

ACE HARDWARE CORPORATION
Quarterly period ended July 4, 2009



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SUPPLEMENTARY DATA**

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Independent Accountants' Review Report

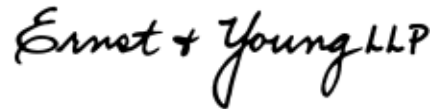
The Board of Directors
Ace Hardware Corporation:

We have reviewed the accompanying condensed consolidated balance sheet of Ace Hardware Corporation and subsidiaries (the "Company") as of July 4, 2009, and the related condensed consolidated statements of income for the three- and six-month periods ended July 4, 2009 and the condensed consolidated statement of cash flows for the six-month period ended July 4, 2009. These financial statements are the responsibility of the Company's management. The condensed consolidated financial statements of the Company for the three and six-month periods ended June 28, 2008 were reviewed by other accountants whose report dated August 5, 2008 stated that they were not aware of any material modifications that should be made to those statements for them to be in conformity with US generally accepted accounting principles.

We conducted our review in accordance with standards established by the American Institute of Certified Public Accountants. A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with auditing standards generally accepted in the United States, the objective of which is the expression of an opinion regarding the financial information taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the accompanying interim financial information as of July 4, 2009, and for the three and six-month periods then ended for it to be in conformity with US generally accepted accounting principles.

The consolidated balance sheet of Ace Hardware Corporation and subsidiaries as of January 3, 2009, and the related consolidated statements of income, member retailers' equity, and cash flows for the year then ended (not presented herein) were audited by other auditors whose report dated March 4, 2009, expressed an unqualified opinion on those statements.

The signature of Ernst & Young LLP is written in a cursive, handwritten style in black ink.

August 7, 2009

CONDENSED CONSOLIDATED BALANCE SHEETS

	July 4, 2009	January 3, 2009
	(In thousands, except share data) (Unaudited)	(Audited)
Assets		
Cash and cash equivalents	\$ 182,688	\$ 80,326
Marketable securities	34,641	31,147
Receivables, net of allowance for doubtful accounts of \$11,813 and \$12,382, respectively ...	269,202	260,933
Inventories	446,933	460,431
Prepaid expenses and other current assets	25,203	25,671
Total current assets	958,667	858,508
Property and equipment, net	305,706	301,693
Notes receivable, net of allowance for doubtful accounts of \$15,874 and \$14,636, respectively	46,167	48,462
Other assets	61,503	62,855
Total assets	\$1,372,043	\$1,271,518
Liabilities and Member Retailers' Equity		
Current maturities of long-term debt	\$ 3,865	\$ 3,358
Short-term borrowings	—	1,100
Accounts payable	551,528	431,880
Patronage distributions payable in cash	12,239	17,216
Patronage refund certificates payable	19,321	19,457
Accrued expenses	102,770	126,694
Total current liabilities	689,723	599,705
Long-term debt	293,927	292,498
Patronage refund certificates payable	35,278	54,654
Other long-term liabilities	58,876	61,522
Total liabilities	1,077,804	1,008,379
Member Retailers' Equity:		
Class A voting common stock, \$1,000 par value, 10,000 shares authorized, 2,977 and 2,989 issued and outstanding, respectively	2,977	2,989
Class B nonvoting common stock, \$1,000 par value, \$2,000 redemption value, 6,500 shares authorized, — and 6,499 issued, — and 1,296 outstanding, respectively	—	6,499
Class C nonvoting common stock, \$100 par value, 4,000,000 shares authorized, 2,944,726 and 2,879,152 issued and outstanding, respectively	294,473	287,915
Class C nonvoting common stock, \$100 par value, issuable to retailers for patronage distributions, 213,738 and 142,708, shares issuable, respectively	21,374	14,271
Additional stock subscribed, net	189	148
Contributed capital	6,986	13,485
Variance allocation	(11,824)	(29,210)
Accumulated deficit	(17,683)	(19,716)
Accumulated other comprehensive loss	(2,253)	(2,836)
Treasury stock, at cost	—	(10,406)
Total member retailers' equity	294,239	263,139
Total liabilities and member retailers' equity	\$1,372,043	\$1,271,518

See accompanying notes to condensed consolidated financial statements.

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

	Three Months Ended		Six Months Ended	
	July 4, 2009 (13 Weeks)	June 28, 2008 (13 Weeks)	July 4, 2009 (26 Weeks)	June 28, 2008 (26 Weeks)
	(Unaudited, in thousands)			
Revenues	\$973,096	\$1,064,896	\$1,824,313	\$1,935,372
Cost of sales	840,624	928,924	1,592,765	1,708,385
Gross profit	132,472	135,972	231,548	226,987
Distribution operations expenses	24,212	22,017	47,952	41,391
Selling, general and administrative expenses	27,846	30,282	58,728	61,445
Retail success and development expenses	30,580	31,802	53,159	56,428
Total operating expenses	82,638	84,101	159,839	159,264
Operating income	49,834	51,871	71,709	67,723
Interest expense	(9,150)	(7,981)	(18,139)	(15,177)
Loss on early extinguishment of debt	—	(11,857)	—	(11,857)
Interest income	1,007	1,465	2,113	3,149
Other income, net	916	1,591	1,951	2,832
Income tax expense	(447)	(1,677)	(1,031)	(2,500)
Net income	<u>\$ 42,160</u>	<u>\$ 33,412</u>	<u>\$ 56,603</u>	<u>\$ 44,170</u>
Accrued patronage distributions	<u>\$ 41,323</u>	<u>\$ 30,453</u>	<u>\$ 54,570</u>	<u>\$ 40,640</u>

See accompanying notes to condensed consolidated financial statements.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

	Six Months Ended	
	July 4, 2009 (26 Weeks)	June 28, 2008 (26 Weeks)
	(Unaudited, in thousands)	
Operating activities		
Net income	\$ 56,603	\$ 44,170
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	16,268	15,031
Amortization of deferred gain on sale leaseback	(617)	(639)
Amortization of deferred financing costs	1,364	308
Loss on early extinguishment of debt	—	11,857
Payments for early extinguishment of debt	—	(6,594)
Settlement of interest rate swap	—	(4,602)
Provision for doubtful accounts	3,806	1,000
Loss on disposal of assets, net	286	248
Deferred income tax expense	152	2,178
Changes in operating assets and liabilities:		
Receivables	(15,360)	(9,469)
Inventories	13,498	4,509
Other current assets	(636)	82
Other long-term assets	1,234	170
Accounts payable and accrued expenses	94,888	113,585
Other long-term liabilities	(2,655)	1,771
Net cash provided by operating activities	168,831	173,605
Investing activities		
Purchases of marketable securities	(9,795)	(12,861)
Proceeds from sale of marketable securities	6,229	8,439
Purchases of property and equipment	(20,296)	(13,898)
Increase in notes receivable, net	(2,120)	(4,204)
Net cash used in investing activities	(25,982)	(22,524)
Financing activities		
Payments of short-term borrowings, net	(1,100)	(130,943)
Proceeds from long-term debt	—	295,800
Principal payments on long-term debt	(1,546)	(184,995)
Payment of deferred financing costs	—	(12,107)
Change in cash book overdraft	675	(20,727)
Payments of cash portion of patronage distribution	(15,598)	(17,443)
Payments of patronage refund certificates and patronage financing deductions	(19,511)	(20,100)
Proceeds from sale of stock	574	699
Repurchases of stock	(3,981)	(4,284)
Net cash used in financing activities	(40,487)	(94,100)
Increase in cash and cash equivalents	102,362	56,981
Cash and cash equivalents at beginning of period	80,326	84,385
Cash and cash equivalents at end of period	\$182,688	\$ 141,366
Supplemental disclosure of cash flow information:		
Interest paid (net of amount capitalized)	\$ 19,312	\$ 21,539
Income taxes paid	\$ 8,366	\$ 323

See accompanying notes to condensed consolidated financial statements.

Notes to the Condensed Consolidated Financial Statements
(Unaudited, in thousands)

(1) Summary of Significant Accounting Policies

The Company and Its Business

Ace Hardware Corporation (“the Company”) is a wholesaler of hardware and other related products and is a manufacturer and wholesaler of paint products. The Company also provides to its retail members value-added services such as advertising, marketing, merchandising and store location and design services. The Company’s goods and services are sold predominately within the United States, primarily to retailers that operate hardware stores and with whom the Company has a retail membership agreement. As a retailer-owned cooperative, the Company distributes substantially all of its patronage sourced income in the form of patronage distributions to member retailers based on their volume of merchandise purchases. See Note 3, Patronage Distributions and Refund Certificates Payable, for further discussion regarding patronage distributions.

Basis of Presentation

The accompanying condensed consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles (“GAAP”). Certain information and note disclosures normally included in the financial statements prepared in accordance with GAAP have been condensed or omitted. The unaudited condensed consolidated financial statements and notes should be read in conjunction with the financial statements and notes thereto included in the Company’s 2008 Annual Report. The Company’s three and six month periods ended on the thirteenth and twenty-sixth weeks ended Saturday, July 4, 2009 and June 28, 2008, respectively.

Subsequent events have been evaluated through August 7, 2009, the date these statements were available to be issued.

The financial information included herein reflects all adjustments (consisting only of normal recurring adjustments), which, in the opinion of management, are necessary for a fair presentation of the results of the interim periods presented. The results of operations for the three and six months ended July 4, 2009 are not necessarily indications of the results to be expected for the full fiscal year 2009.

Principles of Consolidation

The accompanying condensed consolidated financial statements include the accounts of the Company and its majority-owned subsidiaries. All significant intercompany transactions have been eliminated. Due to the timing of receipt of available financial information, the results of the Company’s New Age Insurance Limited (“NAIL”) subsidiary are consolidated on a one-month lag.

Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Reclassifications

Certain prior period amounts have been reclassified to conform to the current financial statement presentation, with no net effect on the condensed consolidated balance sheets, statements of income or statements of cash flows.

Notes to the Condensed Consolidated Financial Statements
(Unaudited, in thousands)

Recently Issued Accounting Pronouncements

In June 2006, the Financial Accounting Standards Board (“FASB”) issued FASB Interpretation No. 48, “Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109” (“FIN No. 48”). FIN No. 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise’s financial statements in accordance with FASB Statement No. 109. This interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. On December 30, 2008, the FASB issued FASB Staff Position No. 48-3 (“FSP FIN No. 48-3”), “Effective date of FIN No. 48 for Certain Nonpublic Enterprises,” which deferred the effective date of FIN No. 48 to fiscal years beginning after December 15, 2008. The Company has elected this deferral under FSP FIN No. 48-3, under which FIN No. 48 will become effective for the Company for the fiscal year ended January 2, 2010. The Company is currently assessing the impact that FIN No. 48 may have on the condensed consolidated financial statements, but the impact of initial adoption is not expected to be material to the Company’s results of operations or its financial condition.

In April 2008, the FASB issued FASB Staff Position (“FSP”) FAS No. 115-2 and FAS No. 124-2, “Recognition and Presentation of Other-Than-Temporary-Impairments” (“FSP No. 115-2/124-2”). FSP No. 115-2/124-2 changes the recognition threshold of an other-than-temporary impairment (“OTTI”) for debt securities and provides income statement relief by permitting the non-credit portion of the OTTI loss to be excluded from current earnings and reported in other comprehensive income. FSP No. 115-2/124-2 was effective for the Company’s interim period ended July 4, 2009, and its adoption did not have a material impact to the Company’s results of operations or its financial condition.

(2) Inventories

Inventories consist primarily of merchandise inventories. Substantially all of the Company’s inventories are valued on the LIFO method. The excess of replacement cost over the LIFO value of inventory was \$83,921 and \$84,053 at July 4, 2009 and January 3, 2009, respectively. During the six months ended July 4, 2009 and June 28, 2008, the Company incurred a LIFO decrement of \$2,851 and \$6,650, respectively. The liquidation of prior year layers resulted in a \$529 and \$821 increase in net income for the six months ended July 4, 2009 and June 28, 2008, respectively. Indirect costs, consisting primarily of an allocated portion of warehousing costs, are absorbed as inventory costs rather than period costs. These costs included in inventory were \$18,779 and \$18,904 at July 4, 2009 and January 3, 2009, respectively.

Inventories consisted of:

	July 4, 2009	January 3, 2009
Manufacturing inventories:		
Raw materials	\$ 3,809	\$ 3,549
Work-in-process and finished goods	12,751	15,416
	16,560	18,965
Merchandise inventories:		
Warehouse inventory	430,373	441,466
Inventories	\$446,933	\$460,431

Certain distribution operations and selling, general and administrative expenses are considered inventory costs and expensed in cost of sales. These costs were \$24,975 and \$47,838 and \$25,892 and \$50,789 for the three and six months ended July 4, 2009 and June 28, 2008, respectively.

Notes to the Condensed Consolidated Financial Statements
(Unaudited, in thousands)

(3) Patronage Distributions and Refund Certificates Payable

The Company operates as a cooperative organization and has paid or may pay patronage distributions to member retailers on the portion of patronage based income derived from business done with such retailers. Patronage distributions are allocated in proportion to the volume of purchases by member retailers during the period.

The first 20% of patronage distributions are distributed in cash. The remaining balance of the patronage distribution is applied to the retailer member's variance allocation account until the account is reduced to zero and any remaining patronage distribution is distributed in the Company's Class C stock.

Prior to 2007, a portion of the patronage distribution was distributed in the form of a patronage refund certificate having maturity dates and bearing interest as determined by the Company's Board of Directors.

The patronage refund certificates outstanding at July 4, 2009 are payable as follows:

	<u>Amount</u>	<u>Interest Rate</u>
2010	\$19,321	5.00%
2011	17,188	6.00%
2012	18,090	6.00%

(4) Debt

Line of Credit

On May 15, 2008, the Company entered into a \$300,000 senior secured revolving credit facility with a group of banks, which matures on May 15, 2013 and includes \$175,000 available for letters of credit. Borrowings under this facility as of July 4, 2009 bear interest at a spread of 175 to 250 basis points over LIBOR based on availability. Fees are assessed on a monthly basis for the unused portion of the line of credit at 50 basis points per annum. This fee decreases to 37.5 basis points when more than 50% of the line of credit is outstanding.

This credit facility is available to fund short-term working capital needs, of which \$214,014 and \$222,108 was available and \$0 and \$1,100 was drawn at July 4, 2009 and January 3, 2009, respectively. The credit facility availability is calculated by considering the qualified underlying asset collateral and is reduced by outstanding letters of credit as defined by the credit facility agreement. At July 4, 2009, the credit facility availability was calculated by considering \$263,005 of qualified pledged collateral less \$48,991 of outstanding letters of credit. The credit agreement requires the Company to comply with various financial and nonfinancial covenants. The financial covenant is a minimum fixed charge coverage ratio triggered if borrowing availability, as determined under the credit agreement, is less than \$30,000. The Company was in compliance with its covenants at July 4, 2009.

Long-Term Debt

On May 15, 2008, the Company issued \$300,000 of senior secured notes maturing June 1, 2016 and bearing an interest coupon of 9.125%. The effective interest rate on this debt is 9.37%. The proceeds were used to retire \$257,286 of prior debt, \$6,594 of make-whole payments associated with the retirement of the prior debt, \$12,762 of deferred financing costs associated with the senior secured notes and for general corporate purposes. As a result of this financing, the Company expensed \$661 of previously unamortized deferred financing costs related to its prior debt. During the second quarter 2008, the Company recorded the make-whole payments, the write-off of the unamortized deferred financing costs associated with the prior debt and a payment of \$4,602 related to the settlement of an interest rate swap as a loss on early extinguishment of debt in the condensed consolidated statements of income.

Notes to the Condensed Consolidated Financial Statements
(Unaudited, in thousands)

Long-term debt is comprised of the following:

	<u>July 4, 2009</u>	<u>January 3, 2009</u>
\$290,005 face value senior notes less unamortized discount of \$3,490 and \$3,743, due at maturity with interest payable semi-annually, commencing on December 1, 2008, bearing an interest coupon rate of 9.125% and a maturity date of June 1, 2016	\$286,515	\$286,262
Installment notes with maturities through 2013 at a fixed rate of 6.00%	11,277	9,594
Total long-term debt	<u>297,792</u>	<u>295,856</u>
Less: maturities within one year	<u>(3,865)</u>	<u>(3,358)</u>
Long-term debt	<u>\$293,927</u>	<u>\$292,498</u>

The weighted average interest rate on long-term debt was 9.25% and 8.66% for the six months ended July 4, 2009 and the year ended January 3, 2009, respectively.

The indenture governing the 9.125% senior secured notes contains covenants, representations and events of default that management considers typical of an indenture of this nature. These covenants limit the Company's ability to: (i) incur additional indebtedness; (ii) create liens; (iii) pay dividends or make other restricted payments; and (iv) make asset sales and enter into sale and leaseback transactions. The Company was in compliance with these covenants at July 4, 2009.

(5) Derivative Financial Instrument

On April 28, 2008, the Company terminated its \$50,000 interest rate swap agreement and incurred a termination payment of \$4,602, which was recorded in loss on early extinguishment of debt in the condensed consolidated statements of income. The Company also recorded an unrealized gain of \$1,341 and unrealized loss of \$1,050 for the three and six months ended June 28, 2008, for the swap agreement in accumulated other comprehensive loss. No amount was recorded in operating income as there was no hedge ineffectiveness for this period.

(6) Comprehensive Income

Comprehensive income includes the following components:

	<u>Three Months Ended</u>		<u>Six Months Ended</u>	
	<u>July 4, 2009</u>	<u>June 28, 2008</u>	<u>July 4, 2009</u>	<u>June 28, 2008</u>
Net income	\$42,160	\$33,412	\$56,603	\$44,170
Foreign currency translation adjustment	3	(62)	46	(62)
Unrealized gain (loss) on investments in marketable securities, net	1,022	(59)	537	(657)
Unrealized gain (loss) on derivative	<u>—</u>	<u>1,341</u>	<u>—</u>	<u>(1,050)</u>
Comprehensive income	<u>\$43,185</u>	<u>\$34,632</u>	<u>\$57,186</u>	<u>\$42,401</u>

Notes to the Condensed Consolidated Financial Statements
(Unaudited, in thousands)

(7) Income Taxes

Income tax expense differs from the amount computed by applying the statutory U.S. Federal income tax rate of 35% to income before income taxes because of the effect of the following items:

	<u>Three Months Ended</u>		<u>Six Months Ended</u>	
	<u>July 4, 2009</u>	<u>June 28, 2008</u>	<u>July 4, 2009</u>	<u>June 28, 2008</u>
Expected tax at U.S. Federal income tax rate	\$(14,912)	\$(12,281)	\$(20,172)	\$(16,335)
State income taxes, net of U.S. Federal income tax benefit (expense) . . .	16	(142)	68	(246)
Patronage distribution deductions	14,463	10,659	19,100	14,224
Other, net	(14)	87	(27)	(143)
Income tax expense	<u>\$ (447)</u>	<u>\$ (1,677)</u>	<u>\$ (1,031)</u>	<u>\$ (2,500)</u>

(8) Capital Stock

During the first quarter of 2009, the Company’s Board of Directors approved the retirement of the Company’s treasury stock and, subject to certain conditions, the redemption of Class B stock. These conditions were satisfied and 1,268 shares of Class B stock were redeemed during the second quarter of 2009. The treasury stock retirement resulted in a reduction to treasury stock of \$10,406, a reduction to Class B stock of \$5,203 and a reduction to contributed capital of \$5,203. The redemption of the Class B stock resulted in reductions to Class B stock and contributed capital of \$1,268 each. The Company has an outstanding liability at July 4, 2009 of \$1,128 for redeemable shares not yet surrendered. The retirement and redemption did not have a material impact on the Company’s condensed consolidated statements of income or statements of cash flows.

(9) Fair Value

Beginning in fiscal year 2008, the Company measures and reports its financial assets and liabilities in its financial statements under the provisions of FASB Statement No. 157, “Fair Value Measurement” (“SFAS No. 157”).

SFAS No. 157 defines fair value as the price that would be received to sell an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date.

SFAS No. 157 established a three-level hierarchy for disclosure to show the extent and level of judgment used to estimate fair value measurements.

Level 1 — Uses unadjusted quoted prices that are available in active markets for the identical assets or liabilities as of the reporting date.

Level 2 — Uses inputs other than Level 1 that are either directly or indirectly observable as of the reporting date through correlation with market data, including quoted prices for similar assets and liabilities in active markets and quoted prices in markets that are not active. Level 2 also includes assets and liabilities that are valued using models or other pricing methodologies that do not require significant judgment since the input assumptions used in the models, such as interest rates and volatility factors, are corroborated by readily observable data.

Notes to the Condensed Consolidated Financial Statements
(Unaudited, in thousands)

Level 3 — Uses inputs that are unobservable and are supported by little or no market activity and reflect the use of significant management judgment. These values are generally determined using pricing models for which the assumptions utilize management’s estimates of market participant assumptions.

The tables below set forth, by level, the Company’s assets that were accounted for at fair value as of July 4, 2009 and January 3, 2009. The tables do not include cash on hand and also do not include assets and liabilities that are measured at historical cost or any basis other than fair value. The carrying values for other current financial assets and liabilities, such as accounts receivable and accounts payable, approximate fair value due to the short maturity of such instruments.

<u>Items measured at fair value on a recurring basis:</u>	<u>Carrying Value Measured at Fair Value July 4, 2009</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
Cash equivalents:				
Money market funds	\$174,123	\$174,123	\$—	\$—
Marketable securities maturing within three months	150	150	—	—
Marketable securities	<u>34,641</u>	<u>34,641</u>	<u>—</u>	<u>—</u>
Total assets	<u>\$208,914</u>	<u>\$208,914</u>	<u>\$—</u>	<u>\$—</u>

<u>Items measured at fair value on a recurring basis:</u>	<u>Carrying Value Measured at Fair Value January 3, 2009</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
Cash equivalents:				
Money market funds	\$ 73,440	\$ 73,440	\$—	\$—
Marketable securities maturing within three months	575	575	—	—
Marketable securities	<u>31,147</u>	<u>31,147</u>	<u>—</u>	<u>—</u>
Total assets	<u>\$105,162</u>	<u>\$105,162</u>	<u>\$—</u>	<u>\$—</u>

The principal balance of the Company’s senior secured notes outstanding at July 4, 2009 and January 3, 2009 was \$290,005. Based on the Company’s current borrowing rates, the fair value of the notes approximates the principal balance.

Notes to the Condensed Consolidated Financial Statements
(Unaudited, in thousands)

(10) Segments

Under FASB Statement No. 131, "Disclosures about Segments of an Enterprise and Related Information," the Company determined that it has two reportable segments based on the way that its chief operating decision maker organizes the Company's business activities for making operating decisions and assessing performance. The Company is principally engaged as a wholesaler of hardware and other related products and is a manufacturer and wholesaler of paint products. The Company identifies segments based on management responsibility and the nature of the business activities of each component of the Company. Corporate expenses are included in the wholesale segment. The Company measures segment profit as operating profit including an allocation of interest expense and income taxes based on sales. Information regarding the identified segments and the related reconciliation to condensed consolidated information is as follows:

	Three Months Ended July 4, 2009				
	Wholesale	Paint Manufacturing	Other	Elimination of Intersegment Activities	Consolidated
Revenues from external customers	\$ 968,122	\$ 3,425	\$ 1,549	\$ —	\$ 973,096
Intersegment sales	—	33,480	—	(33,480)	—
Interest expense	8,983	167	—	—	9,150
Depreciation and amortization	7,592	657	—	—	8,249
Segment profit	38,430	3,530	200	—	42,160
Identifiable segment assets	1,258,062	59,880	54,101	—	1,372,043
Expenditures for long-lived assets	14,072	138	—	—	14,210
	Three Months Ended June 28, 2008				
	Wholesale	Paint Manufacturing	Other	Elimination of Intersegment Activities	Consolidated
Revenues from external customers	\$1,059,404	\$ 3,694	\$ 1,798	\$ —	\$1,064,896
Intersegment sales	—	36,319	—	(36,319)	—
Interest expense	7,783	198	—	—	7,981
Depreciation and amortization	7,100	809	—	—	7,909
Segment profit	29,294	2,666	1,452	—	33,412
Identifiable segment assets	1,313,255	65,228	57,810	—	1,436,293
Expenditures for long-lived assets	8,055	42	—	—	8,097
	Six Months Ended July 4, 2009				
	Wholesale	Paint Manufacturing	Other	Elimination of Intersegment Activities	Consolidated
Revenues from external customers	\$1,813,439	\$ 7,746	\$ 3,128	\$ —	\$1,824,313
Intersegment sales	—	64,112	—	(64,112)	—
Interest expense	17,713	426	—	—	18,139
Depreciation and amortization	14,923	1,345	—	—	16,268
Segment profit	51,551	4,581	471	—	56,603
Identifiable segment assets	1,258,062	59,880	54,101	—	1,372,043
Expenditures for long-lived assets	20,114	182	—	—	20,296

Notes to the Condensed Consolidated Financial Statements
(Unaudited, in thousands)

	Six Months Ended June 28, 2008				Consolidated
	Wholesale	Paint Manufacturing	Other	Elimination of Intersegment Activities	
Revenues from external customers	\$1,922,502	\$ 9,210	\$ 3,660	\$ —	\$1,935,372
Intersegment sales	—	62,992	—	(62,992)	—
Interest expense	14,727	450	—	—	15,177
Depreciation and amortization	13,417	1,614	—	—	15,031
Segment profit	39,209	3,631	1,330	—	44,170
Identifiable segment assets	1,313,255	65,228	57,810	—	1,436,293
Expenditures for long-lived assets	13,831	67	—	—	13,898

The Company has \$51 of long-lived assets outside of the United States.

Revenues by geographic region and revenue type are as follows:

	Three Months Ended		Six Months Ended	
	July 4, 2009	June 28, 2008	July 4, 2009	June 28, 2008
Revenues by geographic region:				
United States	\$927,489	\$1,007,965	\$1,741,049	\$1,833,697
Foreign countries	45,607	56,931	83,264	101,675
Total	\$973,096	\$1,064,896	\$1,824,313	\$1,935,372
Revenue type:				
Merchandise sales	\$893,253	\$ 972,330	\$1,680,005	\$1,773,187
Retail services	79,843	92,566	144,308	162,185
Total	\$973,096	\$1,064,896	\$1,824,313	\$1,935,372

**MANAGEMENT'S DISCUSSION AND ANALYSIS OF
FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

The following Management's Discussion and Analysis of Financial Condition and Results of Operations should be read in conjunction with the Company's condensed consolidated financial statements and the related notes appearing elsewhere in this quarterly report as well as with the Company's 2008 Annual Report. Results of the interim periods presented are not necessarily indicative of the results to be expected for the full fiscal year due to seasonal and other factors.

Executive Overview

For the three and six months ended July 4, 2009, the Company's revenues decreased \$91.8 million and \$111.1 million, or 8.6% and 5.7%, compared to the prior year. For the three and six months ended July 4, 2009, merchandise sales to comparable domestic stores decreased \$59.2 million and \$64.6 million, or 5.6% and 3.3%, compared to the prior year. For the three months ended July 4, 2009, gross profit decreased \$3.5 million, or 2.6%, compared to the prior year. Gross profit increased \$4.6 million, or 2.0%, for the six months ended July 4, 2009, compared to the prior year. For the three months ended July 4, 2009, operating expenses decreased \$1.5 million, or 1.7%, compared to the prior year. Operating expenses increased \$0.6 million, or 0.4%, for the six months ended July 4, 2009, compared to the prior year. For the three and six months ended July 4, 2009, the Company reported net income of \$42.2 million and \$56.6 million, an increase of \$8.7 million and \$12.4 million, or 26.2% and 28.1%, compared to the prior year.

Management utilizes a variety of key performance measures to evaluate the performance of the Company's business. These measures include revenues, store count, gross profit percentage, operating expenses and debt levels.

Results of Operations

Comparison of the Three Months Ended July 4, 2009 to the Three Months Ended June 28, 2008

Consolidated revenues for the three months ended July 4, 2009 totaled \$973.1 million, a decrease of \$91.8 million, or 8.6%, as compared to the prior year. Total merchandise sales were \$893.3 million, a decrease of \$79.1 million, or 8.1%, as compared to the prior year. A reconciliation of consolidated revenues follows (in thousands):

		<u>% Change vs. 2008</u>
2008 Revenues	\$1,064,896	
<i>Merchandise sales change based on new and cancelled domestic stores:</i>		
Sales increase from 2009/2008 new stores	18,031	1.7%
Net decrease in sales from 2009/2008 store cancellations	(27,197)	(2.6)%
Decrease in merchandise sales to comparable domestic stores	(59,237)	(5.6)%
Decrease in international merchandise sales	(10,904)	(1.0)%
Other revenue changes	(12,493)	(1.1)%
2009 Revenues	<u>\$ 973,096</u>	<u>(8.6)%</u>

New stores for this three month comparison are defined as stores that were activated from January 2008 through June 2009. In 2009, the Company had an increase in sales due to new domestic stores of \$18.0 million, which includes the addition of 16 new domestic stores activated that generated revenues of \$11.5 million. This increase was offset by a decrease in sales due to domestic store cancellations of \$27.2 million, which includes retailer cancellations of 51 domestic stores which negatively impacted revenues by \$15.2 million.

The decrease in comparable domestic store sales of \$59.2 million was driven by lower sales in almost all categories with a modest increase in the lawn and garden category. The largest sales declines were driven by the

plumbing, tools and electrical categories. International merchandise sales decreased \$10.9 million driven by lower sales in the Middle East and Central America regions due to a slow global economy.

The number of the Company's retailer outlets is summarized as follows:

<u>Three Months Ended</u>	<u>July 4, 2009</u>	<u>June 28, 2008</u>
Retailer outlets at beginning of period	4,558	4,703
New retailer outlets	25	33
Retailer outlets cancellations	(53)	(53)
Retailer outlets at end of period	<u>4,530</u>	<u>4,683</u>

Management believes that new store count is a key metric in evaluating the health of the Company due to the incremental volume from these stores in future periods. The Company activated 25 and 33 stores in 2009 and 2008, respectively.

Gross profit decreased \$3.5 million and, as a percentage of revenues, increased 84 basis points to 13.61% in 2009 from 12.77% in 2008. The increase in gross profit percentage in 2009 was attributable to a shift from direct ship sales towards a higher percentage of warehouse sales which carry higher handling charges, lower inbound freight costs and a benefit related to certain costs capitalized into inventory. Warehouse sales represented 80.0% of merchandise sales in 2009 compared to 77.7% in 2008, while direct ship sales were 20.0%, down from 22.3%.

Operating expenses decreased by \$1.5 million but increased as a percent of revenues to 8.49% in 2009 from 7.90% in 2008. The primary drivers for the decrease in operating expenses were lower selling, general and administrative expenses of \$2.4 million as a result of lower non-recurring expenses during 2009 compared to 2008 and lower retail success and development expenses of \$1.2 million from lower field support expenses and lower advertising expenses.

The overall decrease in operating expenses was partially offset by higher distribution operations expenses of approximately \$2.1 million which increased as a percent of revenues to 2.49% in 2009 from 2.07% in 2008 primarily driven by lower expenses capitalized into inventory partially offset by lower retail support center expenses.

In addition to the above drivers and offsetting the overall decrease in consolidated operating expenses, consolidated employee benefit expenses were higher as a result of the timing of these accruals during 2009 compared to 2008 whereby these expenses were significantly lower during the first half of 2008 compared to the last half of 2008. Accordingly, these expenses were lower in both the first and second quarters of 2008 compared to the first two quarters of 2009 as a result of the overall timing.

Interest expense increased \$1.2 million due to higher interest rates. Average interest rates increased to 9.25% in 2009 from 7.82% in 2008. The Company also recorded a loss on the early extinguishment of debt of \$11.9 million during the three months ended June 28, 2008.

Interest income decreased \$0.5 million primarily due to lower interest rates and reduced principal balances on outstanding retailer loans.

Income tax expense decreased \$1.2 million primarily due to lower pre-tax earnings from the Company's insurance subsidiary, e-commerce operations and non-member store activity.

Results of Operations

Comparison of Six Months Ended July 4, 2009 to Six Months Ended June 28, 2008

Consolidated revenues for the six months ended July 4, 2009 totaled \$1.8 billion, a decrease of \$111.1 million, or 5.7%, as compared to the prior year. Total merchandise sales for the six months were \$1.7 billion, a

decrease of \$93.2 million, or 5.3%, as compared to the prior year. A reconciliation of consolidated revenues follows (in thousands):

		<u>% Change vs. 2008</u>
2008 Revenues	\$1,935,372	
Merchandise sales change based on new and cancelled domestic stores:		
Sales increase from 2009/2008 new stores	37,583	1.9%
Net decrease in sales from 2009/2008 store cancellations	(48,605)	(2.5)%
Decrease in merchandise sales to comparable domestic stores	(64,568)	(3.3)%
Decrease in international merchandise sales	(18,169)	(0.9)%
Other revenue changes	<u>(17,300)</u>	<u>(0.9)%</u>
2009 Revenues	<u>\$1,824,313</u>	<u>(5.7)%</u>

New stores for this six month comparison are defined as stores that were opened from January 2008 through June 2009. In 2009, the Company had an increase in sales from new domestic stores of \$37.6 million, which includes the addition of 48 new domestic stores activated in 2009 that generated revenues of \$15.9 million. This increase was partially offset by a decrease in sales from domestic store cancellations of \$48.6 million, which includes retailer cancellations of 113 domestic stores in 2009 which negatively impacted revenues by \$20.5 million.

The decrease in comparable domestic store sales of \$64.6 million was driven by lower sales in almost all categories partially offset by an increase in the lawn and garden category. The largest sales declines were driven by the tools and electrical categories. International merchandise sales decreased \$18.2 million driven by lower sales in the Middle East and Asia regions due to a slow global economy.

The number of the Company's retailer outlets is summarized as follows:

<u>Six Months Ended</u>	<u>July 4, 2009</u>	<u>June 28, 2008</u>
Retailer outlets at beginning of period	4,581	4,706
New retailer outlets	65	67
Retailer outlet cancellations	(116)	(90)
Retailer outlets at end of period	<u>4,530</u>	<u>4,683</u>

Management believes that new store count is a key metric in evaluating the health of the Company due to the incremental volume from these stores in future periods. The Company activated 65 and 67 stores in 2009 and 2008, respectively.

Gross profit increased \$4.6 million and, as a percentage of revenues, increased 96 basis points to 12.69% in 2009 from 11.73% in 2008. The increase in gross profit percentage in 2009 was attributable to lower inbound freight costs, a benefit related to certain costs capitalized into inventory and a shift from direct ship sales towards a higher percentage of warehouse sales which carry higher handling charges. Warehouse sales represented 76.9% of merchandise sales in 2009 compared to 74.9% in 2008, while direct ship sales were 23.1%, down from 25.1%.

Operating expenses increased by \$0.6 million and increased as a percent of revenues to 8.76% in 2009 from 8.23% in 2008. One of the drivers of the change in operating expenses was higher distribution operations expenses of \$6.6 million during the year which increased as a percent of revenues to 2.63% in 2009 from 2.14% in 2008 partially driven by lower expenses capitalized into inventory partially offset by lower retail support center expenses.

Higher distribution expenses were partially offset by lower retail success and development expenses of \$3.3 million from lower field support expenses and lower advertising expenses. Total selling, general and

administrative expenses decreased by \$2.7 million as a result of lower non-recurring expenses during 2009 compared to 2008 partially offset by higher bad debt expense.

In addition to the above drivers and contributing to the overall increase in consolidated operating expenses, consolidated employee benefit expenses were higher as a result of the timing of these accruals during 2009 compared to 2008 whereby these expenses were significantly lower during the first half of 2008 compared to the last half of 2008. Accordingly, these expenses were lower in both the first and second quarters of 2008 compared to the first two quarters of 2009 as a result of the overall timing.

Interest expense increased \$3.0 million due to higher interest rates. Average interest rates increased to 9.25% in 2009 from 7.13% in 2008. The Company also recorded a loss on the early extinguishment of debt of \$11.9 million in 2008.

Interest income decreased \$1.0 million primarily due to lower interest rates and reduced principal balances on outstanding retailer loans.

Income tax expense decreased \$1.5 million primarily due to lower pretax earnings from the Company's insurance subsidiary, e-commerce operations and non-member store activity, along with lower foreign taxes on licensing and royalty fee income.

Liquidity and Capital Resources

The Company's liquidity requirements have historically arisen from, and are expected to continue to arise from, working capital, debt service, capital improvements, patronage distribution and other general corporate purposes. In the past, the Company has met its operational cash needs using cash flows from operating activities and borrowings. In addition to using cash flows from operating activities, the Company uses available funds from its revolving credit facility to meet cash obligations. The Company currently estimates that its cash flows from operating activities and working capital, together with its line of credit, will be sufficient to fund its short-term liquidity needs. Actual liquidity and capital funding requirements depend on numerous factors, including operating results and general economic conditions.

Cash Flows

The Company had \$182.7 million and \$80.3 million of cash and cash equivalents, of which \$12.7 million and \$13.6 million related to the Company's insurance subsidiary, at July 4, 2009 and January 3, 2009, respectively.

For the six months ended July 4, 2009 and June 28, 2008, the increase in cash and cash equivalents was primarily due to the following:

- Net cash provided by operating activities was \$168.8 million and \$173.6 million for 2009 and 2008, respectively. The decrease in cash provided by operating activities was primarily due to a lower increase in accounts payable in the current year as compared to the prior year primarily due to reduced inventory levels. These were partially offset by the payment for the early extinguishment of debt in 2008 as well as a larger decrease in inventory levels in the current year as compared to the prior year.
- Net cash used in investing activities was \$26.0 million and \$22.5 million for 2009 and 2008, respectively. Net cash used in 2009 increased primarily due to a higher capital investment related to the Company's supply chain initiative.
- Net cash used in financing activities was \$40.5 million and \$94.1 million for 2009 and 2008, respectively. The decrease in net cash used was primarily due to lower changes in the cash book overdraft and the refinancing of debt in 2008.

Application of Critical Accounting Policies and Estimates

For a description of the Company's critical accounting policies and estimates, please see the Application of Critical Accounting Policies and Estimates section in the Management's Discussion and Analysis of Financial Condition and Results of Operations Section of the Company's 2008 Annual Report.

Recently Issued Accounting Pronouncements

In June 2006, the Financial Accounting Standards Board ("FASB") issued FASB Interpretation No. 48, "Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109" ("FIN No. 48"). FIN No. 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109. This interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This interpretation also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. On December 30, 2008, the FASB issued FASB Staff Position No. 48-3 ("FSP FIN No. 48-3"), "Effective date of FIN No. 48 for Certain Nonpublic Enterprises," which deferred the effective date of FIN No. 48 to fiscal years beginning after December 15, 2008. The Company has elected this deferral under FSP FIN No. 48-3, under which FIN No. 48 will become effective for the Company for the fiscal year ended January 2, 2010. The Company is currently assessing the impact that FIN No. 48 may have on the condensed consolidated financial statements, but the impact of initial adoption is not expected to be material to the Company's results of operations or its financial condition.

In April 2008, the FASB issued FASB Staff Position ("FSP") FAS No. 115-2 and FAS No. 124-2, "Recognition and Presentation of Other-Than-Temporary-Impairments" ("FSP No. 115-2/124-2"). FSP No. 115-2/124-2 changes the recognition threshold of an other-than-temporary impairment ("OTTI") for debt securities and provides income statement relief by permitting the non-credit portion of the OTTI loss to be excluded from current earnings and reported in other comprehensive income. FSP No. 115-2/124-2 was effective for the Company's interim period ended July 4, 2009, and its adoption did not have a material impact to the Company's results of operations or its financial condition.

Qualitative and Quantitative Disclosure About Market Risk

Inflation and Changes in Prices. The Company's business is not generally governed by contracts that establish prices substantially in advance of the receipt of goods or services. As vendors increase their prices for merchandise supplied to the Company, the Company generally increases the price to its retailers in an equal amount plus the normal handling charge on such amounts. In the past, these increases have provided adequate gross profit to offset the impact of inflation on operating expenses.

Non-GAAP Financial Measures

The Company defines "EBITDA" as earnings before interest, loss on early extinguishment of debt, taxes, depreciation and amortization. The Company defines "adjusted EBITDA" as EBITDA adjusted to exclude certain items which the Company considers non-comparable and which the Company believes are not indicative of future performance. The Company cautions investors that amounts presented in accordance with its definitions of EBITDA and adjusted EBITDA may not be comparable to similar measures disclosed by other companies, because not all companies calculate EBITDA or adjusted EBITDA in the same manner.

EBITDA and adjusted EBITDA, as presented in this quarterly report, are supplemental measures of the Company's performance that are not required by or presented in accordance with GAAP. They are not measurements of the Company's financial performance under GAAP and should not be considered as alternatives to net income or any other performance measures derived in accordance with GAAP or as alternatives to cash flows from operating activities as measures of the Company's liquidity.

The Company presents EBITDA and adjusted EBITDA because the Company considers it an important supplemental measure of its performance and believe it is frequently used in the evaluation of companies in its industry. In addition, the instruments governing the Company's indebtedness use EBITDA (with additional adjustments) to measure the Company's compliance with covenants such as interest coverage and debt incurrence. The Company also includes a quantitative reconciliation of EBITDA and adjusted EBITDA to the most directly comparable GAAP financial performance measure, which is net income.

	<u>Three Months Ended</u>		<u>Six Months Ended</u>	
	<u>July 4, 2009 (13 Weeks)</u>	<u>June 28, 2008 (13 Weeks)</u>	<u>July 4, 2009 (26 Weeks)</u>	<u>June 28, 2008 (26 Weeks)</u>
	(Unaudited, in thousands)			
EBITDA Reconciliation:				
Net income	\$42,160	\$33,412	\$56,603	\$44,170
Income tax expense	447	1,677	1,031	2,500
Interest expense (including loss on early extinguishment of debt in 2008)	9,150	19,838	18,139	27,034
Depreciation and amortization	8,249	7,909	16,268	15,031
EBITDA	\$60,006	\$62,836	\$92,041	\$88,735
Adjustments:				
Interest income (a)	(1,007)	(1,465)	(2,113)	(3,149)
Debt restructuring and restatement related expenses (b)	—	686	—	4,204
Remediation expenses (c)	—	1,413	—	3,487
Severance (d)	550	—	564	1,407
Other adjustments	651	—	651	—
Adjusted EBITDA	\$60,200	\$63,470	\$91,143	\$94,684

- (a) Non-cash interest income received from patronage loans to member retailers plus cash interest earned by the Company's insurance subsidiary and from interest bearing cash balances.
- (b) Expenses related to the restatement of the Company's 2004, 2005 and 2006 audited financial statements and related waivers, and similar fees paid to the Company's lenders.
- (c) Expenses related to the implementation of the Company's inventory accounting error remediation plan.
- (d) Expenses related to headcount reductions, primarily at the Company's corporate headquarters.

MANAGEMENT'S RESPONSIBILITY FOR FINANCIAL STATEMENTS

The condensed consolidated financial statements presented in this Quarterly Report have been prepared with integrity and objectivity and are the responsibility of the management of Ace Hardware Corporation. These condensed consolidated financial statements have been prepared in conformity with U.S. generally accepted accounting principles and properly reflect certain estimates and judgments based upon the best available information.

The Company maintains a system of internal accounting controls, which is supported by an internal audit program and is designed to provide reasonable assurance, at an appropriate cost, that the Company's assets are safeguarded and transactions are properly recorded. This system is continually reviewed and modified in response to changing business conditions and operations and as a result of recommendations by the internal and external auditors. In addition, the Company has distributed to employees its policies for conducting business affairs in a lawful and ethical manner.

The Audit Committee of the Board of Directors meets periodically with the independent auditors and with the Company's internal auditors, both privately and with management present, to review accounting, auditing, internal control and financial reporting matters. The Audit Committee retains the independent auditors and regularly reviews the internal accounting controls, the activities of the outside auditors and internal auditors and the financial condition of the Company. Both the Company's independent auditors and the internal auditors have free access to the Audit Committee.

August 7, 2009

/s/ Ray A. Griffith

Ray A. Griffith
President and
Chief Executive Officer

/s/ Dorvin D. Lively

Dorvin D. Lively
Chief Financial Officer



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