SEARS HOLDINGS CORPORATION

Message from the Chairman, March 15, 2006
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Same-Store Sales

The discussion of profitable growth brings me to the issue of same-store sales, and why I believe it is not always the best measure of a retailer's performance. Many analysts and commentators focus on same-store sales (SSS) as the most important statistic in retail, almost to the exclusion of any other statistic (even above profit). I consider SSS to be an important metric for retail performance, but one that is vastly overrated. Like any single metric, SSS has significant limitations. Let me offer a framework to help explain my thinking on SSS and why we do not rely on it to judge our success at Sears Holdings to the degree others in our industry do.

If we take a simple example of a single store, then a comparison of SSS from year to year is fairly straightforward. If a store does $1 million in sales at a 10% operating margin this year, generating $100,000 in operating profit, and does $1.1 million in sales next year at the same operating margin of 10% generating $110,000 in operating profit, it will report a 10% increase in SSS. Now, let's add another dimension. Imagine that this same store spent $500,000 to improve the store experience during that year. The 10% increase in SSS generated an additional $10,000 in profit. Whether the $500,000 investment makes sense or not in hindsight will depend on the future performance of the store. Obviously, if the store only improves by the $10,000 in profit, the $500,000 investment doesn't make sense. I believe that companies that pursue SSS growth at any cost often fall victim to these traps.

In reality, the calculation of SSS becomes even more difficult. Individual retailers are opening, closing, and remodeling stores all the time. In this context, the simple comparison of a single store breaks down. Let me explain. Imagine that a new store opens on January 1, 2006. In the first year of operation, this store would be excluded from a company's calculation of SSS because most calculations only include stores that have been open at least a year. A retail store matures over time and the first year of sales is often at a level that is a fraction of its potential. If we assume that a store opens at 60% of potential and matures to potential over four years, we know that this store will grow by 67% over that period of time (from $6 million to $10 million, let's say). On that $10 million-in-sales store that opens at $6 million in year 1, the SSS increase over the next three years will average 18.6% per year, with the higher growth rates occurring in years 2 and 3 rather than year 4.

At the end of that period of time, the $10 million store may be at a relative steady-state, and let's say it is earning at a 10% operating profit, or $1 million per year. The key question is not how well the store did from a SSS standpoint but rather how much money was invested to generate the $1 million profit. If the store cost $5 million to build, a $1 million profit represents a 20% pre-tax return on investment, which is attractive. However, if the store cost $20 million to build, the 5% return on that investment would not be attractive at all. Nevertheless, regardless of cost, the store would still have reported 18.6% compounded growth in SSS.

Complicating things further and bringing things even closer to reality, the more stores that are opened relative to the outstanding base of stores, the higher the SSS metric a company can produce, regardless of whether the new store openings make economic sense or not. If the mature stores (*i.e.*, those that are over four years old) grow at a 1% rate and the new stores grow at the 18.6% per year rate (remember, it is likely that in years 2 and 3 the rates are materially higher than the 18.6%), then mathematically it is simple to show that the more new stores that are opened, the higher the SSS calculation. Only after a period of years will one know whether the new store investments actually made sense and actually contributed to the creation of value.

With Sears and Kmart, given that we have chosen not to open new stores at the pace of our competition, one can get a more accurate measurement of SSS performance. For retailers that aggressively open new stores, the reported SSS metrics are helpful, but far from complete. Rather, an investor would want to know how the stores greater than four years old are doing from a sales and profit perspective and how much money is being invested in those stores. In addition, an investor would like to know what is being spent on the newer stores and how they are performing from both a sales and profit standpoint. Without that information, any interpretation of SSS performance lacks real meaning. But so often today, SSS figures are cited without providing that critical additional information – giving investors only part of the picture.

In our case, starting with Kmart three years ago, we had many stores that were operating with low levels of profit or at a loss. If we had attempted to sustain our sales levels, it would have been difficult to improve our store and company profitability. By changing the objective from maintaining sales to growing profit, we were able to make a substantial improvement in our company's profitability. No longer are we carrying excessive inventories, spending excessive amounts on marketing, and scheduling excessive labor dollars all in the pursuit of a given level of sales. Instead, our focus is on understanding our customers and figuring out how to provide them products and services that they value, so that we can build relationships with them and profitably serve them over the long term. While reducing sales is not a prescription for success on a base of healthy, profitable stores, it can be a prescription for success where profit was not the primary objective and where sales came from "giving product away" rather than from providing value to the customer. Improving our stores and our store experience will take time, and I am pleased with the progress that we have made to date.