

SEARS HOMETOWN & OUTLET STORES, INC.  
Form 10-Q  
September 04, 2015

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, DC 20549

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FORM 10-Q

☒ QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE  
ACT OF 1934  
FOR THE QUARTERLY PERIOD ENDED AUGUST 1, 2015

OR

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

Commission file number 001-35641

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SEARS HOMETOWN AND OUTLET STORES, INC.  
(Exact Name of Registrant as Specified in Its Charter)

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DELAWARE

(State or Other Jurisdiction of Incorporation or  
Organization)

80-0808358

(I.R.S. Employer Identification No.)

5500 TRILLIUM BOULEVARD, SUITE 501  
HOFFMAN ESTATES, ILLINOIS

(Address of Principal Executive Offices)

60192

(Zip Code)

Registrant's Telephone Number, Including Area Code: (847) 286-7000

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer	<input type="checkbox"/>	Accelerated filer	<input checked="" type="checkbox"/>
Non-accelerated filer (Do not check if a smaller reporting company)	<input type="checkbox"/>	Smaller reporting company	<input type="checkbox"/>

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

As of September 1, 2015, the registrant had 22,721,560 shares of common stock, par value \$0.01 per share, outstanding.

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SEARS HOMETOWN AND OUTLET STORES, INC.  
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SEARS HOMETOWN AND OUTLET STORES, INC.  
 CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS  
 (Unaudited)

## PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements

	13 Weeks Ended		26 Weeks Ended	
Thousands, except per share amounts	August 1, 2015	August 2, 2014	August 1, 2015	August 2, 2014
NET SALES	\$619,610	\$638,693	\$1,202,379	\$1,228,547
COSTS AND EXPENSES				
Cost of sales and occupancy	478,250	491,604	920,660	937,559
Selling and administrative	136,223	139,226	270,725	274,505
Depreciation	2,164	2,067	4,025	4,355
Total costs and expenses	616,637	632,897	1,195,410	1,216,419
Operating income	2,973	5,796	6,969	12,128
Interest expense	(614	) (905	) (1,395	) (1,839
Other income	560	798	1,242	1,478
Income before income taxes	2,919	5,689	6,816	11,767
Income tax expense	(1,409	) (2,329	) (3,156	) (4,728
NET INCOME	\$1,510	\$3,360	\$3,660	\$7,039

NET INCOME PER COMMON SHARE  
 ATTRIBUTABLE TO STOCKHOLDERS

Basic:	\$0.07	\$0.15	\$0.16	\$0.31
Diluted:	\$0.07	\$0.15	\$0.16	\$0.31
Basic weighted average common shares outstanding	22,666	22,666	22,666	22,666
Diluted weighted average common shares outstanding	22,666	22,666	22,666	22,666

See Notes to Condensed Consolidated Financial Statements.

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CONDENSED CONSOLIDATED BALANCE SHEETS  
(Unaudited)

Thousands	August 1, 2015	August 2, 2014	January 31, 2015
<b>ASSETS</b>			
<b>CURRENT ASSETS</b>			
Cash and cash equivalents	\$23,390	\$20,978	\$19,746
Accounts and franchisee receivables, net	13,583	21,211	15,456
Merchandise inventories	431,376	469,607	442,743
Prepaid expenses and other current assets	17,550	13,312	19,350
Total current assets	485,899	525,108	497,295
<b>PROPERTY AND EQUIPMENT, net</b>	52,841	51,973	50,708
<b>GOODWILL</b>	—	167,000	—
<b>LONG-TERM DEFERRED TAXES</b>	53,904	48,345	54,273
<b>OTHER ASSETS, net</b>	43,395	45,898	43,446
<b>TOTAL ASSETS</b>	<b>\$636,039</b>	<b>\$838,324</b>	<b>\$645,722</b>
<b>LIABILITIES</b>			
<b>CURRENT LIABILITIES</b>			
Short-term borrowings	\$10,100	\$74,800	\$84,100
Payable to Sears Holdings Corporation	91,778	83,711	61,089
Accounts payable	29,463	13,897	14,888
Other current liabilities	76,855	64,495	60,938
Current portion of capital lease obligations	32	286	147
Total current liabilities	208,228	237,189	221,162
<b>CAPITAL LEASE OBLIGATIONS</b>	291	3	176
<b>OTHER LONG-TERM LIABILITIES</b>	1,973	3,475	2,098
<b>TOTAL LIABILITIES</b>	<b>210,492</b>	<b>240,667</b>	<b>223,436</b>
<b>COMMITMENTS AND CONTINGENCIES (Note 10)</b>			
<b>STOCKHOLDERS' EQUITY</b>			
<b>TOTAL STOCKHOLDERS' EQUITY</b>	<b>425,547</b>	<b>597,657</b>	<b>422,286</b>
<b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b>	<b>\$636,039</b>	<b>\$838,324</b>	<b>\$645,722</b>

See Notes to Condensed Consolidated Financial Statements.

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SEARS HOMETOWN AND OUTLET STORES, INC.  
 CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS  
 (Unaudited)

Thousands	26 Weeks Ended	
	August 1, 2015	August 2, 2014
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net income	\$3,660	\$7,039
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	4,025	4,355
Share-based compensation	(399	) 393
Provision for losses on franchisee receivables	364	—
Change in operating assets and liabilities:		
Accounts and franchisee receivables	1,231	(7,821
Merchandise inventories	11,367	12,500
Payable to Sears Holdings Corporation	30,689	15,315
Accounts payable	14,575	(10,232
Customer deposits	2,610	(257
Deferred income taxes	2,635	4,278
Other operating assets	154	102
Other operating liabilities	13,181	3,558
Net cash provided by operating activities	84,092	29,230
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Purchases of property and equipment	(6,448	) (7,050
Net cash used in investing activities	(6,448	) (7,050
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Payments of capital lease obligations	—	(377
Net short-term borrowings (payments)	(74,000	) (24,300
Net cash used in financing activities	(74,000	) (24,677
<b>NET CHANGE IN CASH AND CASH EQUIVALENTS</b>	3,644	(2,497
<b>CASH AND CASH EQUIVALENTS—Beginning of period</b>	19,746	23,475
<b>CASH AND CASH EQUIVALENTS—End of period</b>	\$23,390	\$20,978
<b>SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION</b>		
Cash paid for interest	\$1,457	\$1,737
Cash paid (refunded) for income taxes	\$(2,484	) \$204
See Notes to Condensed Consolidated Financial Statements.		

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## SEARS HOMETOWN AND OUTLET STORES, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY

(Unaudited)

Thousands	Number of Shares of Common Stock	Common Stock/Par Value	Capital in Excess of Par Value	Retained Earnings (Deficit)	Total Stockholders' Equity
Balance at February 1, 2014	22,753	\$228	\$547,021	\$42,976	\$ 590,225
Net income		—	—	7,039	7,039
Share-based compensation	(14 )	(1 )	394	—	393
Balance at August 2, 2014	22,739	\$227	\$547,415	\$50,015	\$ 597,657
Balance at January 31, 2015	22,736	\$227	\$547,888	\$(125,829 )	\$ 422,286
Net income		—	—	3,660	3,660
Share-based compensation	(14 )	—	(399 )	—	(399 )
Balance at August 1, 2015	22,722	\$227	\$547,489	\$(122,169 )	\$ 425,547
See Notes to Condensed Consolidated Financial Statements.					

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SEARS HOMETOWN AND OUTLET STORES, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

NOTE 1—BACKGROUND AND BASIS OF PRESENTATION

Background

Sears Hometown and Outlet Stores, Inc. is a national retailer primarily focused on selling home appliances, hardware, tools, and lawn and garden equipment. As of August 1, 2015 the Company or its dealers and franchisees operated a total of 1,215 stores across all 50 states and in Puerto Rico and Bermuda. In these notes and elsewhere in this Quarterly Report on Form 10-Q the terms “we,” “us,” “our,” “SHO,” and the “Company” refer to Sears Hometown and Outlet Stores, Inc. and its subsidiaries.

The Separation

The Company separated from Sears Holdings Corporation (“Sears Holdings”) in October 2012 (the “Separation”). Effective upon the Separation, Sears Holdings ceased to own shares of our common stock, and thereafter our common stock began trading on the NASDAQ Stock Market under the trading symbol “SHOS.”

Basis of Presentation

These unaudited condensed consolidated financial statements include the accounts of Sears Hometown and Outlet Stores, Inc. and its subsidiaries, all of which are wholly owned. These unaudited condensed consolidated financial statements do not include all of the information and footnotes required in annual consolidated financial statements prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”). In the opinion of management, all adjustments (which include normal recurring adjustments) considered necessary for a fair presentation have been included. Operating results for the first and second quarters ended August 1, 2015 are not necessarily indicative of the results that may be expected for the full fiscal year. These financial statements and related notes should be read in conjunction with the audited consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the fiscal year ended January 31, 2015.

We operate through two segments--our Sears Hometown and Hardware segment (“Hometown”) and our Sears Outlet segment (“Outlet”).

Our fiscal-year end is the Saturday closest to January 31 each year. Our second fiscal-quarter end is the Saturday closest to July 31 each year.

Variable Interest Entities and Consolidation

The Financial Accounting Standards Board (“FASB”) has issued guidance on variable interest entities and consolidation for determining whether an entity is a variable interest entity as well as the methods permitted for determining the primary beneficiary of a variable interest entity. In addition, this guidance requires ongoing reassessments of whether a company is the primary beneficiary of a variable interest entity and disclosures related to a company’s involvement with a variable interest entity.

On an ongoing basis the Company evaluates its business relationships, such as those with its dealers, franchisees, and suppliers, to identify potential variable interest entities. Generally, these businesses either qualify for a scope exception under the consolidation guidance or, where a variable interest exists, the Company does not possess the power to direct the activities that most significantly impact the economic performance of these businesses. The Company has not consolidated any of such entities in the periods presented.

Fair Value of Financial Instruments

We determine the fair value of financial instruments in accordance with standards pertaining to fair value measurements. Such standards define fair value and establish a framework for measuring fair value under GAAP. Under fair value measurement accounting standards, fair value is considered to be the exchange price in an orderly transaction between market participants to sell an asset or transfer a liability at the measurement date. We report the fair value of financial assets and liabilities based on the fair value hierarchy prescribed by accounting standards for fair value measurements, which prioritizes the inputs to valuation techniques used to measure fair value into three levels, as follows:



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

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SEARS HOMETOWN AND OUTLET STORES, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

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

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

Cash and cash equivalents (level 1), accounts receivable, notes receivable (level 2), short-term debt (level 2), merchandise payables, and accrued expenses are reflected in the Condensed Consolidated Balance Sheets at cost, which approximates fair value due to the short-term nature of these instruments. For short-term debt, the variable interest rates are a significant input in our fair value assessments. The carrying value of long-term notes receivable approximates fair value.

We measure certain non-financial assets and liabilities, including long-lived assets, at fair value on a non-recurring basis.

The Company was not required to measure any other significant non-financial asset or liability at fair value as of August 1, 2015.

Recent Accounting Pronouncements

Consolidation

In February 2015, the Financial Accounting Standards Board ("FASB") issued an accounting standards update which revises the consolidation model. Specifically, the amendments modify the evaluation of whether limited partnerships and similar legal entities are variable interest entities (VIEs) or voting interest entities, eliminate the presumption that a general partner should consolidate a limited partnership, affect the consolidation analysis of reporting entities that are involved with VIEs, particularly those that have fee arrangements and related party relationships, and provide a scope exception from consolidation guidance for reporting entities with interests in legal entities that are required to comply with or operate in accordance with requirements that are similar to those in Rule 2a-7 of the Investment Company Act of 1940 for registered money market funds. This update was effective for the Company in the first quarter of 2015. The adoption of the new standard did not impact the Company's consolidated financial position, results of operations, cash flows or disclosures.

Extraordinary and Unusual Items

In January 2015, the FASB issued an accounting standards update which eliminates the concept of an extraordinary item. Extraordinary items are events and transactions that are distinguished by their unusual nature and by the infrequency of their occurrence. Eliminating the extraordinary classification simplifies income statement presentation by altogether removing the concept of extraordinary items from consideration. This update was effective for the Company in the first quarter of 2015. The adoption of the new standard did not impact the Company's consolidated financial position, results of operations, cash flows or disclosures.

Presentation of Financial Statements - Going Concern

In August 2014, the FASB issued an accounting standards update which requires management to assess whether there are conditions or events, considered in the aggregate, that raise substantial doubt about the entity's ability to continue as a going concern within one year after the financial statements are issued. If substantial doubt exists, additional disclosures are required. This update will be effective for the Company in the fourth quarter of 2016. The adoption of the new standard is not expected to have a material impact on the Company's consolidated financial position, results of operations, cash flows or disclosures.

Revenue from Contracts with Customers

In May 2014, the FASB issued an accounting standards update which replaces the current revenue recognition standards. The new revenue recognition standard provides a five-step analysis of transactions to determine when and

how revenue is recognized. The core principle is that a company should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. This update will be effective for the Company in the first quarter of 2018 and may be applied retrospectively for each period presented or as a cumulative-effect adjustment at the date of adoption. The Company is evaluating the effect of adopting this new standard and has not yet determined the method by which the standard will be adopted.

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## SEARS HOMETOWN AND OUTLET STORES, INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

## Reporting Discontinued Operations and Disclosures of Disposals of Components of an Entity

In April 2014, the FASB issued an accounting standards update which modifies the requirements for disposals to qualify as discontinued operations and expands related disclosure requirements. The update was effective for the Company in the first quarter of 2015. The adoption of the new standard did not impact the Company's consolidated financial position, results of operations, cash flows or disclosures.

## NOTE 2—ACCOUNTS AND FRANCHISEE RECEIVABLES AND OTHER ASSETS

Accounts and franchisee receivables and other assets consist of the following:

	August 1, 2015		
Thousands	Hometown	Outlet	Total
Short-term franchisee receivables	\$1,867	\$3,576	\$5,443
Miscellaneous receivables	5,136	3,396	8,532
Long-term franchisee receivables	17,321	28,132	45,453
Other assets	1,635	236	1,871
Provision for losses on short-term franchisee receivables (1)	(384	) (8	) (392
Provision for losses on long-term franchisee receivables (1)	(3,839	) (90	) (3,929
Total Accounts and franchisee receivables and other assets	\$21,736	\$35,242	\$56,978

  

	August 2, 2014		
Thousands	Hometown	Outlet	Total
Short-term franchisee receivables	\$2,749	\$2,999	\$5,748
Miscellaneous receivables	12,839	2,624	15,463
Long-term franchisee receivables	20,159	23,320	43,479
Other assets	2,224	195	2,419
Total Accounts and franchisee receivables and other assets	\$37,971	\$29,138	\$67,109

  

	January 31, 2015		
Thousands	Hometown	Outlet	Total
Short-term franchisee receivables	\$6,169	\$3,652	\$9,821
Miscellaneous receivables	6,316	2,540	8,856
Long-term franchisee receivables	20,678	28,652	49,330
Other assets	1,973	290	2,263
Provision for losses on short-term franchisee receivables (1)	(3,212	) (9	) (3,221
Provision for losses on long-term franchisee receivables (1)	(8,068	) (79	) (8,147
Total Accounts and franchisee receivables and other assets	\$23,856	\$35,046	\$58,902

(1) The Company recognizes a provision for losses on franchisee receivables (which consist primarily of franchisee promissory notes) in an amount equal to estimated probable losses net of recoveries. The provision is based on an analysis of expected future write-offs, existing economic conditions, and an assessment of specific identifiable

franchisee promissory notes and other franchisee receivables considered at risk or uncollectible. The expense associated with the provision for losses on franchisee receivables is recognized as selling and administrative expense. Most of our franchisee promissory notes authorize us to deduct debt service from our commissions otherwise due and payable to the franchisees, and we routinely make those

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SEARS HOMETOWN AND OUTLET STORES, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

deductions to the extent of available commissions payable. We established the provision for losses on franchisee receivables during the 2014 fiscal year based on our receivable-by-receivable assessment that some of the franchisee receivables were potentially uncollectible in future periods due to (a) declining results of operations of, or other adverse financial events with respect to, Hometown franchise stores that indicated that the franchisees might not be able to meet their debt-service and other obligations to us as they became due and (b) the refusal during the year of one of our Hometown franchisees to continue to operate its franchise stores in accordance with the franchisee's agreements with us. We have commenced litigation that seeks to recover approximately \$4.4 million on guarantees with respect to some of the 2014 losses, but we cannot predict whether we will recover any monies.

**NOTE 3—PROVISION FOR LOSSES ON FRANCHISEE RECEIVABLES**

The provision for losses on Franchisee Receivables, which was established in fiscal 2014, consists of the following:

Thousands	August 1, 2015	August 2, 2014	January 31, 2015
Provision for losses on franchisee receivables, beginning of period	\$ 11,368	\$—	\$—
Expense accruals during the period	364	—	13,055
Write off of franchisee receivables (1)	(7,411)	) —	(1,687)
Provision for losses on franchisee receivables, end of period	\$ 4,321	\$—	\$ 11,368

(1) We established a provision for losses on these franchisee receivables during the 2014 fiscal year.

**NOTE 4—OTHER CURRENT AND LONG-TERM LIABILITIES**

Other current and long-term liabilities consist of the following:

Thousands	August 1, 2015	August 2, 2014	January 31, 2015
Customer deposits	\$32,850	\$35,290	\$30,241
Sales and other taxes	15,547	13,739	12,458
Accrued expenses	22,311	12,201	16,265
Payroll and related items	5,580	6,740	4,072
Store closing, severance, and executive transition costs	2,540	—	—
Total Other current and long-term liabilities	\$78,828	\$67,970	\$63,036

**NOTE 5—GOODWILL**

We recorded a \$167.0 million non-cash goodwill impairment charge in the third quarter of fiscal 2014.

We reviewed the Hometown Stores and Home Appliance Showrooms ("Hometown Reporting Unit") goodwill for impairment annually at the beginning of the fourth fiscal quarter and whenever events or changes in circumstances indicated the carrying value of goodwill may not be recoverable. The goodwill impairment test involved a two-step process. In the first step, SHO compared the fair value of the Hometown Reporting Unit to its carrying value. If the fair value of the Hometown Reporting Unit exceeded its carrying value, goodwill was not impaired and no further testing was required. If the fair value of the Hometown Reporting Unit was less than its carrying value, SHO performed the second step of the impairment test to measure the amount of impairment loss. In the second step, the Hometown Reporting Unit's fair value was allocated to all of the assets and liabilities of the Hometown Reporting Unit, including any unrecognized intangible assets, in a hypothetical analysis that calculates the implied fair value of

goodwill in the same manner as if the Hometown Reporting Unit were being acquired in a business combination. If the implied fair value of the Hometown Reporting Unit's goodwill was less than its carrying value, the difference was recorded as a non-cash impairment loss.

During the third quarter of fiscal 2014 we determined that sufficient indicators of potential impairment existed to require that we conduct an interim impairment analysis of the Hometown Reporting Unit's goodwill. These indicators included a significant and sustained decline in the recent trading values of SHO's stock, coupled with market conditions and business

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SEARS HOMETOWN AND OUTLET STORES, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

trends affecting the Hometown Reporting Unit. The primary operating factors were declines in revenue and profitability for fiscal 2014. Merchandise revenues in fiscal 2014 were impacted by the highly promotional environment, along with other factors that caused declines in comparable store sales and related profitability below expectations for the Hometown Reporting Unit.

SHO estimated the fair value of the Hometown Reporting Unit using a weighting of fair values derived from the income approach and the market approach. Under the income approach, SHO calculated the fair value of the Hometown Reporting Unit based on the present value of the Hometown Reporting Unit's estimated future cash flows. The cash flow projections were based on management's estimates of revenue growth rates and operating margins, taking into consideration industry and market conditions. SHO used a discount rate that was based on a weighted average cost of capital adjusted for the relevant risk associated with the characteristics of the Hometown Reporting Unit and its projected cash flows. SHO's market approach used estimated fair values based on market multiples of revenue and earnings derived from comparable publicly traded companies with operating and investment characteristics that were comparable to the operating and investment characteristics of the Hometown Reporting Unit.

Due to the complexity and the effort required to estimate the fair value of the Hometown Reporting Unit for the first step of the impairment test and to estimate the fair values of all assets and liabilities of the Hometown Reporting Unit for the second step of the impairment test, SHO used fair value estimates that were derived based on assumptions and analyses that are subject to change. SHO's first-step evaluation concluded that the fair value of the Hometown Reporting Unit was substantially below its carrying value. Based on SHO's second-step analyses, the implied fair value of the Hometown Reporting Unit's goodwill was \$0. As a result, a full impairment of goodwill was required and we recorded the \$167.0 million non-cash goodwill impairment charge in the third quarter of fiscal 2014, which was reflected as "Impairment of goodwill" in the Condensed Consolidated Statements of Operations. The primary factor that contributed to the goodwill impairment loss was the aforementioned 2014 operating issues leading to less-optimistic forecasts for the remainder of fiscal 2014 and fiscal 2015 and the projected corresponding impact beyond those periods.

**NOTE 6—INCOME TAXES**

SHO and Sears Holdings have entered into a Tax Sharing Agreement that governs the rights and obligations of the parties with respect to pre-Separation and post-Separation tax matters. Under the Tax Sharing Agreement, Sears Holdings generally is responsible for any federal, state, or foreign income tax liability relating to tax periods ending on or before the Separation. For all periods after the Separation, the Company generally is responsible for any federal, state, or foreign tax liability. Current income taxes payable for any federal, state, or foreign income tax returns is reported in the period incurred.

We account for uncertainties in income taxes according to accounting standards for uncertain tax positions. The Company is present in a large number of taxable jurisdictions and, at any point in time, can have audits underway at various stages of completion in one or more of these jurisdictions. We evaluate our tax positions and establish liabilities for uncertain tax positions that may be challenged by local authorities and may not be fully sustained, despite our belief that the underlying tax positions are fully supportable. Unrecognized tax benefits are reviewed on an ongoing basis and are adjusted in light of changing facts and circumstances, including progress of tax audits, developments in case law, and closings of statutes of limitation. Such adjustments are reflected in the tax provision as appropriate. For the 26 weeks ended August 1, 2015 and August 2, 2014, no unrecognized tax benefits have been identified and reflected in the financial statements.

We classify interest expense and penalties related to unrecognized tax benefits and interest income on tax overpayments as components of income tax expense. As no unrecognized tax benefits have been identified and reflected in the condensed consolidated financial statements, no interest or penalties related to unrecognized tax



benefits are reflected in the condensed consolidated balance sheets or statements of operations.

As of August 1, 2015 the Company's net deferred tax asset balance was \$62.5 million compared to \$53.7 million as of August 2, 2014 and \$65.2 million as of January 31, 2015.

#### NOTE 7—RELATED-PARTY AGREEMENTS AND TRANSACTIONS

According to publicly available information ESL Investments, Inc. and investment affiliates (collectively, "ESL") beneficially own approximately 46% of our outstanding shares of common stock and approximately 56% of Sears Holdings' outstanding shares of common stock.

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SEARS HOMETOWN AND OUTLET STORES, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

SHO and Sears Holdings have entered into various agreements (the "SHO-Sears Holdings Agreements") that, among other things, (1) govern specified aspects of our relationship with Sears Holdings, (2) establish terms under which subsidiaries of Sears Holdings provide services to us, and (3) establish terms pursuant to which subsidiaries of Sears Holdings obtain merchandise inventories for us. The terms of the SHO-Sears Holdings Agreements were agreed to prior to the Separation (except for terms changes agreed to after the Separation that have been approved by the Audit Committee of SHO's Board of Directors) in the context of a parent-subsidary relationship and in the overall context of the Separation. The costs and allocations charged to the Company by Sears Holdings do not necessarily reflect the costs of obtaining the services from unaffiliated third parties or of the Company itself providing the applicable services. The Company engages in frequent discussions, and seeks to resolve disputes, with Sears Holdings about the terms and conditions of the SHO-Sears Holdings Agreements, the business relationships that are reflected in the SHO-Sears Holdings Agreements, and the details of these business relationships, many of which details are not addressed by the terms and conditions of the SHO-Sears Holdings Agreements or, if addressed, are in dispute as to their meaning or application in the context of the existing business relationships. Some of these discussions have resulted in adjustments to the relationships that the Company believes together are in Company's best interests. In many other instances the Company's dispute-resolution efforts, which are continuing, have yet to resolve the underlying disputes.

The following is a summary of the nature of the related-party transactions between SHO and Sears Holdings:

SHO receives commissions from Sears Holdings for specified sales of merchandise made through [www.sears.com](http://www.sears.com) and [www.searsoutlet.com](http://www.searsoutlet.com), the sale of extended service contracts, delivery and handling services, and relating to the use in our stores of credit cards branded with the Sears name. For specified transactions SHO pays a commission to Sears Holdings.

We obtain a significant amount of our merchandise inventories from Sears Holdings. We have a retailer's customary rights to return to Sears Holdings merchandise that is defective (except with respect to agreed-upon amounts of defective apparel that we purchase and then liquidate) or otherwise does not meet contract requirements. In addition, we may determine that an item of Outlet merchandise (usually merchandise that is not new in-box) we have received from Sears Holdings cannot be refurbished or reconditioned or is otherwise not in a physical condition to offer for sale to our customers. We and Sears Holdings (and our Outlet vendors generally) refer to an item of merchandise in this condition as "not saleable" or "non-saleable," and in the normal course we can return the item to Sears Holdings. We generally have comparable return rights with our other Outlet vendors.

We pay royalties related to our sale of products branded with the KENMORE®, CRAFTSMAN®, and DIEHARD® marks (which marks are owned by subsidiaries of Sears Holdings, together the "KCD Marks").

We pay fees for participation in Sears Holdings' SHOP YOUR WAY REWARDS® program.

We have also entered into agreements with Sears Holdings for logistics, handling, warehouse, and transportation services, the charges for which are based generally on merchandise inventory units.

Sears Holdings provides the Company with specified corporate services. These services include accounting and finance, human resources, and information technology, among other services. Sears Holdings charges the Company for these corporate services based on actual usage or pro rata charges based upon sales, head count, or other measurements.

Sears Holdings leases stores and distribution/repair facilities to the Company, for which the Company pays rent and related occupancy charges to Sears Holdings.

The following table summarizes the results of the transactions with Sears Holdings reflected in the Company's Condensed Consolidated Financial Statements:

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Thousands	13 Weeks Ended		26 Weeks Ended	
	August 1, 2015	August 2, 2014	August 1, 2015	August 2, 2014
Net Commissions from Sears Holdings	\$24,170	\$26,570	\$48,566	\$54,739
Purchases related to cost of sales and occupancy	375,440	417,511	734,794	804,697
Services	22,938	24,048	46,316	49,787

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SEARS HOMETOWN AND OUTLET STORES, INC.

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(Unaudited)

We incur payables to Sears Holdings for merchandise inventory purchases and service and occupancy charges (net of commissions) based on the SHO-Sears Holdings Agreements. Amounts due to or from Sears Holdings are non-interest bearing and are settled on a net basis. We generally pay undisputed amounts within 10 days after the invoice date.

NOTE 8—FINANCING ARRANGEMENT

As of August 1, 2015 we had \$10.1 million outstanding under our asset-based senior secured revolving credit facility with a group of financial institutions (the "Senior ABL Facility"), which approximated the fair value of these borrowings. The Senior ABL Facility provides (subject to availability under a borrowing base) for maximum borrowings up to the aggregate commitments of all of the lenders, which as of August 1, 2015 totaled \$250 million. Up to \$75 million of the Senior ABL Facility is available for the issuance of letters of credit and up to \$25 million is available for swingline loans. The Senior ABL Facility permits us to request commitment increases in an aggregate principal amount of up to \$100 million. Availability under the Senior ABL Facility as of August 1, 2015 was \$234.3 million, with \$5.6 million of letters of credit outstanding under the facility.

The principal terms of the Senior ABL Facility are summarized below.

Senior ABL Facility

Maturity; Amortization and Prepayments

The Senior ABL Facility will mature on the earlier of (i) October 11, 2017 or (ii) six months prior to the expiration of our Merchandising Agreement with Sears Holdings (the "Merchandising Agreement"), our Services Agreement with Sears Holdings (the "Services Agreement"), and the other agreements with Sears Holdings or its subsidiaries in connection with the Separation that are specified in the Senior ABL Facility, unless such agreements have been extended to a date later than October 11, 2017 or terminated on a basis reasonably satisfactory to the administrative agent under the Senior ABL Facility.

The Senior ABL Facility is subject to mandatory prepayment in amounts equal to the amount by which the outstanding extensions of credit exceed the lesser of the borrowing base and the commitments then in effect.

Guarantees; Security

The obligations under the Senior ABL Facility are guaranteed by us and each of our existing and future direct and indirect wholly owned domestic subsidiaries (subject to certain exceptions). The Senior ABL Facility and the guarantees thereunder are secured by a first priority security interest in assets of the borrowers and guarantors consisting primarily of accounts and notes receivable, inventory, cash, cash equivalents, deposit accounts and securities accounts, as well as certain other assets (other than intellectual property) ancillary to the foregoing and all proceeds of all of the foregoing, including cash proceeds and the proceeds of applicable insurance.

Interest; Fees

The interest rates per annum applicable to the loans under the Senior ABL Facility are based on a fluctuating rate of interest measured by reference to, at our election, either (1) an adjusted London inter-bank offered rate (LIBOR) plus a borrowing margin, which rate was approximately 2.19% at August 1, 2015 or (2) an alternate base rate plus a borrowing margin, with the borrowing margin subject to adjustment based on the average excess availability under the Senior ABL Facility for the preceding fiscal quarter, which rate was approximately 4.25% at August 1, 2015.

Customary fees are payable in respect of the Senior ABL Facility, including letter of credit fees and commitment fees.

Covenants

The Senior ABL Facility includes a number of covenants that, among other things, limit or restrict our ability to, subject to specified exceptions, incur additional indebtedness (including guarantees), grant liens, make investments, make prepayments on other indebtedness, engage in mergers, or change the nature of our business.

The Senior ABL Facility limits SHO's ability to declare and pay cash dividends and repurchase its common stock. SHO may declare and pay cash dividends to its stockholders and may repurchase stock if the following conditions are satisfied: either (a) (i) no specified default then exists or would arise as a result of the declaration or payment of the cash dividend or as a result of the stock repurchase, (ii) SHO and its subsidiaries that are also borrowers have demonstrated to the reasonable satisfaction of the agent for the lenders that monthly availability (as determined in accordance with the Senior ABL Facility), immediately following the declaration and payment of the cash dividend or the stock repurchase and as projected on a pro forma basis for the twelve months following and after giving effect to the declaration and payment of the cash dividend or the stock repurchase,

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would be at least equal to the greater of (x) 25% of the Loan Cap (which is the lesser of (A) the aggregate commitments of the lenders and (B) the borrowing base) and (y) \$50,000,000, and (iii) after giving pro forma effect to the declaration and payment of the cash dividend or the stock repurchase as if it constituted a specified debt service charge, the specified consolidated fixed charge coverage ratio, as calculated on a trailing twelve months basis, would be equal to or greater than 1.1:1.0, or (b) (i) no specified default then exists or would arise as a result of the declaration or payment of the cash dividend or the stock repurchase, (ii) payment of the cash dividend or the stock repurchase is not made with the proceeds of any credit extension under the Senior ABL Facility, (iii) during the 120-day period prior to declaration and payment of the cash dividend or the stock repurchase, no credit extension was outstanding under the Senior ABL Facility, and (iv) SHO demonstrates to the reasonable satisfaction of the agent for the lenders that, on a pro forma and projected basis, no credit extensions would be outstanding under the Senior ABL Facility for the 120-day period following the declaration and payment of the cash dividend or the stock repurchase. No default or event of default presently exists. At August 1, 2015 we did not meet either of the foregoing conditions and as a result the Senior ABL Facility does not permit us to pay cash dividends or repurchase our common stock.

The Senior ABL Facility also contains affirmative covenants, including financial and other reporting requirements.

Events of Default

The Senior ABL Facility includes customary events of default including non-payment of principal, interest or fees, violation of covenants, inaccuracy of representations or warranties, cross default to certain other material indebtedness, bankruptcy and insolvency events, invalidity or impairment of guarantees or security interests, material judgments, change of control, failure to perform a "Material Contract" (which includes the Merchandising Agreement, the Services Agreement, and other SHO-Sears Holdings Agreements) to the extent required to maintain it in full force and effect, the failure to enforce a Material Contract in accordance with its terms, and Sears Holdings terminating the "Separation Agreements" (which include, among other SHO-Sears Holdings Agreements, the Merchandising Agreement and the Services Agreement).

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## SEARS HOMETOWN AND OUTLET STORES, INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

## NOTE 9—SUMMARY OF SEGMENT DATA

The Hometown reportable segment consists of the aggregation of our Hometown Stores, Hardware Stores, and Home Appliance Showrooms business formats described in "Item 2 Management's Discussion and Analysis of Financial Condition and Results of Operations-Executive Overview" of this Quarterly Report on Form 10-Q. The Outlet reportable segment also represents a business format. These segments are evaluated by our Chief Operating Decision Maker to make decisions about resource allocation and to assess performance. Each of these segments derives its revenues from the sale of merchandise and related services to customers, primarily in the U.S. The net sales categories include appliances, lawn and garden, tools and paint, and other (which includes initial franchise revenue of \$(0.2) million and \$5.4 million for the 13 weeks ended August 1, 2015 and August 2, 2014, respectively). Initial franchise revenue consists of franchise fees paid with respect to new or existing Company-operated stores that we transfer to franchisees plus the net gain or loss on any related transfer of assets to the franchisees. For the 26 weeks ended August 1, 2015, initial franchise revenue was \$0.3 million compared to \$8.7 million in the 26 weeks ended August 2, 2014.

	13 Weeks Ended August 1, 2015		
Thousands	Hometown	Outlet	Total
Net sales			
Appliances	\$287,026	\$124,214	\$411,240
Lawn and garden	114,570	8,263	122,833
Tools and paint	39,362	4,311	43,673
Other	19,789	22,075	41,864
Total	460,747	158,863	619,610
Costs and expenses			
Cost of sales and occupancy	357,533	120,717	478,250
Selling and administrative	98,133	38,090	136,223
Depreciation	883	1,281	2,164
Total	456,549	160,088	616,637
Operating income (loss)	\$4,198	\$(1,225)	) \$2,973
Total assets	\$434,220	\$201,819	\$636,039
Capital expenditures	\$1,508	\$2,862	\$4,370

	13 Weeks Ended August 2, 2014		
Thousands	Hometown	Outlet	Total
Net sales			
Appliances	\$288,748	\$121,252	\$410,000
Lawn and garden	123,518	7,590	131,108
Tools and paint	44,597	4,426	49,023
Other	23,390	25,172	48,562
Total	480,253	158,440	638,693
Costs and expenses			
Cost of sales and occupancy	372,047	119,557	491,604
Selling and administrative	105,515	33,711	139,226
Depreciation	730	1,337	2,067
Total	478,292	154,605	632,897
Operating income	\$1,961	\$3,835	\$5,796
Total assets	\$632,249	\$206,075	\$838,324
Capital expenditures	\$1,251	\$1,859	\$3,110





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## SEARS HOMETOWN AND OUTLET STORES, INC.

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Thousands	26 Weeks Ended August 1, 2015		Total
	Hometown	Outlet	
Net sales			
Appliances	\$541,938	\$264,979	\$806,917
Lawn and garden	204,546	12,694	217,240
Tools and paint	81,674	8,642	90,316
Other	43,249	44,657	87,906
Total	871,407	330,972	1,202,379
Costs and expenses			
Cost of sales and occupancy	668,620	252,040	920,660
Selling and administrative	191,937	78,788	270,725
Depreciation	1,536	2,489	4,025
Total	862,093	333,317	1,195,410
Operating income (loss)	\$9,314	\$(2,345)	) \$6,969
Total assets	\$434,220	\$201,819	\$636,039
Capital expenditures	\$2,479	\$3,969	\$6,448

Thousands	26 Weeks Ended August 2, 2014		Total
	Hometown	Outlet	
Net sales			
Appliances	\$534,274	\$258,780	\$793,054
Lawn and garden	218,858	12,481	231,339
Tools and paint	90,734	8,917	99,651
Other	54,923	49,580	104,503
Total	898,789	329,758	1,228,547
Costs and expenses			
Cost of sales and occupancy	684,201	253,358	937,559
Selling and administrative	204,352	70,153	274,505
Depreciation	1,381	2,974	4,355
Total	889,934	326,485	1,216,419
Operating income	\$8,855	\$3,273	\$12,128
Total assets	\$632,249	\$206,075	\$838,324
Capital expenditures	\$1,930	\$5,120	\$7,050

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SEARS HOMETOWN AND OUTLET STORES, INC.

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## NOTE 10—COMMITMENTS AND CONTINGENCIES

We are subject to various legal and governmental proceedings arising out of the ordinary course of business, the outcome of which, individually or in the aggregate, in the opinion of management, would not have a material adverse effect on our business, financial position, results of operations, or cash flows.

## NOTE 11—INCOME PER COMMON SHARE

Basic income per common share is calculated by dividing net income by the weighted average number of common shares outstanding for each period. Diluted income per common share also includes the dilutive effect of potential common shares.

The following table sets forth the components used to calculate basic and diluted income per common share attributable to our stockholders.

	13 Weeks Ended August 1, 2015	13 Weeks Ended August 2, 2014	26 Weeks Ended August 1, 2015	26 Weeks Ended August 2, 2014
Thousands except income per common share				
Basic weighted average shares	22,666	22,666	22,666	22,666
Dilutive effect of restricted stock	—	—	—	—
Diluted weighted average shares	22,666	22,666	22,666	22,666
Net income	\$1,510	\$3,360	\$3,660	\$7,039
Income per common share:				
Basic	\$0.07	\$0.15	\$0.16	\$0.31
Diluted	\$0.07	\$0.15	\$0.16	\$0.31

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## NOTE 12—EQUITY

## Stock-based Compensation

Four million shares of the Company's common stock are reserved for issuance under the Company's Amended and Restated 2012 Stock Plan (the "Plan"). A total of 89,221 shares of restricted stock were granted under the Plan in the second quarter of 2013 to a group of eligible individuals (as defined in the Plan) and 14,000 shares of restricted stock were granted under the Plan to an eligible individual in the second quarter of 2015. All of the eligible individuals were employees of the Company at the time of the grants. As of August 1, 2015, 47,263 shares of the original grant of 89,221 shares of restricted stock had been forfeited. During the first quarter of 2015 the Company granted a total of 159,475 stock units under the Plan (all of which stock units are payable solely in cash based on our stock price at the vesting date) to a group of eligible individuals, all of whom were employees of the Company at the time of the grants. As of August 1, 2015, 28,237 stock units had been forfeited. We are authorized to grant stock options and to make other awards (in addition to restricted stock and stock units) to eligible participants pursuant to the Plan. The Company has made no stock-option awards under the Plan. Except for the 103,221 shares of restricted stock and the 159,475 stock units, the Company has made no grants or awards under the Plan. We do not currently have a broad-based program that provides for awards under the Plan on an annual basis.

We account for stock-based compensation using the fair value method in accordance with accounting standards regarding share-based payment transactions. During the first and second quarters of 2015 we recorded \$(0.4) million in total compensation expense for the remaining 55,958 shares of restricted stock, including the reversal of approximately \$0.7 million of compensation expense related to severance and executive transition costs, and \$0.1 million in total compensation expense for the remaining 131,238 stock units (none of which had vested as of August 1, 2015). At August 1, 2015 we had \$0.6 million in total unrecognized compensation cost related to the remaining non-vested restricted stock, which cost we expect to recognize over approximately the next two years. At August 1, 2015, we had \$1.0 million in total unrecognized compensation cost related to the remaining non-vested stock units, which cost we expect to recognize over approximately the next three years.

The remaining 41,958 shares of restricted stock will vest, if at all, on May 16, 2016, and 14,000 shares of restricted stock will vest, if at all, on July 10, 2017, in accordance with and subject to the terms and conditions of restricted-stock agreements (including forfeiture conditions) and the Plan. The fair value of these awards is equal to the market price of our common stock on the date of grant. Changes in restricted-stock awards for 2015 were as follows:

(Shares in Thousands)	26 Weeks Ended August 1, 2015	
	Shares	Weighted-Average Fair Value on Date of Grant
Beginning of year balance	70	\$ 44.45
Granted	14	9.38
Vested	—	—
Forfeited	(28	) 44.45
Balance at 8/1/2015	56	\$ 35.68

The remaining 131,238 stock units will vest, if at all, on April 13, 2018 in accordance with and subject to the terms and conditions of stock unit agreements, including forfeiture conditions, and the Plan. The fair value of these awards

will vary based on changes in our stock price at each reporting period.

#### Share Repurchase Program

On August 28, 2013 the Company's Board of Directors authorized a \$25 million repurchase program for the Company's outstanding shares of common stock. The timing and amount of repurchases depend on various factors, including market conditions, the Company's capital position and internal cash generation, and other factors. The Company's repurchase program does not include specific price targets, may be executed through open-market, privately negotiated, and other transactions that may be available, and may include utilization of Rule 10b5-1 plans. The repurchase program does not obligate the Company to repurchase any dollar amount, or any number of shares, of common stock. The repurchase program does not have a termination date, and the

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Company may suspend or terminate the repurchase program at any time. At August 1, 2015, the Senior ABL Facility prohibited cash dividends and the repurchase of our common stock.

Shares that are repurchased by the Company pursuant to the repurchase program will be retired and resume the status of authorized and unissued shares of common stock.

No shares were repurchased during the 13 and 26 weeks ended August 1, 2015. At August 1, 2015, we had approximately \$12.5 million of remaining authorization under the repurchase program.

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SEARS HOMETOWN AND OUTLET STORES, INC.

13 and 26 Weeks Ended August 1, 2015 and August 2, 2014

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion should be read in conjunction with the Condensed Consolidated Financial Statements and notes contained in this Quarterly Report on Form 10-Q and the Consolidated Financial Statements and notes contained in our Annual Report on Form 10-K for the fiscal year ended January 31, 2015 (the "2014 10-K"). This discussion contains forward-looking statements that reflect our plans, estimates, and beliefs. Our actual results could differ materially from those discussed in these forward-looking statements.

Executive Overview

We are a national retailer primarily focused on selling home appliances, hardware, tools, and lawn and garden equipment. As of August 1, 2015 we or our dealers and franchisees operated a total of 1,215 stores across all 50 states, Puerto Rico, and Bermuda. In the second quarter of 2015, the Company opened nine new stores and closed 42 stores. In addition to merchandise, we provide our customers with access to a suite of services, including home delivery, installation, and extended service contracts.

Our Hometown and Hardware stores are designed to provide our customers with in-store and online access to a wide selection of national brands of home appliances, tools, lawn and garden equipment, sporting goods, and household goods, depending on the particular format. Our Outlet stores are designed to provide our customers with in-store and online access to purchase, at prices that are significantly lower than manufacturers' list prices, new, one-of-a-kind, out-of-carton, discontinued, obsolete, used, reconditioned, overstocked, and scratched and dented products across a broad assortment of merchandise categories, including home appliances, lawn and garden equipment, apparel, mattresses, sporting goods, and tools.

As of August 1, 2015 Hometown consisted of 1,057 stores as follows:

898 Sears Hometown Stores—Primarily independently operated stores, predominantly located in smaller communities and offering appliances, lawn and garden equipment, and hardware. Most of our Sears Hometown Stores carry proprietary Sears brand products, such as Kenmore, Craftsman, and DieHard, as well as a wide assortment of other national brands.

- 65 Sears Hardware Stores—Stores that carry Craftsman brand tools and lawn and garden equipment, DieHard brand batteries, and a wide assortment of other national brands and other home improvement products along with a selection of Kenmore and other national brands of home appliances.

94 Sears Home Appliance Showrooms—Stores that have a simple, primarily appliance showroom design that are positioned in metropolitan areas.

As of August 1, 2015, Hometown consisted of 892 dealer-operated stores, 109 franchisee-operated stores, and 56 Company-operated stores. The Company requires all dealer and franchisee-operated stores to operate according to the Company's standards to protect and enhance the quality of its brands. These stores must display the required merchandise, offer all required products and services, and use the Company's point of sale system. Also, the Company has the right to approve advertising and promotional and marketing materials and imposes certain advertising requirements. The Company owns the merchandise offered for sale by all dealer and franchisee-operated stores, establishes all selling prices for the merchandise, and bears general inventory risk (with specific exceptions) until sale of the merchandise and if the customer returns the merchandise. In addition, because each transaction is recorded in the Company's point of sale system, the Company bears customer credit risk. The Company establishes a commission structure for stores operated by dealers and franchisees and pays commissions to the dealers and franchisees when they sell the Company's merchandise and provide services.

The Company completed the first Outlet store franchise transactions in the first quarter of 2013. As of August 1, 2015, 66 of the 158 Outlet stores were operated by franchisees.

Dealers and franchisees exercise control over the day-to-day operations of their stores, make capital decisions regarding their stores, and exclusively make all hiring, compensation, benefits, termination, and other decisions

regarding the terms and conditions of employment, and exclusively establish all employment policies, procedures, and practices, with respect to employees.

Several of the primary differences between Company-operated stores and dealer or franchisee-operated stores are that (1) the Company is responsible for occupancy and payroll costs associated with Company-operated stores while dealers and franchisees are responsible for these costs for their stores, (2) the Company is responsible for all terms and conditions of

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## SEARS HOMETOWN AND OUTLET STORES, INC.

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employment for the employees in the Company-operated stores and its dealers and franchisees are responsible for all terms and conditions of employment for the employees in their stores, and (3) we pay commissions to our dealers and franchisees.

In the normal course of business, stores can transition from Company-operated to franchisee or dealer-operated, and vice-versa. Potential new stores may be identified by the Company, an existing dealer or franchisee, or a potential dealer or franchisee. If the Company identifies and develops a new store, the Company will generally seek to transfer that store to a dealer or a franchisee. When a dealer or a franchisee ceases to operate a store, the Company may take over its operation, generally on an interim basis, until the Company can transfer the store to another dealer or franchisee. At any given time the Company is generally operating a number of stores that are in transition from one dealer or franchisee to another dealer or franchisee. Transition stores are not included in our count of Company-operated stores due to the expected short-term nature of transition operation.

The Company's transfer of a Company-operated store to a franchisee historically has (1) in most instances increased the Company's gross margin primarily due to decreased occupancy costs and (2) increased the Company's selling and administrative expense primarily due to increased commission payments, offset partially by lower payroll and benefits expense.

Initial franchise revenues consist of franchise fees paid by franchisees with respect to new and existing Company-operated stores that we transferred to the franchisees plus the net gain or loss on related transfers of assets to the franchisees. The number of new franchised stores, the number of Company-operated stores transferred, and the net gain or loss per store transferred are highly variable from quarter to quarter. The variation results from a number of factors, including general economic conditions, which influence both the level of new store development and the level of interest of existing or potential franchisees in acquiring store locations, and economic factors specific to our major product categories, such as appliances. Each of these factors impacts the expected financial returns to the Company from new store development, which in turn impacts the number of Company-operated stores that the Company decides from time to time to make available for transfer to franchisees. During the second quarter of 2015 the Company indefinitely suspended its franchising of additional stores except to existing Company franchisees. Initial franchise revenues were \$(0.2) million and \$5.4 million in the second quarter of 2015 and 2014, respectively.

Thousands	13 Weeks Ended		26 Weeks Ended	
	August 1, 2015	August 2, 2014	August 1, 2015	August 2, 2014
Hometown	\$(102	) \$172	\$(108	) \$(22
Outlet	(60	) 5,236	436	8,718
Total initial franchise revenues	\$(162	) \$5,408	\$328	\$8,696

Online

We believe that the results of operations for our businesses have been adversely affected by the continuing growth at other retailers of online sales of merchandise in important product categories, especially home appliances. While our online commissions from Sears Holdings have grown over time, our rights to engage in our own online initiatives that would leverage www.sears.com, and our rights to engage on our own terms and conditions in our own online initiatives that would be independent of www.sears.com, are constrained by the SHO-Sears Holdings Agreements and by actions that Sears Holdings has taken that we believe are not in compliance with the Merchandising Agreement and the Services Agreements and as to which we have objected. We believe that these constraints and actions likely will continue to adversely affect our ability to conduct, and grow, our online business and, as a consequence, likely will continue to adversely affect our results of operations. These adverse effects likely will increase over time. We have, for some time, been engaging in discussions with Sears Holdings regarding the elimination of these constraints and the cessation of actions, but we are unable to determine the outcome of these discussions.

Inventory



Part of the decrease in our merchandise inventories at August 1, 2015 compared to our merchandise inventories at August 2, 2014 resulted from reduced merchandise availability from our primary vendor, Sears Holdings. Outlet's as-is, out-of-box product receipts from Sears Holdings declined 9.0% in the second quarter from the prior-year quarter. This reduced inventory availability is adversely affecting our business and, if it continues, or worsens, could have a material adverse effect on our business. We are unable to predict whether Outlet's as-is, out-of-box product receipts from Sears Holdings will increase,

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## SEARS HOMETOWN AND OUTLET STORES, INC.

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and they could decline. We are taking actions that seek to address Outlet's inventory-availability, including seeking to accelerate Outlet's sourcing-diversification initiatives. We also are unable to predict whether our actions will yield alternative sources of supply that are adequate to meet Outlet's future inventory needs.

## Shared Vendor Funds

In accordance with the Merchandising Agreement, SHO receives from Sears Holdings specified portions of merchandise subsidies collected by Sears Holdings from its merchandise vendors. During the second quarter of 2015 Sears Holdings' subsidy collections were lower compared to the same period in 2014, and SHO's portion of the collected subsidies during the second quarter declined by approximately \$4.1 million compared to the same period in 2014. Also in accordance with the Merchandising Agreement, SHO receives from Sears Holdings specified portions of cash discounts earned by Sears Holdings as a result of its early payment of merchandise-vendor payables. During the second quarter of 2015 Sears Holdings earned higher cash discounts compared to the same period in 2014, and SHO's portion of the earned cash discounts increased during the second quarter by approximately \$2.6 million compared to the same period in 2014. Sears Holdings is responsible for the collection of merchandise subsidies and the extent to which Sears Holdings will earn cash discounts. As a consequence we cannot provide any assurance that SHO's portion of merchandise subsidies collected by Sears Holdings will stay the same or cease declining and we cannot provide any assurance that SHO's portion of Sears Holdings' earned cash discounts will not decline, stay the same or continue to increase. If SHO's portion of merchandise subsidies collected by Sears Holdings were to continue to decline, and if at the same time SHO's portion of Sears Holdings' earned cash discounts were to decline, SHO's results of operations could be adversely affected to a material extent.

## Seasonality

Our business is not concentrated in the holiday season, as the majority of the products we sell are not typically thought of as holiday gifts. Lawn and Garden sales generally peak in our second quarter as customers prepare for and execute outdoor projects during the spring and early summer. See Note 10 to the Consolidated Financial Statements included in the 2014 10-K for our quarterly financial results (unaudited) for our 2013 and 2014 fiscal years.

## Results of Operations

The following table sets forth items derived from our consolidated results of operations for the 13 and 26 weeks ended August 1, 2015 and August 2, 2014.

Thousands	13 Weeks Ended		26 Weeks Ended	
	August 1, 2015	August 2, 2014	August 1, 2015	August 2, 2014
NET SALES	\$619,610	\$638,693	\$1,202,379	\$1,228,547
COSTS AND EXPENSES				
Cost of sales and occupancy	478,250	491,604	920,660	937,559
Gross margin dollars	141,360	147,089	281,719	290,988
Margin rate	22.8	% 23.0	% 23.4	% 23.7
Selling and administrative	136,223	139,226	270,725	274,505
Selling and administrative expense as a percentage of net sales	22.0	% 21.8	% 22.5	% 22.3
Depreciation	2,164	2,067	4,025	4,355
Total costs and expenses	616,637	632,897	1,195,410	1,216,419
Operating income	2,973	5,796	6,969	12,128
Interest expense	(614)	) (905)	(1,395)	) (1,839)
Other income	560	798	1,242	1,478

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Income before income taxes	2,919	5,689	6,816	11,767
Income tax expense	(1,409 )	(2,329 )	(3,156 )	(4,728 )
NET INCOME	\$1,510	\$3,360	\$3,660	\$7,039

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SEARS HOMETOWN AND OUTLET STORES, INC.

13 and 26 Weeks Ended August 1, 2015 and August 2, 2014

Comparable Store Sales

Comparable store sales amounts include merchandise sales for all stores operating for a period of at least 12 full months, including remodeled and expanded stores but excluding store relocations and stores that have undergone format changes. Comparable store sales include online transactions fulfilled and recorded by SHO and give effect to the change in the unshipped sales reserves recorded at the end of each reporting period.

Adjusted Comparable Store Sales

In addition to our net sales determined in accordance with GAAP, for purposes of evaluating our sales performance we also use "Adjusted comparable store sales." This measure includes in net sales, as if fulfilled and recorded by SHO, all in-store sales that were transacted by SHO and its independent dealers and franchisees through www.sears.com and that were fulfilled and recorded by Sears Holdings and for which SHO received an online commission from Sears Holdings ("Commission Sales"). Our management uses Adjusted comparable store sales to evaluate the sales performance of our overall business and individual stores for comparable periods. Adjusted comparable store sales should not be used by investors or other third parties as the sole basis for formulating investment decisions as it includes Commission Sales, which were not fulfilled or recorded by SHO or its independent dealers or franchisees and for which sales SHO received only commissions from Sears Holdings. Adjusted comparable store sales should not be considered as a substitute for GAAP measurements.

While Adjusted comparable store sales is a non-GAAP measure, management believes that it is an important indicator of store sales performance because:

• SHO receives commissions on all Commission Sales.

Store sales recorded and fulfilled by SHO and Commission Sales involve essentially the same in-store selling activity.

• As a consequence, unadjusted comparable store sales, which do not include Commission Sales, understate what SHO believes to be its effective comparable store sales performance.

The following table presents a reconciliation of Adjusted comparable store sales to net sales, the most comparable GAAP measure, for each of the periods indicated:

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## SEARS HOMETOWN AND OUTLET STORES, INC.

13 and 26 Weeks Ended August 1, 2015 and August 2, 2014

Thousands	13 Weeks Ended August 1, 2015			26 Weeks Ended August 1, 2015		
	Hometown	Outlet	Total	Hometown	Outlet	Total
Net sales	\$460,747	\$158,863	\$619,610	\$871,407	\$330,972	\$1,202,379
Less: Non-comparable store sales	(41,030 )	(23,604 )	(64,634 )	(79,526 )	(49,637 )	(129,163 )
Comparable store sales recorded by SHO	419,717	135,259	554,976	791,881	281,335	1,073,216
Commission Sales (1)	7,694	2,244	9,938	18,089	3,860	21,949
Adjusted comparable store sales	\$427,411	\$137,503	\$564,914	\$809,970	\$285,195	\$1,095,165
Thousands	13 Weeks Ended August 2, 2014			26 Weeks Ended August 2, 2014		
	Hometown	Outlet	Total	Hometown	Outlet	Total
Net sales	\$480,253	\$158,440	\$638,693	\$898,789	\$329,758	\$1,228,547
Less: Non-comparable store sales	(55,767 )	(20,167 )	(75,934 )	(100,643 )	(40,977 )	(141,620 )
Comparable store sales recorded by SHO	424,486	138,273	562,759	798,146	288,781	1,086,927
Commission Sales (1)	14,080	3,024	17,104	37,860	7,343	45,203
Adjusted comparable store sales	\$438,566	\$141,297	\$579,863	\$836,006	\$296,124	\$1,132,130
	13 Weeks Ended August 1, 2015 vs. 13 Weeks Ended August 2, 2014			26 Weeks Ended August 1, 2015 vs. 26 Weeks Ended August 2, 2014		
	Hometown	Outlet	Total	Hometown	Outlet	Total
Comparable store sales recorded by SHO	(1.1 )%	(2.2 )%	(1.4 )%	(0.8 )%	(2.6 )%	(1.3 )%
Adjusted comparable store sales	(2.5 )%	(2.7 )%	(2.6 )%	(3.1 )%	(3.7 )%	(3.3 )%

(1) Commission Sales are for comparable stores only. For all comparable and non-comparable stores, Commission Sales for the 13 weeks ended August 1, 2015 and August 2, 2014 were \$10.4 million and \$18.7 million, respectively, and for the 26 weeks ended August 1, 2015 and August 2, 2014, Commission Sales were \$22.9 million and \$48.1 million, respectively.

**Adjusted EBITDA**

In addition to our net income determined in accordance with GAAP, for purposes of evaluating operating performance we also use Adjusted Earnings Before Interest, Taxes, Depreciation and Amortization, or “Adjusted EBITDA,” which excludes certain significant items as set forth below. Our management uses Adjusted EBITDA, among other factors, for evaluating the operating performance of our business for comparable periods. Adjusted EBITDA should not be used by investors or other third parties as the sole basis for formulating investment decisions as it excludes a number of important cash and non-cash recurring items. Adjusted EBITDA should not be considered as a substitute for GAAP measurements.

While Adjusted EBITDA is a non-GAAP measurement, management believes that it is an important indicator of operating performance because:

EBITDA excludes the effects of financing and investing activities by eliminating the effects of interest and depreciation costs; and

Excludes other significant items that may vary significantly from period to period and may have a disproportionate effect in a given period, which affects comparability of results.

Starting with the second quarter of 2015 the Company is excluding initial franchise revenues from Adjusted EBITDA. This change is based on (1) the Company's decision to indefinitely suspend its franchising of additional stores except to existing

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## SEARS HOMETOWN AND OUTLET STORES, INC.

13 and 26 Weeks Ended August 1, 2015 and August 2, 2014

Company franchisees and (2) the Company's decision to exclude initial franchise revenues from Adjusted EBITDA for the purposes of fiscal year 2015 annual incentive compensation.

The following table presents a reconciliation of Adjusted EBITDA to net income, the most comparable GAAP measure, for each of the periods indicated:

Thousands	13 Weeks Ended		26 Weeks Ended	
	August 1, 2015	August 2, 2014	August 1, 2015	August 2, 2014
Net income	\$1,510	\$3,360	\$3,660	\$7,039
Income tax expense	1,409	2,329	3,156	4,728
Other income	(560)	(798)	(1,242)	(1,478)
Interest expense	614	905	1,395	1,839
Operating income	2,973	5,796	6,969	12,128
Depreciation	2,164	2,067	4,025	4,355
Store closing, severance, and executive transition costs	(305)	—	1,066	—
Initial franchise revenues	162	(5,408)	(328)	(8,696)
Adjusted EBITDA	\$4,994	\$2,455	\$11,732	\$7,787

## 13-Week Period Ended August 1, 2015 Compared to the 13-Week Period Ended August 2, 2014

## Net Sales

Net sales in the second quarter of 2015 decreased \$19.1 million, or 3.0%, to \$619.6 million from the second quarter of 2014. This decrease was driven primarily by (1) a 1.4% decrease in comparable store sales, (2) lower initial franchise revenues, which were \$(0.2) million in the second quarter of 2015 compared to \$5.4 million in the second quarter of 2014, (3) the impact of closed stores (net of new store openings), and (4) lower online commissions from Sears Holdings (\$3.1 million in the second quarter of 2015 compared to \$5.2 million in the second quarter of 2014).

Commission Sales during the second quarter of 2015 were \$10.4 million compared to \$18.7 million in the second quarter of 2014. The decline was primarily due to online promotions offered by Sears Holdings during the second quarter of 2014. As a result, comparable store sales, which measure the increase in sales on transactions fulfilled and recorded by SHO and do not include Commission Sales, were favorably impacted. Including Commission Sales, Adjusted comparable store sales for the second quarter of 2015 decreased 2.6%. Comparable store sales in Hometown were down 1.1% while comparable store sales in Outlet were down 2.2%. Adjusted comparable store sales were down 2.5% in Hometown and down 2.7% in Outlet. The Adjusted comparable store sales decrease of 2.6% was primarily due to (1) lower sales in Hometown's home appliances, which were negatively impacted by transitions in built-in cooking, (2) lower Outlet home appliances sales due to a reduction of as-is, out-of-box products receipts from Sears Holdings, (3) soft early quarter lawn and garden sales in Hometown, which improved later in the quarter, and (4) lower tools sales in three Hometown key merchandise categories: tool storage and mechanical tool sets resulting from less promotional activity due to lower year-over-year vendor promotional support and compressors resulting from cost increases leading to less competitive out-the-door prices, and (5) lower Outlet tools sales due to non-recurring opportunity buys in the second quarter of 2014.

## Gross Margin

Gross margin was \$141.4 million, or 22.8% of net sales, in the second quarter of 2015 compared to \$147.1 million, or 23.0% of net sales, in the second quarter of 2014. The decrease in gross margin rate was primarily driven by (1) lower initial franchise revenues, (2) lower delivery income, (3) lower online commissions from Sears Holdings, and (4) higher occupancy costs due to a higher number of Company-operated locations. These decreases were partially offset

by higher margin on merchandise sales and lower shrink. Excluding the impact of online commissions from Sears Holdings and initial franchise revenues, gross margin improved 70 basis points to 22.4% of net sales in the second quarter of 2015 compared to 21.7% of net sales in the second quarter of 2014.



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SEARS HOMETOWN AND OUTLET STORES, INC.

13 and 26 Weeks Ended August 1, 2015 and August 2, 2014

Selling and Administrative Expenses

Selling and administrative expenses decreased to \$136.2 million, or 22.0% of net sales, in the second quarter of 2015 from \$139.2 million, or 21.8% of net sales, in the prior-year quarter. The decrease was primarily due to the impact of closed stores (net of new store openings), lower commissions paid to dealers and franchisees on lower sales volume and lower commissions paid to Sears Holdings for online transactions due to lower Commission Sales partially offset by higher payroll and benefits due to operating more Company-operated stores compared to the prior year.

Operating Income

We recorded operating income of \$3.0 million and \$5.8 million in the second quarters of 2015 and 2014, respectively. The \$2.8 million decrease in operating income was primarily driven by lower initial franchise revenues and lower volume partially offset by lower selling and administrative expenses and a higher gross margin rate (excluding initial franchise revenues). Excluding initial franchise revenues from both periods, second quarter 2015 operating income would have increased by \$2.7 million to \$3.1 million compared to \$0.4 million in the second quarter of 2014.

Income Taxes

Income tax expense of \$1.4 million and \$2.3 million was recorded in the second quarters of 2015 and 2014, respectively. The effective tax rate was 48.3% and 40.9% in the second quarters of 2015 and 2014, respectively.

Net Income

We recorded net income of \$1.5 million for the second quarter of 2015 compared to net income of \$3.4 million for the prior-year quarter. The decrease in net income was primarily attributable to the factors discussed above.

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SEARS HOMETOWN AND OUTLET STORES, INC.

13 and 26 Weeks Ended August 1, 2015 and August 2, 2014

26-Week Period Ended August 1, 2015 Compared to the 26-Week Period Ended August 2, 2014

Net Sales

Net sales in the first two quarters of 2015 decreased \$26.2 million, or 2.1%, to \$1,202.4 million from the first two quarters of 2014. This decrease was driven primarily by a 1.3% decrease in comparable store sales, lower initial franchise revenues, which were \$0.3 million in the first two quarters of 2015 compared to \$8.7 million in the first two quarters of 2014, and lower online commissions from Sears Holdings (\$7.1 million in the first two quarters of 2015 compared to \$14.2 million in the first two quarters of 2014).

Commission Sales during the first two quarters of 2015 were \$22.9 million compared to \$48.1 million in the first two quarters of 2014. The decline was primarily due to online promotions offered by Sears Holdings during the first two quarters of 2014. As a result, comparable store sales, which measure the increase in sales on transactions fulfilled and recorded by SHO and do not include Commission Sales, were favorably impacted. Including Commission Sales, Adjusted comparable store sales for the first two quarters of 2015 decreased 3.3%. Comparable store sales in Hometown were down 0.8% while comparable store sales in Outlet were down 2.6%. Adjusted comparable store sales were down 3.1% in Hometown and down 3.7% in Outlet. The Adjusted comparable store sales decrease of 3.3% was primarily due to (1) lower sales in home appliances, which were negatively impacted in Hometown by lower in-stock position in the first quarter of 2015, impact of product transitions, and lower sales during the President's Day and Memorial Day promotional periods and in Outlet due to a reduction of as-is, out-of-box products receipts from Sears Holdings, (2) lower lawn and garden sales in Hometown due, in part, to poor early season in-stock position of outdoor power equipment and lower Outlet as-is, out-of-box tractor receipts from Sears Holdings and lower winter weather-related product sales in the first quarter of 2015, (3) lower tools sales in Hometown key categories due to three merchandise categories; tool storage and mechanical tool sets driven by less promotional activity due to lower year-over-year vendor promotional support and compressors where we experienced cost increases leading to less competitive out the door prices, (4) lower tools sales in Outlet due to non-recurring excess inventory clearance events in the first quarter of 2014 and non-recurring opportunity buys in the second quarter of 2014, and (5) lower consumer electronic sales as we continue to reduce the category.

Gross Margin

Gross margin was \$281.7 million, or 23.4% of net sales, in the first two quarters of 2015 compared to \$291.0 million, or 23.7% of net sales, in the first two quarters of 2014. The decrease in gross margin rate was primarily driven by lower initial franchise revenues, lower online commissions from Sears Holdings, and lower delivery income, partially offset by higher margin on Outlet merchandise sales, and lower shrink. Excluding the impact of online commissions from Sears Holdings and initial franchise revenues, gross margin improved 80 basis points to 23.0% of net sales in the first two quarters of 2015 compared to 22.2% of net sales in the first two quarters of 2014.

Selling and Administrative Expenses

Selling and administrative expenses decreased to \$270.7 million, or 22.5% of net sales, in the first two quarters of 2015 from \$274.5 million, or 22.3% of net sales, in the first two quarters of 2014. The decrease was primarily due to the impact of closed stores (net of new stores), lower commissions paid to Sears Holdings for online transactions due to lower Commission Sales, and lower payroll and benefits. These decreases were partially offset by \$1.1 million of executive transition costs and an incremental \$0.4 million for the provision for losses on franchisee receivables.

Operating Income

We recorded operating income of \$7.0 million and \$12.1 million for the first two quarters of 2015 and 2014, respectively. The \$5.1 million decrease in operating income was primarily driven by lower initial franchise revenues and lower volume partially offset by lower selling and administrative expenses and a higher gross margin rate

(excluding initial franchise revenues). Excluding initial franchise revenues from both periods, operating income for the first two quarters of 2015 would have increased by \$3.2 million to \$6.6 million compared to \$3.4 million in the first two quarters of 2014.

**Income Taxes**

We recorded income tax expense of \$3.2 million and \$4.7 million in the first two quarters of 2015 and 2014, respectively. The effective tax rate was 46.3% and 40.2% in the first two quarters of 2015 and 2014, respectively.

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SEARS HOMETOWN AND OUTLET STORES, INC.

13 and 26 Weeks Ended August 1, 2015 and August 2, 2014

Net Income

We recorded net income of \$3.7 million for the first two quarters of 2015 compared to net income of \$7.0 million for the first two quarters of 2014. The decrease in net income was primarily attributable to the factors discussed above.

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## SEARS HOMETOWN AND OUTLET STORES, INC.

13 and 26 Weeks Ended August 1, 2015 and August 2, 2014

## Business Segment Results

## Hometown

Hometown results and key statistics were as follows:

Thousands, except for number of stores	13 Weeks Ended		26 Weeks Ended	
	August 1, 2015	August 2, 2014	August 1, 2015	August 2, 2014
Net sales	\$460,747	\$480,253	\$871,407	\$898,789
Comparable store sales % (1)	(1.1)%	(5.1)%	(0.8)%	(6.2)%
Cost of sales and occupancy	357,533	372,047	668,620	684,201
Gross margin dollars	103,214	108,206	202,787	214,588
Margin rate	22.4%	22.5%	23.3%	23.9%
Selling and administrative	98,133	105,515	191,937	204,352
Selling and administrative expense as a percentage of net sales	21.3%	22.0%	22.0%	22.7%
Depreciation	883	730	1,536	1,381
Total costs and expenses	456,549	478,292	862,093	889,934
Operating income	\$4,198	\$1,961	\$9,314	\$8,855
Total Hometown stores			1,057	1,103

(1) Adjusted comparable store sales for the 13 and 26 weeks ended August 1, 2015 were (2.5)% and (3.1)%, respectively.

## 13-Week Period ended August 1, 2015 Compared to the 13-Week Period Ended August 2, 2014

## Net Sales

Hometown net sales decreased \$19.5 million, or 4.1%, to \$460.7 million in the second quarter of 2015 from \$480.3 million in the second quarter of 2014. The decrease was primarily due to the impact of closed stores (net of new stores), a 1.1% decrease in comparable store sales, and lower online commissions from Sears Holdings (\$2.4 million in the second quarter of 2015 compared to \$4.3 million in the second quarter of 2014). Adjusted comparable store sales for the second quarter of 2015, which includes Commission Sales, decreased 2.5% primarily attributable to (1) soft early quarter sales in lawn and garden, which later experienced sales improvement through the July 4th promotional period and the introduction of new branded power items, (2) lower home appliance sales, which were negatively impacted by transitions in built-in cooking, and (3) lower tools sales in three Hometown key merchandise categories: tool storage and mechanical tool sets resulting from less promotional activity due to lower year-over-year vendor promotional support and compressors resulting from cost increases leading to less competitive out-the-door prices.

## Gross Margin

Gross margin was \$103.2 million, or 22.4% of net sales, in the second quarter of 2015 compared to \$108.2 million, or 22.5% of net sales, in the prior-year quarter. The gross margin rate decline was primarily due to higher occupancy costs due to an increase in the number of Company-operated stores, lower online commissions from Sears Holdings, and lower delivery income, partially offset by lower shrink and higher margin on merchandise sales. Excluding the impact of online commissions from Sears Holdings and initial franchise revenues, gross margin was 22.0% of net sales in the second quarter of 2015 compared to 21.8% of net sales in the second quarter of 2014.

## Selling and Administrative Expenses

Selling and administrative expenses decreased to \$98.1 million, or 21.3% of net sales, in the second quarter of 2015 from \$105.5 million, or 22.0% of net sales, in the prior-year quarter. The decrease was primarily due to a reduction in dealer and franchisee commissions on lower sales volume, the impact of closed stores (net of new store openings), and lower commissions paid to Sears Holdings for online transactions due to lower Commission Sales, partially offset by higher payroll and benefits associated with a higher Company-operated store count.

Since the Separation we have included an allocation of Home Office overhead expenses in Selling and administrative expenses for Hometown and for Outlet. Home Office overhead expenses are primarily comprised of corporate headquarters

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SEARS HOMETOWN AND OUTLET STORES, INC.

13 and 26 Weeks Ended August 1, 2015 and August 2, 2014

payroll, benefits, and other costs and include charges related to our Services Agreement with Sears Holdings. In the first quarter of 2015 we adjusted the allocation of these Home Office overhead expenses between Hometown and Outlet to reflect our expected allocation of resources between Hometown and Outlet during the 2015 fiscal year. For the second quarter of 2015, had the allocation weighting been similar to the prior year, an additional \$0.9 million of Home Office overhead expenses would have been allocated to Hometown's Selling and administrative expenses. Beginning with our 2015 fiscal year we intend to reevaluate the allocation of Home Office overhead expenses on an annual basis.

**Operating Income**

We recorded operating income of \$4.2 million in the second quarter of 2015 and \$2.0 million in the second quarter of 2014. The increase in operating income of \$2.2 million was driven primarily by lower selling and administrative expense partially offset by lower volume and a lower gross margin rate.

**26-Week Period Ended August 1, 2015 Compared to the 26-Week Period Ended August 2, 2014**

**Net Sales**

Net sales in the first two quarters of 2015 decreased \$27.4 million, or 3.0%, to \$871.4 million from the first two quarters of 2014. This decrease was driven primarily by the impact of closed stores (net of new store openings), a 0.8% decrease in comparable store sales, and lower online commissions from Sears Holdings (\$5.9 million in the first two quarters of 2015 compared to \$12.0 million in the first two quarters of 2014). Adjusted comparable store sales for the first two quarters of 2015, which includes Commission Sales, decreased 3.1% primarily attributable to (1) lower lawn and garden sales due, in part, to poor early season in-stock position of outdoor power equipment, which later improved during the July 4th promotional period and the introduction of new branded power items, (2) lower home appliances sales, which were negatively impacted by lower in-stock position in the first quarter of 2015, impact of product transitions, and lower sales during the President's Day and Memorial Day promotional periods, (3) lower tools sales in three Hometown key merchandise categories: tool storage and mechanical tool sets resulting from less promotional activity due to lower year-over-year vendor promotional support and compressors resulting from cost increases leading to less competitive out-the-door prices, and (4) lower consumer electronic sales as we continue to reduce the category.

**Gross Margin**

Gross margin was \$202.8 million, or 23.3% of net sales, in the first two quarters of 2015 compared to \$214.6 million, or 23.9% of net sales, in the first two quarters of 2014. The decrease in gross margin rate was primarily driven by lower online commissions from Sears Holdings, higher occupancy costs due to an increase in the number of Company-operated stores, and lower delivery income, partially offset by lower shrink. Excluding the impact of online commissions from Sears Holdings and initial franchise revenues, gross margin was 22.8% of net sales in both the first two quarters of 2015 and the first two quarters of 2014.

**Selling and Administrative Expenses**

Selling and administrative expenses decreased to \$191.9 million, or 22.0% of net sales, in the first two quarters of 2015 from \$204.4 million, or 22.7% of net sales, in the first two quarters of 2014. The decrease was primarily due to lower dealer and franchisee commissions on lower sales volume, the impact of closed stores (net of new stores openings), and lower commissions paid to Sears Holdings for online transactions due to lower Commission Sales. These decreases were partially offset by higher payroll and benefits, allocated executive transition costs, and an incremental \$0.4 million for the provision for losses on franchisee receivables.

Since the Separation we have included an allocation of Home Office overhead expenses in Selling and administrative expenses for Hometown and for Outlet. Home Office overhead expenses are primarily comprised of corporate headquarters payroll, benefits, and other costs and include charges related to our Services Agreement with Sears

Holdings. In the first quarter of 2015 we adjusted the allocation of these Home Office overhead expenses between Hometown and Outlet to reflect our expected allocation of resources between Hometown and Outlet during the 2015 fiscal year. For the first two quarters of 2015, had the allocation weighting been similar to the prior year, an additional \$2.1 million of Home Office overhead expenses would have been allocated to Hometown's Selling and administrative expenses. Beginning with our 2015 fiscal year we intend to reevaluate the allocation of Home Office overhead expenses on an annual basis.



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## SEARS HOMETOWN AND OUTLET STORES, INC.

13 and 26 Weeks Ended August 1, 2015 and August 2, 2014

## Operating Income

We recorded operating income of \$9.3 million and \$8.9 million in the first two quarters of 2015 and 2014, respectively. The \$0.4 million increase in operating income was primarily driven by lower selling and administrative expenses partially offset by lower volume and a lower gross margin rate (excluding initial franchise revenues).

## Outlet

Outlet results and key statistics were as follows:

	13 Weeks Ended		26 Weeks Ended	
	August 1, 2015	August 2, 2014	August 1, 2015	August 2, 2014
Thousands, except for number of stores				
Net sales	\$158,863	\$158,440	\$330,972	\$329,758
Comparable store sales % (1)	(2.2) %	(10.4) %	(2.6) %	(6.5) %
Cost of sales and occupancy	120,717	119,557	252,040	253,358
Gross margin dollars	38,146	38,883	78,932	76,400
Margin rate	24.0 %	24.5 %	23.8 %	23.2 %
Selling and administrative	38,090	33,711	78,788	70,153
Selling and administrative expense as a percentage of net sales	24.0 %	21.3 %	23.8 %	21.3 %
Depreciation	1,281	1,337	2,489	2,974
Total costs and expenses	160,088	154,605	333,317	326,485
Operating income (loss)	\$(1,225)	\$3,835	\$(2,345)	\$3,273
Total Outlet stores			158	148

(1) Adjusted comparable store sales for the 13 and 26 weeks ended August 1, 2015 were (2.7)% and (3.7)%, respectively.

13-Week Period ended August 1, 2015 Compared to the 13-Week Period Ended August 2, 2014

## Net Sales

Outlet net sales increased \$0.4 million, or 0.3%, to \$158.9 million in the second quarter of 2015 from \$158.4 million in the second quarter of 2014. The increase was primarily due to new store sales (net of closures) and higher excess apparel liquidation revenues partially offset by a decrease in initial franchise revenues, which were \$(0.1) million in the second quarter of 2015 compared to \$5.2 million in the second quarter of 2014, and a 2.2% decrease in comparable store sales. Adjusted comparable store sales for the second quarter of 2015, which include Commission Sales, decreased 2.7%. The decrease was driven by (1) lower sales in home appliance primarily due to a reduction of as-is, out-of-box products receipts from Sears Holdings, (2) a decline in apparel sales due to a lower mix of inventory in wearables vs. accessories and a reduction in allocated space within the selling stores, and (3) lower tools sales due to non-recurring opportunity buys in the second quarter of 2014.

## Gross Margin

Gross margin was \$38.1 million, or 24.0% of net sales, in the second quarter of 2015 compared to \$38.9 million, or 24.5% of net sales, in the prior year. The gross margin rate decreased in the second quarter of 2015 compared to the prior-year quarter primarily due to lower initial franchise revenues and lower delivery income. These decreases were partially offset by (1) higher margin on merchandise sales as a result of an improvement in inventory mix, (2) lower occupancy costs resulting from the conversion of Company-operated stores to franchisee-operated stores, (3) higher margin on excess apparel liquidation, (4) lower distribution center and product repair costs and (5) lower shrink. Excluding the impact of online commissions from Sears Holdings and initial franchise revenues, gross margin improved 220 basis points to 23.7% of net sales in the second quarter of 2015 compared to 21.5% of net sales in the second quarter of 2014.

## Selling and Administrative Expenses

Selling and administrative expenses increased to \$38.1 million, or 24.0% of net sales, in the second quarter of 2015 from \$33.7 million, or 21.3% of net sales, in the prior-year quarter. The increase in selling and administrative

expenses was

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SEARS HOMETOWN AND OUTLET STORES, INC.

13 and 26 Weeks Ended August 1, 2015 and August 2, 2014

primarily due to higher franchisee commissions for stores that we converted from Company-operated to franchisee-operated and expenses associated with new stores partially offset by lower payroll and benefits costs resulting from the conversion of Company-operated stores.

Since the Separation we have included an allocation of Home Office overhead expenses in Selling and administrative expenses for Outlet and for Hometown. Home Office overhead expenses are primarily comprised of corporate headquarters payroll, benefits, and other costs and include charges related to our Services Agreement with Sears Holdings. In the first quarter of 2015 we adjusted the allocation of these Home Office overhead expenses between Outlet and Hometown to reflect our expected allocation of resources between Outlet and Hometown during the 2015 fiscal year. For the second quarter of 2015, had the allocation weighting been similar to the prior year, Home Office overhead expenses allocated to Outlet's Selling and administrative expenses would have been \$0.9 million lower. Beginning with our 2015 fiscal year we intend to reevaluate the allocation of Home Office overhead expenses on an annual basis.

Operating Loss

We recorded an operating loss of \$1.2 million in the second quarter of 2015 compared to an operating income of \$3.8 million in the second quarter of 2014. The decrease in operating income of \$5.0 million was driven primarily by lower initial franchise revenues and higher selling and administrative expenses partially offset by a higher gross margin rate (excluding franchise revenues) and higher volume. Excluding initial franchise revenues from both periods, the second quarter 2015 operating loss of \$1.2 million would have decreased by \$0.2 million compared to the operating loss of \$1.4 million in the second quarter of 2014.

26-Week Period Ended August 1, 2015 Compared to the 26-Week Period Ended August 2, 2014

Net Sales

Net sales in the first two quarters of 2015 increased \$1.2 million, or 0.4%, to \$331.0 million from the first two quarters of 2014. This increase was driven primarily by new stores (net of closures) partially offset by lower initial franchise revenues, which were \$0.4 million in the first two quarters of 2015 compared to \$8.7 million in the first two quarters of 2014, and a 2.6% decrease in comparable store sales. Adjusted comparable store sales for the first two quarters of 2015, which includes Commission Sales, decreased 3.7% primarily attributable to (1) lower home appliances sales resulting from a reduction of as-is, out-of-box products receipts from Sears Holdings, (2) a decline in apparel sales due to inventory mix, a decrease in allocated selling store space, and non-recurring promotional events in the first quarter of 2014, (3) lower lawn and garden sales due to large decreases in as-is, out-of-box tractor receipts from Sears Holdings and lower winter weather-related product sales in the first quarter of 2015, and (4) lower sales in tools primarily due to non-recurring excess inventory clearance events in the first quarter of 2014 and non-recurring opportunity buys in second quarter of 2014.

Gross Margin

Gross margin was \$78.9 million, or 23.8% of net sales, in the first two quarters of 2015 compared to \$76.4 million, or 23.2% of net sales, in the first two quarters of 2014. The increase in gross margin rate was primarily driven by (1) higher margin on merchandise sales, (2) lower occupancy costs associated with the conversion of Company-operated to franchisee-operated stores, (3) lower distribution center and product repair costs, and (4) lower shrink. These increases were partially offset by lower franchise revenues and lower delivery income. Excluding the impact of online commissions from Sears Holdings and initial franchise revenues, gross margin improved 300 basis points to 23.5% of net sales in the first two quarters of 2015 compared to 20.5% of net sales in the first two quarters of 2014.

Selling and Administrative Expenses

Selling and administrative expenses increased to \$78.8 million, or 23.8% of net sales, in the first two quarters of 2015 from \$70.2 million, or 21.3% of net sales, in the first two quarters of 2014. The increase was primarily due to higher franchisee commissions for stores that we converted from Company-operated to franchisee-operated, the impact of new stores (net of closed stores), and allocated executive transition costs partially offset by lower payroll and benefits costs resulting from the conversion of Company-operated stores.

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13 and 26 Weeks Ended August 1, 2015 and August 2, 2014

Since the Separation we have included an allocation of Home Office overhead expenses in Selling and administrative expenses for Outlet and for Hometown. Home Office overhead expenses are primarily comprised of corporate headquarters payroll, benefits, and other costs and include charges related to our Services Agreement with Sears Holdings. In the first quarter of 2015 we adjusted the allocation of these Home Office overhead expenses between Outlet and Hometown to reflect our expected allocation of resources between Outlet and Hometown during the 2015 fiscal year. For the first two quarters of 2015, had the allocation weighting been similar to the prior year, Home Office overhead expenses allocated to Outlet's Selling and administrative expenses would have been \$2.1 million lower. Beginning with our 2015 fiscal year we intend to reevaluate the allocation of Home Office overhead expenses on an annual basis.

Operating Income

We recorded an operating loss of \$2.3 million and \$3.3 million of operating income in the first two quarters of 2015 and 2014, respectively. The \$5.6 million decrease in operating income was primarily driven by lower initial franchise revenues and higher selling and administrative expenses, partially offset by a higher gross margin rate (excluding initial franchise revenues) and higher volume. Excluding initial franchise revenues from both periods, the operating loss of \$2.8 million in the first two quarters of 2015 would have decreased by \$2.6 million compared to the operating loss of \$5.4 million in the first two quarters of 2014.

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13 and 26 Weeks Ended August 1, 2015 and August 2, 2014

Analysis of Financial Condition

Cash and Cash Equivalents

We had cash and cash equivalents of \$23.4 million as of August 1, 2015, \$21.0 million as of August 2, 2014, and \$19.7 million as of January 31, 2015.

For the first two quarters of 2015 we funded ongoing operations with cash on-hand and cash generated by operating activities. Our primary needs for liquidity are to fund inventory purchases and capital expenditures and for general corporate purposes.

Cash Flows from Operating Activities

For the 26 weeks ended August 1, 2015 cash provided by operating activities was \$84.1 million compared to \$29.2 million for the 26 weeks ended August 2, 2014. The increase in operating cash flow was due predominately to increases in merchandise payables, payables to Sears Holdings, and income and other taxes payable along with accounts receivable timing favorability and an increase in franchisee notes receivables in the prior year.

Total merchandise inventories were \$431.4 million at August 1, 2015 and \$469.6 million at August 2, 2014. Merchandise inventories decreased \$21.7 million in Outlet and \$16.5 million in Hometown. Outlet's reduction was primarily driven by lower home-appliances inventory due to a shift in the mix of inventory towards as-is, out-of-box products with a lower average cost, a reduced flow of as-is, out-of-box products from Sears Holdings, and tighter management of replenishment stock resulting in less non-productive inventory in the Outlet distribution centers. This reduction was partially offset by growth in as-is product purchases from vendors other than Sears Holdings. The decrease in Hometown was primarily due to lower tools and home appliances inventory due to the net decrease in store count.

We obtain our merchandise through agreements with subsidiaries of Sears Holdings and with other vendors. Merchandise acquired from subsidiaries of Sears Holdings (including Kenmore, Craftsman, DieHard, and other merchandise) accounted for approximately 83% and 84% of total purchases of all inventory from all vendors for the 13 and 26 weeks ended August 1, 2015, respectively. The loss of, or a material reduction in, the amount of merchandise made available to us by Sears Holdings could have a material adverse effect on our business and results of operations. See also "Risk Factors" in this Quarterly Report on Form 10-Q

In addition, our merchandise-vendor arrangements generally are not long-term (except for the Merchandising Agreement) and none of them guarantees the availability of merchandise inventory in the future. Our growth strategy depends to a significant extent on the willingness and ability of our vendors to supply us with sufficient merchandise inventory. As a result, our success depends, in part, on maintaining or improving relationships with existing vendors to seek to ensure continuity of merchandise inventory and on developing relationships with new vendors, especially with respect to merchandise inventory to be sold by Outlet. If we fail to maintain or improve our relations with our existing vendors or fail to maintain the quality of merchandise inventory they supply us, or if we cannot maintain or acquire new vendors of favored brand-name merchandise inventory, and if we cannot acquire new vendors of merchandise inventory to be sold by Outlet, our ability to obtain a sufficient amount and variety of merchandise at acceptable prices may be limited, which could have a negative impact on our business and could materially affect our results of operations, financial condition, liquidity, and cash flows. In addition, merchandise inventory acquired from alternative sources, if any, may be of a lesser quality and more expensive than the merchandise inventory that we currently purchase.

Cash Flows from Investing Activities

Cash used in investing activities was \$6.4 million for the 26 weeks ended August 1, 2015 compared to \$7.1 million for the 26 weeks ended August 2, 2014. Cash used in investing activities in both periods was for purchases of property and equipment.

Cash Flows from Financing Activities

Cash used in financing activities was \$74.0 million for the 26 weeks ended August 1, 2015 compared to \$24.7 million during the 26 weeks ended August 2, 2014. The increase of \$49.3 million in cash used by financing activities was primarily due to a reduction of \$74.0 million in net borrowings under our Senior ABL Facility in 2015 compared to a \$24.3 million reduction in 2014.

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SEARS HOMETOWN AND OUTLET STORES, INC.

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Financing Arrangements

As of August 1, 2015 we had \$10.1 million outstanding under the Senior ABL Facility, which approximated the fair value of these borrowings. The Senior ABL Facility provides (subject to availability under a borrowing base) for maximum borrowings up to the aggregate commitments of all of the lenders, which as of August 1, 2015 totaled \$250 million. Up to \$75 million of the Senior ABL Facility is available for the issuance of letters of credit and up to \$25 million is available for swingline loans. The Senior ABL Facility permits us to request commitment increases in an aggregate principal amount of up to \$100 million. Availability under the Senior ABL Facility as of August 1, 2015 was \$234.3 million with \$5.6 million of letters of credit outstanding under the facility.

The principal terms of the Senior ABL Facility are summarized below.

Senior ABL Facility

Maturity; Amortization and Prepayments

The Senior ABL Facility will mature on the earlier of (i) October 11, 2017 or (ii) six months prior to the expiration of the Merchandising Agreement and the other agreements with Sears Holdings or its subsidiaries in connection with the Separation that are specified in the Senior ABL Facility, unless such agreements have been extended to a date later than October 11, 2017 or terminated on a basis reasonably satisfactory to the administrative agent under the Senior ABL Facility.

The Senior ABL Facility is subject to mandatory prepayment in amounts equal to the amount by which the outstanding extensions of credit exceed the lesser of the borrowing base and the commitments then in effect.

Guarantees; Security

The obligations under the Senior ABL Facility are guaranteed by us and each of our existing and future direct and indirect wholly owned domestic subsidiaries (subject to certain exceptions). The Senior ABL Facility and the guarantees thereunder are secured by a first priority security interest in assets of the borrowers and guarantors consisting primarily of accounts and notes receivable, inventory, cash, cash equivalents, deposit accounts, and securities accounts, as well as certain other assets (other than intellectual property) ancillary to the foregoing and all proceeds of all of the foregoing, including cash proceeds and the proceeds of applicable insurance.

Interest; Fees

The interest rates per annum applicable to the loans under the Senior ABL Facility are based on a fluctuating rate of interest measured by reference to, at our election, either (1) adjusted LIBOR plus a borrowing margin, approximately 2.18% at August 1, 2015, or (2) an alternate base rate plus a borrowing margin, approximately 4.25% at August 1, 2015, with the borrowing margin subject to adjustment based on the average excess availability under the Senior ABL Facility for the preceding fiscal quarter.

Customary fees are payable in respect of the Senior ABL Facility, including letter of credit fees and commitment fees.

Covenants

The Senior ABL Facility includes a number of covenants that, among other things, limit or restrict our ability to, subject to specified exceptions, incur additional indebtedness (including guarantees), grant liens, make investments, make prepayments on other indebtedness, engage in mergers, or change the nature of our business.

The Senior ABL Facility limits SHO's ability to declare and pay cash dividends and repurchase its common stock. SHO may declare and pay cash dividends to its stockholders and may repurchase stock if the following conditions are satisfied: either (a) (i) no specified default then exists or would arise as a result of the declaration or payment of the cash dividend or as a result of the stock repurchase, (ii) SHO and its subsidiaries that are also borrowers have demonstrated to the reasonable satisfaction of the agent for the lenders that monthly availability (as determined in accordance with the Senior ABL Facility), immediately following the declaration and payment of the cash dividend or the stock repurchase and as projected on a pro forma basis for the twelve months following and after giving effect to the declaration and payment of the cash dividend or the stock repurchase, would be at least equal to the greater of (x) 25% of the Loan Cap (which is the lesser of (A) the aggregate commitments of the lenders and (B) the borrowing



base) and (y) \$50,000,000, and (iii) after giving pro forma effect to the declaration and payment of the cash dividend or the stock repurchase as if it constituted a specified debt service charge, the specified consolidated fixed

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SEARS HOMETOWN AND OUTLET STORES, INC.

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charge coverage ratio, as calculated on a trailing twelve months basis, would be equal to or greater than 1.1:1.0, or (b) (i) no specified default then exists or would arise as a result of the declaration or payment of the cash dividend or the stock repurchase, (ii) payment of the cash dividend or the stock repurchase is not made with the proceeds of any credit extension under the Senior ABL Facility, (iii) during the 120-day period prior to declaration and payment of the cash dividend or the stock repurchase, no credit extension was outstanding under the Senior ABL Facility, and (iv) SHO demonstrates to the reasonable satisfaction of the agent for the lenders that, on a pro forma and projected basis, no credit extensions would be outstanding under the Senior ABL Facility for the 120-day period following the declaration and payment of the cash dividend or the stock repurchase. No default or event of default presently exists. At August 1, 2015 we did not meet either of the foregoing conditions and as a result the Senior ABL Facility does not permit us to pay cash dividends or repurchase our common stock.

The Senior ABL Facility also contains certain affirmative covenants, including financial and other reporting requirements. As of August 1, 2015 we were in compliance with all of the covenants of the Senior ABL Facility.

Events of Default

The Senior ABL Facility includes customary events of default including non-payment of principal, interest or fees, violation of covenants, inaccuracy of representations or warranties, cross default to certain other material indebtedness, bankruptcy and insolvency events, invalidity or impairment of guarantees or security interests, material judgments, change of control, and other events of default including the failure to perform a "Material Contract" (which includes the Merchandising Agreement and other SHO-Sears Holdings Agreements) to the extent required to maintain it in full force and effect and the failure to enforce a Material Contract in accordance with its terms.

Uses and Sources of Liquidity

We believe that our existing cash and cash equivalents, cash flows from our operating activities, and, to the extent necessary, availability under the Senior ABL Facility will be sufficient to meet our anticipated liquidity needs for at least the next 12 months. As of August 1, 2015, we had cash and cash equivalents of \$23.4 million. The adequacy of our available funds will depend on many factors, including the macroeconomic environment and the operating performance of our stores.

Capital lease obligations as of August 1, 2015 and August 2, 2014 were \$0.3 million and \$0.3 million, respectively.

Off-Balance Sheet Arrangements

As of August 1, 2015, we had no off-balance sheet arrangements as defined in Item 303(a)(4) of the Securities and Exchange Commission's Regulation S-K.

Recent Accounting Pronouncements

See Part I, Item 1, "Financial Statements—Notes to Condensed Consolidated Financial Statements— Note 1 — Recent Accounting Pronouncements," for information regarding new accounting pronouncements.

Business Process Outsourcing and Information Systems

During the first quarter SHO entered into a Master Services Agreement with Capgemini U.S. LLC in which Capgemini agrees to provide business process outsourcing services and services for the migration of the current information technology systems and processes provided by Sears Holdings to new, state-of-art business and technology infrastructure and systems primarily provided by NetSuite Inc. We expect the new infrastructure and systems will provide greater strategic and operational flexibility, provide better control of our systems and processes, reduce our total cost of information-system ownership over the term of the Master Services Agreement, and reduce some of the risks inherent in our services relationship with, and reduce our dependence on, Sears Holdings.

Our plan and expectation is that the new infrastructure and systems will be fully operational by the end of our 2016 fiscal year, well in advance of the April 2018 termination date of our Services Agreement with Sears Holdings. The new infrastructure and systems will enable us, and we currently intend, to replace many of the corporate services provided by Sears Holdings with services provided by Capgemini, other third-party providers, and, on a limited-basis, internally by SHO. The replaced services could include tax, accounting, non-merchandise procurement, risk

management and insurance, advertising and marketing, human resources, loss prevention, environmental, product and human safety, facilities, information technology, online, payment clearing, and other financial, real estate management, merchandising, and other support services.

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We expect to incur increases in capital expenditures and corporate expenses in fiscal 2015 and in fiscal 2016 as a result of the migration to the new infrastructure and systems. As we report our results, we intend to report on the expenses related to the migration when we believe that disclosure is material or will aid the understanding of our financial condition and results of operations. Selling and administrative expenses related to business process outsourcing ("BPO") were \$0.5 million and \$0.7 million for the second quarter and first two quarters of 2015, respectively. For the first two quarters of 2015, BPO capital expenditures were \$2.0 million, all of which were incurred in the second quarter of 2015.

The migration to the new infrastructure and systems involves significant risks for us, such as with respect to, among other things, the following: conversion and migration of data; customization of solutions; availability of Company personnel and other resources to manage and implement the project; expansion of migration and implementation scope, cost, and timing; the amount, quality, and timing of cooperation that we receive from Sears Holdings with respect to the migration; and disruption of our day-to-day business activities. These risks and other risks with respect to the project could have a material adverse effect on our business and results of operations.

**CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING INFORMATION**

Certain statements made in this Quarterly Report on Form 10-Q contain forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Statements preceded or followed by, or that otherwise include, the words "believes," "expects," "anticipates," "intends," "project," "estimates," "plans," "forecast," "is likely to," and similar expressions or future or conditional verbs such as "will," "may," "would," "should," and "could" are generally forward-looking in nature and not historical facts. The forward-looking statements are subject to significant risks and uncertainties that may cause our actual results, performance, and achievements in the future to be materially different from the future results, future performance, and future achievements expressed or implied by the forward-looking statements. The forward-looking statements include, without limitation, information concerning our future financial performance, business strategies, plans, goals, beliefs, expectations, and objectives. The forward-looking statements are based upon the current beliefs and expectations of our management.

The following factors, among others, could cause our actual results, performance, and achievements to differ materially from those expressed in the forward-looking statements, and one or more of the differences could have a material adverse effect on our ability to operate our business and could have a material adverse effect on our results of operations, financial condition, liquidity, and cash flows: the possible material adverse effects on SHO if Sears Holdings' financial condition were to significantly deteriorate, including if as a consequence Sears Holdings were to choose to seek the protection of the U.S. bankruptcy laws; our ability to offer merchandise and services that our customers want, including those under the KCD Marks; the Merchandising Agreement provides that (1) if a third party that is not an affiliate of Sears Holdings acquires the rights to one or more (but less than all) of the KCD Marks Sears Holdings may terminate our rights to buy merchandise branded with any of the acquired KCD Marks and (2) if a third party that is not an affiliate of Sears Holdings acquires the rights to all of the KCD Marks Sears Holdings may terminate the Merchandising Agreement in its entirety, over which events we have no control; the sale by Sears Holdings and its subsidiaries to other retailers that compete with us of major home appliances and other products branded with one of the KCD Marks; the willingness and ability of Sears Holdings to fulfill its contractual obligations to us; our ability to successfully manage our inventory levels and implement initiatives to improve inventory management and other capabilities; competitive conditions in the retail industry; worldwide economic conditions and business uncertainty, the availability of consumer and commercial credit, changes in consumer confidence, tastes, preferences and spending, and changes in vendor relationships; the fact that our past performance generally, as reflected on our historical financial statements, may not be indicative of our future performance as a result of, among other things, the consolidation of Hometown and Outlet into a single business entity, the Separation, and operating as a standalone business entity; the impact of increased costs due to a decrease in our purchasing power following the Separation, and other losses of benefits (such as a more effective and productive business relationship with Sears

Holdings) that were associated with having been wholly owned by Sears Holdings and its subsidiaries prior to the Separation; our continuing reliance on Sears Holdings for most products and services that are important to the successful operation of our business, and our potential need to rely on Sears Holdings for some products and services beyond the expiration, or earlier termination by Sears Holdings, of our agreements with Sears Holdings; the willingness of Sears Holdings' appliance, lawn and garden, tools, and other vendors to continue to supply to Sears Holdings, on terms (including vendor payment terms for Sears Holdings' merchandise purchases) that are acceptable to it and to us, merchandise that we would need to purchase from Sears Holdings to ensure continuity of merchandise supplies for our businesses; the willingness of Sears Holdings' appliance, lawn and garden, tools, and other vendors to continue to pay to Sears Holdings merchandise-related subsidies and allowances and cash discounts (some of which Sears Holdings is obligated to pay to us); our ability to obtain the resolution, on commercially reasonable terms, of existing disputes and, when they arise, future

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SEARS HOMETOWN AND OUTLET STORES, INC.

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disputes with Sears Holdings regarding many of the material terms and conditions of our agreements with Sears Holdings; our ability to establish information, merchandising, logistics, and other systems separate from Sears Holdings that would be necessary to ensure continuity of merchandise supplies for our businesses if vendors were to reduce, or cease, their merchandise sales to Sears Holdings or if Sears Holdings were to reduce, or cease, its merchandise sales to us; if Sears Holdings' sales of major appliances and lawn and garden merchandise to its retail customers decline Sears Holdings' sales to us of outlet-value merchandise could decline; our ability to establish a more effective and productive business relationship with Sears Holdings, particularly in light of the existence of pending, and the likelihood of future, disputes with respect to the terms and conditions of our agreements with Sears Holdings; most of our agreements related to the Separation and our continuing relationship with Sears Holdings were negotiated while we were a subsidiary of Sears Holdings, and we may have received different terms from unaffiliated third parties (including with respect to merchandise-vendor and service-provider indemnification and defense for negligence claims and claims arising out of failure to comply with contractual obligations); our reliance on Sears Holdings to provide computer systems to process transactions with our customers (including the point-of-sale system for the stores we operate and the stores that our independent dealers and franchisees operate, which point-of-sale system captures, among other things, credit-card information supplied by our customers) and others, quantify our results of operations, and manage our business ("SHO's SHC-Supplied Systems"); SHO's SHC-Supplied Systems could be subject to disruptions and data/security breaches (Kmart, owned by Sears Holdings, announced in October 2014 that its payment-data systems had been breached), and Sears Holdings could be unwilling or unable to indemnify and defend us against third-party claims and other losses resulting from such disruptions and data/security breaches, which could have one or more material adverse effects on SHO; limitations and restrictions in the Senior ABL Facility and related agreements governing our indebtedness and our ability to service our indebtedness; our ability to obtain additional financing on acceptable terms; our dependence on the ability and willingness of our independent dealers and independent franchisees to operate their stores profitably and in a manner consistent with our concepts and standards; our ability to sell profitably online all of our merchandise and services; our dependence on sources outside the U.S. for significant amounts of our merchandise inventories; fixed-asset impairment for long-lived assets; our ability to attract, motivate, and retain key executives and other employees; our ability to maintain effective internal controls as a publicly held company; our ability to realize the benefits that we expect to achieve from the Separation; litigation and regulatory trends challenging various aspects of the franchisor-franchisee relationship in the fast-food industry could expand to challenge or adversely affect our relationships with our independent dealers and independent franchisees; low trading volume of our common stock due to limited liquidity or a lack of analyst coverage; and the impact on our common stock and our overall performance as a result of our principal stockholders' ability to exert control over us.

The foregoing factors should not be understood as exhaustive and should be read in conjunction with the other cautionary statements, including the "Risk Factors," that are included in this Quarterly Report on Form 10-Q and in the 2014 10-K and in our other filings with the Securities and Exchange Commission and our other public announcements. While we believe that our forecasts and assumptions are reasonable, we caution that actual results may differ materially. If one or more of these or other risks or uncertainties materialize, or if our underlying assumptions prove to be incorrect, actual results may vary materially from what we projected. Consequently, actual events and results may vary significantly from those included in or contemplated or implied by our forward-looking statements. The forward-looking statements included in this Quarterly Report on Form 10-Q are made only as of the date of this Quarterly Report on Form 10-Q. We undertake no obligation to publicly update or review any forward-looking statement made by us or on our behalf, whether as a result of new information, future developments, subsequent events or circumstances, or otherwise, except as required by law.

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### Item 3. Quantitative and Qualitative Disclosures about Market Risk

We are subject to interest rate risk associated with our Senior ABL Facility, which requires us to pay interest on outstanding borrowings at variable rates. Assuming our Senior ABL Facility were fully drawn in principal amount equal to \$250 million, each one percentage point change in interest rates payable with respect to the Senior ABL Facility would result in a \$2.5 million change in annual cash interest expense with respect to our Senior ABL Facility.

### Item 4. Controls and Procedures

#### Disclosure Controls and Procedures

Under the supervision and with the participation of our management, including our principal executive officer and our principal financial officer, we conducted an evaluation of our disclosure controls and procedures, as such term is defined in Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934, as amended. Based on this evaluation, our principal executive officer and our principal financial officer concluded that our disclosure controls and procedures were effective as of the end of the period covered by this Quarterly Report on Form 10-Q.

#### Changes in Internal Control over Financial Reporting

There were no changes in our internal control over financial reporting that occurred during the 26 weeks ended August 1, 2015 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## PART II. OTHER INFORMATION

### Item 1. Legal Proceedings

As of the date of this Quarterly Report on Form 10-Q we are not party to any litigation that we consider material to our operations.

Notwithstanding the above, from time to time we are, and will continue to be, subject to various legal claims, including those alleging wage and hour violations, payroll violations, employment discrimination, unlawful employment practices, Americans with Disabilities Act claims, Family and Medical Leave Act claims, product liability claims as a result of the sale of merchandise and services, claims with respect to franchise and dealer transactions, relationships, and operations, as well as various legal and governmental proceedings. Some of these claims from time to time include, and will continue to include, class or collective-action allegations, and the proceedings for some of these claims are, and will continue to be, in jurisdictions with reputations for aggressive application of laws and procedures against corporate defendants. Litigation is inherently unpredictable. Each proceeding, claim, and regulatory action against us, whether meritorious or not, could be time consuming, result in significant legal expenses, require significant amounts of management time, result in the diversion of significant operational resources, require changes in our methods of doing business that could be costly to implement, reduce our net sales, increase our expenses, require us to make substantial payments to settle claims or satisfy judgments, require us to cease conducting certain operations or offering certain products in certain areas or generally, and otherwise harm our business, results of operations, financial condition, and cash flows, perhaps materially. See also "Cautionary Statement Regarding Forward-Looking Information" and "Risk Factors" in this Quarterly Report on Form 10-Q.

### Item 1A. Risk Factors

There have been no material changes from the risk factors previously disclosed in the 2014 10-K. However, the risks described in "Risk Factors" beginning on page 8 of the 2014 10-K should be carefully considered. Those risks could materially affect our results of operations, financial condition, liquidity, and cash flows. Those risks are not exclusive, and additional risks to which we are subject include, but are not limited to, the factors mentioned under "Cautionary Statement Regarding Forward-Looking Information," and the risks to our businesses described elsewhere, in this Quarterly Report on Form 10-Q.

### Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

#### Share Repurchases

On August 28, 2013 the Company's Board of Directors authorized a \$25 million repurchase program for the Company's outstanding shares of common stock. The timing and amount of repurchases depend on various factors, including market conditions, the Company's capital position and internal cash generation, and other factors. The Company's repurchase program does not include specific price targets, may be executed through open-market, privately negotiated, and other transactions that



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may be available, and may include utilization of Rule 10b5-1 plans. The repurchase program does not obligate the Company to repurchase any dollar amount, or any number of shares, of common stock. The repurchase program does not have a termination date, and the Company may suspend or terminate the repurchase program at any time. At August 1, 2015 the Senior ABL Facility prohibited cash dividends and the repurchase of our common stock. Shares that are repurchased by the Company pursuant to the repurchase program will be retired and will resume the status of authorized and unissued shares of common stock.

The Company did not repurchase any shares during the 26 weeks ended August 1, 2015. As of August 1, 2015 we had approximately \$12.5 million of remaining authorization under the repurchase program.

The Senior ABL Facility limits SHO's ability to declare and pay cash dividends and repurchase its common stock. SHO may declare and pay cash dividends to its stockholders and may repurchase stock if the following conditions are satisfied: either (a) (i) no specified default then exists or would arise as a result of the declaration or payment of the cash dividend or as a result of the stock repurchase, (ii) SHO and its subsidiaries that are also borrowers have demonstrated to the reasonable satisfaction of the agent for the lenders that monthly availability (as determined in accordance with the Senior ABL Facility), immediately following the declaration and payment of the cash dividend or the stock repurchase and as projected on a pro forma basis for the twelve months following and after giving effect to the declaration and payment of the cash dividend or the stock repurchase, would be at least equal to the greater of (x) 25% of the Loan Cap (which is the lesser of (A) the aggregate commitments of the lenders and (B) the borrowing base) and (y) \$50,000,000, and (iii) after giving pro forma effect to the declaration and payment of the cash dividend or the stock repurchase as if it constituted a specified debt service charge, the specified consolidated fixed charge coverage ratio, as calculated on a trailing twelve months basis, would be equal to or greater than 1.1:1.0, or (b) (i) no specified default then exists or would arise as a result of the declaration or payment of the cash dividend or the stock repurchase, (ii) payment of the cash dividend or the stock repurchase is not made with the proceeds of any credit extension under the Senior ABL Facility, (iii) during the 120-day period prior to declaration and payment of the cash dividend or the stock repurchase, no credit extension was outstanding under the Senior ABL Facility, and (iv) SHO demonstrates to the reasonable satisfaction of the agent for the lenders that, on a pro forma and projected basis, no credit extensions would be outstanding under the Senior ABL Facility for the 120-day period following the declaration and payment of the cash dividend or the stock repurchase.

The Senior ABL Facility also imposes various other requirements, such as a cash dominion requirement and a requirement that the fixed charge ratio at the last day of any quarter be not less than 1.0 to 1.0, which take effect if availability falls below designated thresholds and which may limit our ability to make share repurchases.

Item 5. Other Information

On September 2, 2015 Jeffrey Flug, a member of the Company's Board of Directors, Audit Committee, Nominating and Corporate Governance Committee, and Compensation Committee (Chair), notified the Board of Directors that, for personal reasons, he will resign from the Board and the committees effective September 30, 2015.

Item 6. Exhibits

The Exhibits listed in the accompanying "Exhibit Index" have been filed as part of this Quarterly Report on Form 10-Q.

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SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Sears Hometown and Outlet Stores, Inc.

By: /S/ RYAN D. ROBINSON  
Name: Ryan D. Robinson  
Senior Vice President and Chief Financial Officer  
Title: (Principal Financial Officer  
and Principal Accounting Officer)  
Date: September 3, 2015

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SEARS HOMETOWN AND OUTLET STORES, INC.

EXHIBIT INDEX

Exhibit Number	Document Description
*31.1	Certification of Chief Executive Officer Required Under Rule 13a-14(a) and 15(d)-14(a) of the Securities Exchange Act of 1934, as amended.
*31.2	Certification of Chief Financial Officer Required Under Rule 13a-14(a) and 15(d)-14(a) of the Securities Exchange Act of 1934, as amended.
*32	Certification of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (furnished only).
**101	The following financial information from the Quarterly Report on Form 10-Q for the fiscal quarter ended August 1, 2015, formatted in XBRL (eXtensible Business Reporting Language) and furnished electronically herewith: (i) the Condensed Consolidated Statements of Operations (Unaudited) for the 13 and 26 Weeks Ended August 1, 2015 and August 2, 2014; (ii) the Condensed Consolidated Balance Sheets (Unaudited) at August 1, 2015, August 2, 2014, and January 31, 2015; (iii) the Condensed Consolidated Statements of Cash Flows (Unaudited) for the 13 and 26 Weeks Ended August 1, 2015 and August 2, 2014; (iv) the Condensed Combined Statements of Stockholders' Equity (Unaudited) for the 13 and 26 Weeks Ended August 1, 2015 and August 2, 2014; and (v) the Notes to the Condensed Consolidated Financial Statements (Unaudited).

\* Filed herewith.

\*\* Pursuant to Rule 406T of Regulation S-T, these interactive data files are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, are deemed not filed for purposes of Section 18 of the Securities and Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.