,532	1,661
Income Before Taxes	931	322	(127)	(238)	(367)	(515)
Provision for Income Taxes	279	97	(38)	(83)	(129)	(180)
Minority interest	14	11	7	6	6	5
NET INCOME	$ 637	$ 215	$ (96)	$ (161)	$ (244)	$ (339)

Equity Research

Pro Forma Income Statement: K-Mart Division

$ millions	2002	1st 13 weeks of 2003	2nd 39 weeks of 2003	2004	2005	2006	2007	2008	2009
Sales	$ 29,352	$ 6,181	$ 17,072	$ 21,515	$ 21,623	$ 21,731	$ 21,839	$ 21,949	$ 22,058
Cost of Sales, Buying, & Occupancy	24,842	4,762	13,084	16,708	16,935	16,969	17,002	17,036	17,070
Gross Margin	4,510	1,419	3,988	4,807	4,688	4,762	4,837	4,913	4,989
Selling, General, and Administrative Expenses	6,242	1,421	3,577	4,494	4,503	4,512	4,521	4,530	4,541
Restructuring, Impairment, and Other Charges	574	37	-	-	-	-	-	-	-
Net (Gains)/Losses on Sale of Assets	5	-	(89)	(93)	(98)	(103)	(108)	(114)	(119)
Equity Income in Unconsolidated Subsidiaries	(34)	(7)	(5)	(15)	(9)	(10)	(11)	(10)	(10)
Income (Loss) before Interest, Reorganization Items, Taxes, and Discontinued Ops	(2,277)	(32)	505	421	292	363	436	506	577
Interest Expense, Net	155	57	105	101	103	104	106	107	109
Reorganization Items, Net	363	769	-	-	-	-	-	-	-
Income (Loss) before Income Taxes Discontinued Operations	(2,795)	(858)	400	320	189	258	330	399	468
Provision for (Benefit from) Income Taxes	(24)	(6)	152	122	72	98	125	152	178
Dividends on Convertible Preferred Securities of Subsidiary Trust	-	-	-	-	-	-	-	-	-
Income (Loss) before Discontinued	(2,771)	(852)	248	198	117	160	204	247	290
Discontinued Operations (Net of Income Taxes)	(448)	(10)	-	-	-	-	-	-	-
Net Income (Loss)	(3,219)	(862)	248	198	117	160	204	247	290

Pro Forma Income Statement: Sears Division

$ millions	2001	2002	2003	2004	2005	2006	2007	2008	2009
REVENUES									
Merchandise sales and services	$ 35,755	$ 35,698	$ 36,372	$ 37,751	$ 39,182	$ 40,666	$ 42,205	$ 43,800	$ 45,452
Credit and financial products revenues	5,235	5,668	4,752	4,776	4,800	4,824	4,848	4,872	4,896
Total revenues	40,990	41,366	41,124	42,527	43,982	45,490	47,052	48,672	50,349
COSTS AND EXPENSES									
Cost of sales, buying and occupancy	26,234	25,646	26,231	27,392	28,715	30,100	31,161	32,258	33,391
Selling and administrative	8,892	9,249	9,111	9,473	9,761	10,057	10,364	10,680	11,006
Provision for uncollectible accounts	1,866	2,261	1,747	1,844	1,945	2,053	2,166	2,286	2,412
Depreciation and amortization	863	875	909	935	976	1,018	1,063	1,109	1,158
Interest, net	1,415	1,143	1,025	1,110	1,203	1,304	1,413	1,532	1,661
Loss on early retirement of debt, net	-	-	791	-	-	-	-	-	-
Special charges and impairments	542	111	112	116	120	124	128	133	137
Total costs and expenses	39,812	39,285	39,926	40,870	42,719	44,657	46,295	47,997	49,765
Operating income	1,178	2,081	1,198	1,657	1,262	833	757	674	583
Gain on sale of businesses	-	-	4,224	-	-	-	-	-	-
Other income, net	45	372	27	37	28	19	17	15	13
Income before income taxes, minority interest and cumulative effect of change in accounting principle	1,223	2,453	5,449	1,694	1,291	852	774	689	596
Income taxes	467	858	2,007	624	475	314	285	254	220
Minority interest	21	11	45	14	11	7	6	6	5
Income before cumulative effect of change in accounting principle	735	1,584	3,397	1,056	805	531	483	430	372
Cumulative effect of change in accounting for goodwill	-	(208)	-	-	-	-	-	-	-
NET INCOME	$ 735	$ 1,376	$ 3,397	$ 1,056	$ 805	$ 531	$ 483	$ 430	$ 372

Equity Research

Pro Forma Balance Sheet: K-Mart Division

$ millions	1/29/2003 (A)	4/30/2003 (A)	1/28/2004 (A)	(end of) 2004	2005	2006	2007	2008	2009
ASSETS									
Current Assets:									
Cash and Cash Equivalents	613	1,232	2,088	1,554	1,711	1,913	2,160	2,452	2,789
Merchandise Inventories	4,825	4,431	3,238	3,844	3,859	3,873	3,887	3,901	3,914
Accounts Receivable	473	382	301	279	281	283	286	288	290
Other Current Assets	191	509	182	168	169	170	171	172	173
Total Current Assets	6,102	6,554	5,809	5,846	6,020	6,239	6,504	6,812	7,166
Property and Equipment, Net	4,892	10	153	142	142	143	144	144	145
Other Assets and Deferred Charges	244	96	120	111	112	112	113	113	114
Total Assets	11,238	6,660	6,082	6,099	6,274	6,494	6,760	7,070	7,425
LIABILITIES AND SHAREHOLDER'S EQUITY (DEFICIT)									
Current Liabilities:									
Mortgages Payable Due Within One Year	-	8	4	5	6	7	8	10	12
Accounts Payable	1,248	1,160	820	774	793	813	834	855	876
Accrued Payroll and Other Liabilities	710	1,321	671	621	624	627	630	633	637
Taxes other Than Income Taxes	162	274	281	265	272	279	286	293	300
Total Current Liabilities	2,120	2,763	1,776	1,665	1,695	1,726	1,758	1,791	1,825
Long-term Liabilities									
Long-term Debt and Mortgages Payable	-	108	103	95	96	96	97	97	98
Capital Lease Obligations	623	415	374	346	348	350	351	353	355
Pension Obligation	-	854	873	895	917	940	964	988	1,012
Unfavorable Operating Leases	-	344	342	316	318	320	321	323	324
Other Long-term Liabilities	181	463	424	392	394	396	398	400	402
Total Long-term Liabilities	804	2,184	2,116	2,045	2,073	2,102	2,131	2,161	2,192
Total Liabilities Not Subject to Compromise	2,924	4,947	3,892	3,710	3,768	3,828	3,889	3,952	4,016
Liabilities Subject to Compromise	7,969	-	-	-	-	-	-	-	-
Predecessor Company Obligated Convert Preferreds	646	-	-	-	-	-	-	-	-
Shareholders' Equity (Deficit):									
Successor Company Preferred Stock	-	-	-	-	-	-	-	-	-
Predecessor Company Common Stock	519	-	-	-	-	-	-	-	-
Successor Company Common Stock	-	1	1	-	-	-	-	-	-
Treasury Stock	-	-	(1)	-	-	-	-	-	-
Capital In Excess of Par Value	1,922	1,712	1,943	1,943	1,943	1,943	1,943	1,943	1,943
Retained Earnings (Accumulated Deficit)	(1,835)	-	248	446	563	724	928	1,175	1,466
Accumulated Other Comprehensive Income (Loss)	(907)	-	1	-	-	-	-	-	-
Total Shareholders' Equity (Deficit)	(301)	1,713	2,192	2,389	2,506	2,667	2,871	3,118	3,409
Total Liabilties and Shareholders' Equity	11,238	6,660	6,084	6,099	6,274	6,494	6,760	7,070	7,425

Equity Research

Pro Forma Balance Sheet: Sears Division

$ millions	2002 (A)	2003 (A)	2004	2005	2006	2007	2008	2009
ASSETS								
Current assets								
Cash and cash equivalents	$ 1,962	$ 9,057	$ 12,507	$ 13,683	$ 14,617	$ 15,286	$ 15,918	$ 16,508
Credit card receivables	32,563	1,998	2,126	2,199	2,274	2,353	2,434	2,517
Less allowance for uncollectible accounts	1,832	42	43	45	46	48	50	51
Net credit card receivables	30,731	1,956	2,083	2,154	2,228	2,305	2,384	2,466
Other receivables	891	733	767	802	838	876	916	958
Merchandise inventories, net	5,115	5,335	5,526	5,723	5,929	6,142	6,363	6,592
Prepaid expenses and deferred charges	535	407	421	435	450	466	482	498
Deferred income taxes	749	708	732	757	783	810	838	867
Total current assets	39,983	18,196	22,035	23,555	24,845	25,885	26,901	27,890
Property and equipment								
Land	442	392	396	400	404	408	412	416
Buildings and improvements	6,930	7,151	7,162	7,172	7,183	7,194	7,205	7,216
Furniture, fixtures and equipment	5,050	4,972	4,979	4,987	4,994	5,002	5,009	5,017
Capitalized leases	557	609	624	640	656	672	689	706
Gross property and equipment	12,979	13,124	13,161	13,199	13,237	13,276	13,315	13,355
Less accumulated depreciation	6,069	6,336	6,347	6,359	6,370	6,382	6,393	6,405
Total property and equipment, net	6,910	6,788	6,814	6,841	6,867	6,894	6,922	6,950
Deferred income taxes	734	378	399	422	445	470	496	523
Goodwill	944	943	929	915	901	888	874	861
Tradenames and other intangible assets	704	710	734	759	785	812	840	869
Other assets	1,134	708	732	757	783	810	838	867
TOTAL ASSETS	$ 50,409	$ 27,723	$ 31,644	$ 33,249	$ 34,627	$ 35,759	$ 36,871	$ 37,960
LIABILITIES								
Current liabilities								
Short-term borrowings	$ 4,525	$ 1,033	$ 1,068	$ 1,105	$ 1,143	$ 1,182	$ 1,223	$ 1,265
Current portion of long-term debt and capitalized lease obligations	4,808	2,950	3,051	3,155	3,263	3,375	3,491	3,612
Merchandise payables	2,945	3,106	3,223	3,344	3,470	3,601	3,737	3,878
Income taxes payable	787	1,867	1,931	1,997	2,065	2,136	2,210	2,286
Other liabilities	3,753	2,950	3,051	3,155	3,263	3,375	3,491	3,612
Unearned revenues	1,199	1,244	1,286	1,330	1,376	1,423	1,472	1,523
Other taxes	580	609	630	651	674	697	721	746
Total current liabilities	18,597	13,759	14,239	14,737	15,254	15,790	16,345	16,921
Long-term debt and capitalized lease obligations	21,304	4,218	4,446	4,686	4,940	5,207	5,490	5,787
Pension and postretirement benefits	2,491	1,956	2,054	2,156	2,264	2,378	2,496	2,621
Minority interest and other liabilities	1,264	1,389	1,417	1,445	1,474	1,503	1,534	1,564
Total Liabilities	43,656	21,322	22,156	23,025	23,932	24,878	25,865	26,893
COMMITMENTS AND CONTINGENT LIABILITIES								
SHAREHOLDERS' EQUITY								
Common shares issued ($. 75 par value per share, 1,000 shares authorized, 230.4 and 316.7 shares outstanding, respectively)	323	323	323	323	323	323	323	323
Capital in excess of par value	3,505	3,519	3,519	3,519	3,519	3,519	3,519	3,519
Retained earnings	8,497	11,636	15,033	16,089	16,894	17,425	17,908	18,337
Treasury stock - at cost	(4,474)	(7,945)	(8,216)	(8,497)	(8,788)	(9,090)	(9,403)	(9,727)
Deferred ESOP expense	(42)	(26)	(27)	(28)	(29)	(30)	(31)	(32)
Accumulated other comprehensive loss	(1,056)	(1,106)	(1,144)	(1,183)	(1,223)	(1,265)	(1,309)	(1,354)
Total Shareholders' Equity	6,753	6,401	9,488	10,223	10,695	10,881	11,007	11,066
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	$ 50,409	$ 27,723	$ 31,644	$ 33,249	$ 34,627	$ 35,759	$ 36,871	$ 37,960

Equity Research

Pro Forma Income Statement: K-Mart Division (Stand Alone Basis)

$ millions	2002	1st 13 weeks of 2003	2nd 39 weeks of 2003	2004	2005	2006	2007	2008	2009
Sales	$ 29,352	$ 6,181	$ 17,072	$ 21,515	$ 21,623	$ 21,731	$ 21,839	$ 21,949	$ 22,058
Cost of Sales, Buying, & Occupancy	24,842	4,762	13,084	16,708	17,495	17,670	17,847	17,883	17,918
Gross Margin	4,510	1,419	3,988	4,807	4,128	4,061	3,992	4,066	4,140
Selling, General, and Administrative Expenses	6,242	1,421	3,577	4,494	4,503	4,512	4,521	4,530	4,541
Restructuring, Impairment, and Other Charges	574	37	-	-	-	-	-	-	-
Net (Gains)/Losses on Sale of Assets	5	-	(89)	(93)	(98)	(103)	(108)	(114)	(119)
Equity Income in Unconsolidated Subsidiaries	(34)	(7)	(5)	(15)	(9)	(10)	(11)	(10)	(10)
Income (Loss) before Interest, Reorganization Items, Taxes, and Discontinued Ops	(2,277)	(32)	505	421	(268)	(339)	(409)	(340)	(272)
Interest Expense, Net	155	57	105	101	103	104	106	107	109
Reorganization Items, Net	363	769	-	-	-	-	-	-	-
Income (Loss) before Income Taxes Discontinued Operations	(2,795)	(858)	400	320	(371)	(443)	(515)	(448)	(380)
Provision for (Benefit from) Income Taxes	(24)	(6)	152	122	(141)	(168)	(196)	(170)	(144)
Dividends on Convertible Preferred Securities of Subsidiary Trust	-	-	-	-	-	-	-	-	-
Income (Loss) before Discontinued	(2,771)	(852)	248	198	(230)	(275)	(319)	(278)	(236)
Discontinued Operations (Net of Income Taxes)	(448)	(10)	-	-	-	-	-	-	-
Net Income (Loss)	(3,219)	(862)	248	198	(230)	(275)	(319)	(278)	(236)

Pro Forma Income Statement: Sears Division (Stand Alone Basis)

$ millions	2001	2002	2003	2004	2005	2006	2007	2008	2009
REVENUES									
Merchandise sales and services	$ 35,755	$ 35,698	$ 36,372	$ 37,373	$ 38,412	$ 39,471	$ 40,569	$ 41,689	$ 42,849
Credit and financial products revenues	5,235	5,668	4,752	4,776	4,800	4,824	4,848	4,872	4,896
Total revenues	40,990	41,366	41,124	42,149	43,212	44,294	45,417	46,561	47,746
COSTS AND EXPENSES									
Cost of sales, buying and occupancy	26,234	25,646	26,231	27,145	28,206	29,303	30,449	31,634	32,872
Selling and administrative	8,892	9,249	9,111	9,424	9,662	9,904	10,155	10,410	10,675
Provision for uncollectible accounts	1,866	2,261	1,747	1,844	1,945	2,053	2,166	2,286	2,412
Depreciation and amortization	863	875	909	935	976	1,018	1,063	1,109	1,158
Interest, net	1,415	1,143	1,025	1,110	1,203	1,304	1,413	1,532	1,661
Loss on early retirement of debt, net	-	-	791	-	-	-	-	-	-
Special charges and impairments	542	111	112	115	118	121	124	127	130
Total costs and expenses	39,812	39,285	39,926	40,572	42,110	43,702	45,370	47,098	48,909
Operating income	1,178	2,081	1,198	1,576	1,102	592	47	(538)	(1,163)
Gain on sale of businesses	-	-	4,224	-	-	-	-	-	-
Other income, net	45	372	27	36	25	13	1	(12)	(26)
Income before income taxes, minority interest and cumulative effect of change in accounting principle	1,223	2,453	5,449	1,612	1,127	606	48	(550)	(1,189)
Income taxes	467	858	2,007	594	415	223	18	(202)	(438)
Minority interest	21	11	45	13	9	5	0	(5)	(10)
Income before cumulative effect of change in accounting principle	735	1,584	3,397	1,005	702	378	30	(343)	(741)
Cumulative effect of change in accounting for goodwill	-	(208)	-	-	-	-	-	-	-
NET INCOME	$ 735	$ 1,376	$ 3,397	$ 1,005	$ 702	$ 378	$ 30	$ (343)	$ (741)

Equity Research

Pro Forma Income Statement: Successor Company under Base Case Scenario

$ millions	2004	2005	2006	2007	2008	2009
REVENUES:						
K-Mart Contribution to Revenues	$ 21,515	$ 21,623	$ 21,731	$ 21,839	$ 21,949	$ 22,058
Sears Contribution to Revenues	42,149	43,212	44,294	45,417	46,561	47,746
Total Revenues	63,664	64,834	66,025	67,256	68,509	69,804
COSTS AND EXPENSES:						
K-Mart Cost of Goods Sold	16,708	17,495	17,670	17,847	17,883	17,918
Sears Cost of Goods Sold	27,145	28,206	29,303	30,449	31,634	32,872
Total Cost of sales	43,853	45,701	46,973	48,296	49,516	50,790
GROSS PROFIT:						
K-Mart Gross Profit	4,807	4,128	4,061	3,992	4,066	4,140
Sears Gross Profit	15,004	15,005	14,992	14,968	14,927	14,874
Total Gross Profit	19,811	19,133	19,053	18,960	18,993	19,014
OPERATING EXPENSES:						
K-Mart Selling and Administrative, Depreciation, & Other Operating Expenses	4,386	4,396	4,399	4,402	4,406	4,412
Sears Selling and Administrative, Depreciation, & Other Operating Expenses	13,428	13,904	14,399	14,921	15,465	16,037
Total Operating Expenses	17,813	18,300	18,799	19,322	19,871	20,449
OPERATING INCOME:						
K-Mart Contribution to Operating Income	421	(268)	(339)	(409)	(340)	(272)
Sears Contribution to Operating Income	1,576	1,102	592	47	(538)	(1,163)
Total Cost of sales	1,998	834	254	(363)	(878)	(1,435)
Other Income	36	25	13	1	(12)	(26)
EBIT	1,962	809	240	(364)	(866)	(1,408)
Interest Expense	1,110	1,203	1,304	1,413	1,532	1,661
Income Before Taxes	852	(394)	(1,064)	(1,777)	(2,398)	(3,070)
Provision for Income Taxes	256	(118)	(319)	(622)	(839)	(1,074)
Minority interest	13	9	5	0	(5)	(10)
NET INCOME	$ 583	$ (285)	$ (750)	$ (1,155)	$ (1,554)	$ (1,986)

APV Calculations based on Base Case Scenario

Valuation Date:	11/19/2004
Trading Price (closing):	52.95

Cost of Equity Calculation:
Equity Risk Premium = 7% per Ibbotson Associates SBBI
Risk-free rate = 4.115% (10-year Bond [UST4.25 11/15/14] at close 11/18/04)
Beta = 1.48% (Sear's Adjusted Beta per Bloomberg)
Equity Discount Rate R(e) = [Beta * RP] + R(f)]
R(e) = 14.5%

Cost of Debt:
Cost of Debt K(d) = 7.168% (6.668 = yield on S6.25 05/01/09 on 11/18/04 + 1.5% penalty for K-Mart credit)
K(d) = 7.17%

Terminal Value Calculation:
Terminal Value = Final Cash Flow / (rate equity - growth)
TV = CF Yr 2010/ (R(e) - g)
TV = $2518/ (14.5% - 2%)
TV = $ 20,184

Cash Flows	2004	2005	2006	2007	2008	2009	TV
EBIT	1,962	809	240	(364)	(866)	(1,408)	
- Taxes (100% Equity Scenario)	589	243	72	(109)	(260)	(423)	
+ Depreciation	935	976	1,018	1,063	1,109	1,158	
- Delta Working Cap Required	100	(314)	(360)	(409)	(368)	(330)	
- CapEx	17	39	40	40	40	41	
All Equity Cash Flows	2,192	1,817	1,507	1,177	831	461	20,184
Discount Factor (r = 14.5%)	1.00	0.87	0.76	0.67	0.58	0.51	0.51
Discounted Value	2,192	1,587	1,150	784	484	234	10,267

Total Discounted Value =	**$ 16,699.46**
Share Oustanding (mm) =	**213**
Theoretic Value Equity Cash Flows =	**$ 78.40**

Tax Shield:
Cash Flow from Tax Shield

	2004	2005	2006	2007	2008	2009
Tax Rate	30.0%	30.0%	30.0%	35.0%	35.0%	35.0%
D	4,446	4,686	4,940	5,207	5,490	5,787
Kd *	7.17%	7.20%	7.24%	7.28%	7.31%	7.35%
CF(tax shield)	96	101	107	133	140	149
Discount Factor (r = 5.67%)	1.00	0.93	0.87	0.81	0.76	0.71
Discounted Value	96	95	93	108	107	105

Total Discounted Value =	**$ 603.09**
Share Oustanding (mm) =	**213**
Theoretic Value Equity Cash Flows =	**$ 2.83**

Total Theoretical Value =	**$ 81.23**

** We increase Kd in future periods to enumerate the impact that increasing the firm's leverage will have on the firm's perceived credit quality and hence on its cost of debt financing.*
** The average maturity of S bonds is 2009 and this is company's second largest bond issue.*

Sum-of-the-Parts Valuation:

Much has been made of the "break-up" value of Kmart and Sears' assets. Many research reports discussing the company point to the value of its real assets as a rationale for holding the company.[27] We calculated the break-up value of the combined entity, assuming liquidation, at about $70 per-share. We see this analysis as providing a good baseline for valuation—if the trading price drops below $70, it makes sense for Eddie Lampert to break up the company. At the present, however, we do not see the company's liquidation value exceeding its value as a going concern. The $70 value we derive through the sum-of-the-parts valuation lies below our $91.08 APV valuation (the firm's value as a going concern) because the sum-of-the-parts method omits the combined firm's cash flow going forward.

The $70 value we derive through the sum-of-the-parts valuation lies below our $91.08 APV valuation (the firm's value as a going concern) …

Break-Up/Sum-of-Parts Valuation

Sears' Assets:

Real Estate		Square Footage	Price/Sq Ft	Value	Per Share
		92.7	48.60	4,505.22	19.55

Brands		Sales (mm)	Op Inc (approx.)	Cap'ed	Per Share
	Land's End	2,000	192.00	1,808.76	7.85
	Kenmore	5,500	418.00	3,937.83	17.09
	Craftsman	4,100	352.60	3,321.72	14.42

Disc. Rate	
kd	7.2%
ke	14.5%
wd	52.8%
we	47.2%
WACC	10.6%

Cash	Balance	Per Share
	9,057.00	39.31

Receivables (net)	Balance	Per Share
	2,689.00	11.67

Inventory Liquidation (15% of Inventory balance)	Balance	Per Share
	800.25	3.47

Sub-total (Disposable Assets)	113.37

Debt	Balance	Per Share
	19,366.00	84.05

Pension Liability	Balance	Per Share
	1,956.00	8.49

Sub-total (Transferable Assets) - Sears	20.82

K-mart's Assets:

Owned Real Estate Assets	Low	Average	High
Value of Owned Stores	997,500	1,282,500	1,648,929
Less Mortgages	47,000	47,000	47,000
Less Taxes	95,050	123,550	160,193
Less Closing Costs	33,750	33,750	33,750
Total Value	821,700	1,078,200	1,407,986
Per Share Gain	8.25	10.83	14.14

Source: UBS Coverage ("Initiated with a Buy-2 Rating," April 7, 2004)

Subleased Asset Values	Low	Average	High
Lease Value	914,915	1,045,635	1,176,355
Expense Today	694,200	694,200	694,200
Unlocked Lease Value Per Year	220,715	351,435	482,155
11-year Value	1,502,008	3,281,157	2,391,585
Per Share Gain	15.08	32.94	24.01

Source: UBS Coverage ("Initiated with a Buy-2 Rating," April 7, 2004)

Deferred Tax Assets	
PV of NOL	1,068,800
Value per Share	10.73

Source: UBS Coverage ("Initiated with a Buy-2 Rating," April 7, 2004)

Sub-total (Transferable Assets) - K-Mart	48.88

Total Value of Transferable Assets for Combined Company	69.70

Important Disclaimer

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[1] Beck, Rachel. "Will Kmart-Sears Live Up To Promises?" AP, November 19, 2004.
[2] Conversation with Marty Whitman of Third Avenue Management on November 12, 2004, in Third Avenue's offices in New York City. Meeting was attended by Abdullah Karatash and Len Rittberg.
[3] Balter, Gary, Nagel, Brian, and Chris Smith. "Kmart: Initiated With Buy 2 Rating." UBS, April 7, 2004.
[4] Marty Whitman of Third Avenue Management mentioned Carrefour as a potential play.
[5] Wiggins, Jenny. "Analysts skeptical of group's chances." Financial Times, November 19, 2004.
[6] One of the most recent proclamations of this sentiment is the November 22, 2004, issue of BusinessWeek where a picture of Eddie Lampert adorns the front cover, entitled "The Next Warren Buffett?"
[7] Bloomberg.
[8] Marty Whitman of Third Avenue Management.
[9] Bloomberg.
[10] Marty Whitman of Third Avenue Management.
[11] Bloomberg.
[12] Beck, Rachel. "Will Kmart-Sears Live Up To Promises?" AP, November 19, 2004.
[13] Beck, Rachel. "Will Kmart-Sears Live Up To Promises?" AP, November 19, 2004.
[14] Bloomberg.
[15] Balter, Gary, and Chris Smith. "Kmart Hired Aylwin Lewis As CEO." UBS, October 18, 2004.

[16] Marty Whitman of Third Avenue Management.
[17] Melich, Gregory, Lopez, Armando, and Kristina Westura. "Sears Roebuck: Trying to Find The Trough." Morgan Stanley, October 21, 2004.
[18] Bloomberg.
[19] Beck, Rachel. "Will Kmart-Sears Live Up To Promises?" AP, November 19, 2004.
[20] Foster, Lauren, and James Politi. "Sears Takes to the Streets in Retail Fight." Financial Times, November 19, 2004.
[21] Foster, Lauren, and James Politi. "Sears Takes to the Streets in Retail Fight." Financial Times, November 19, 2004.
[22] Foster, Lauren, and James Politi. "Corporate Cultures Will Have To Be Merged." Financial Times, November 18, 2004.
[23] Hays, Constance. "What Wal-Mart Knows About Customers' Habits." New York Times, November 14, 2004.
[24] Marty Whitman of Third Avenue Management mentioned Toys 'R Us as a potential play.
[25] Marty Whitman of Third Avenue Management.
[26] We want to clarify that we decided to use Kmart's share price as a proxy for Sears Holding Corp.'s share price and as the benchmark for our valuation. This decision is driven by the fact that Kmart is the entity that is taking over and that will remain the driver of the merged companies, even though the Kmart name will be dropped in favor of Sears Holding Corp.
[27] Eberts, Shari, Archille, Lionel, and Nancy Hoch. "Sears Roebuck & Co.: Stuck Between a Rock and a Hard Place." JP Morgan, August 4, 2004.
Balter, Gary, Nagel, Brian, and Chris Smith. "Kmart: Initiated With Buy 2 Rating." UBS, April 7, 2004.