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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, DC 20549

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**FORM 10-Q**

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☒ QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934  
FOR THE QUARTERLY PERIOD ENDED NOVEMBER 1, 2014

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 ☐

Accelerated filer ☒

Non-accelerated filer  
(Do not check if a smaller reporting company) ☐

Smaller reporting company ☐

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 December 4, 2014, the registrant had 22,735,849 shares of common stock, par value \$0.01 per share, outstanding.

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**SEARS HOMETOWN AND OUTLET STORES, INC.**  
**INDEX TO QUARTERLY REPORT ON FORM 10-Q**  
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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      |                     | 39 Weeks Ended      |                     |
|--|---------------------|---------------------|---------------------|---------------------|
|  | November 1,<br>2014 | November 2,<br>2013 | November 1,<br>2014 | November 2,<br>2013 |
| <i>Thousands, except per share amounts</i>         |                     |                     |                     |                     |
| <b>NET SALES</b>                                   | <b>\$ 565,147</b>   | <b>\$ 561,068</b>   | <b>\$ 1,793,694</b> | <b>\$ 1,819,084</b> |
| <b>COSTS AND EXPENSES</b>                          |                     |                     |                     |                     |
| Cost of sales and occupancy                        | 430,085             | 425,596             | 1,367,644           | 1,380,966           |
| Selling and administrative                         | 139,766             | 121,698             | 414,271             | 379,815             |
| Impairment of goodwill                             | 167,000             | —                   | 167,000             | —                   |
| Depreciation                                       | 2,035               | 2,177               | 6,390               | 6,569               |
| Gain on the sale of assets                         | (155)               | (1,567)             | (155)               | (1,567)             |
| Total costs and expenses                           | 738,731             | 547,904             | 1,955,150           | 1,765,783           |
| Operating income (loss)                            | (173,584)           | 13,164              | (161,456)           | 53,301              |
| Interest expense                                   | (915)               | (738)               | (2,754)             | (1,969)             |
| Other income                                       | 888                 | 460                 | 2,366               | 1,306               |
| Income (loss) before income taxes                  | (173,611)           | 12,886              | (161,844)           | 52,638              |
| Income tax benefit (expense)                       | 2,401               | (5,191)             | (2,327)             | (20,812)            |
| <b>NET INCOME (LOSS)</b>                           | <b>\$ (171,210)</b> | <b>\$ 7,695</b>     | <b>\$ (164,171)</b> | <b>\$ 31,826</b>    |
| <b>NET INCOME (LOSS) PER COMMON SHARE</b>          |                     |                     |                     |                     |
| <b>ATTRIBUTABLE TO STOCKHOLDERS</b>                |                     |                     |                     |                     |
| Basic:   | \$ (7.55)           | \$ 0.33             | \$ (7.24)           | \$ 1.38             |
| Diluted:   | \$ (7.55)           | \$ 0.33             | \$ (7.24)           | \$ 1.38             |
| Basic weighted average common shares outstanding   | 22,666              | 22,999              | 22,666              | 23,066              |
| Diluted weighted average common shares outstanding | 22,666              | 22,999              | 22,666              | 23,070              |

See Notes to Condensed Consolidated Financial Statements.

**SEARS HOMETOWN AND OUTLET STORES, INC.**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**  
**(Unaudited)**

| <i>Thousands</i>                                  | <u>November 1,<br/>2014</u> | <u>November 2,<br/>2013</u> | <u>February 1,<br/>2014</u> |
|---|-----------------------------|-----------------------------|-----------------------------|
| <b>ASSETS</b>                                     |                             |                             |                             |
| <b>CURRENT ASSETS</b>                             |                             |                             |                             |
| Cash and cash equivalents                         | \$ 23,189                   | \$ 21,487                   | \$ 23,475                   |
| Accounts and franchisee receivables               | 20,930                      | 17,207                      | 19,252                      |
| Merchandise inventories                           | 462,226                     | 488,626                     | 482,107                     |
| Prepaid expenses and other current assets         | 17,893                      | 8,113                       | 13,216                      |
| Total current assets                              | 524,238                     | 535,433                     | 538,050                     |
| PROPERTY AND EQUIPMENT, net                       | 50,454                      | 49,544                      | 48,973                      |
| GOODWILL  | —                           | 167,000                     | 167,000                     |
| LONG-TERM DEFERRED TAXES                          | 47,359                      | 63,916                      | 52,672                      |
| OTHER ASSETS                                      | 41,185                      | 32,115                      | 40,490                      |
| <b>TOTAL ASSETS</b>                               | <u>\$ 663,236</u>           | <u>\$ 848,008</u>           | <u>\$ 847,185</u>           |
| <b>LIABILITIES</b>                                |                             |                             |                             |
| <b>CURRENT LIABILITIES</b>                        |                             |                             |                             |
| Short-term borrowings                             | \$ 73,200                   | \$ 87,900                   | \$ 99,100                   |
| Payable to Sears Holdings Corporation             | 79,940                      | 57,414                      | 68,396                      |
| Accounts payable                                  | 20,238                      | 31,727                      | 24,129                      |
| Other current liabilities                         | 60,079                      | 74,306                      | 60,319                      |
| Current portion of capital lease obligations      | 75                          | 1,082                       | 662                         |
| Total current liabilities                         | 233,532                     | 252,429                     | 252,606                     |
| CAPITAL LEASE OBLIGATIONS                         | 136                         | 98                          | 95                          |
| OTHER LONG-TERM LIABILITIES                       | 2,908                       | 5,139                       | 4,259                       |
| <b>TOTAL LIABILITIES</b>                          | <u>236,576</u>              | <u>257,666</u>              | <u>256,960</u>              |
| COMMITMENTS AND CONTINGENCIES (Note 9)            |                             |                             |                             |
| <b>STOCKHOLDERS' EQUITY</b>                       |                             |                             |                             |
| <b>TOTAL STOCKHOLDERS' EQUITY</b>                 | <u>426,660</u>              | <u>590,342</u>              | <u>590,225</u>              |
| <b>TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY</b> | <u>\$ 663,236</u>           | <u>\$ 848,008</u>           | <u>\$ 847,185</u>           |

See Notes to Condensed Consolidated Financial Statements.

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

| <i>Thousands</i>   | 39 Weeks Ended      |                     |
|--|---------------------|---------------------|
|  | November 1,<br>2014 | November 2,<br>2013 |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES</b>  |                     |                     |
| Net income (loss)  | \$ (164,171)        | \$ 31,826           |
| Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities: |                     |                     |
| Depreciation   | 6,390               | 6,569               |
| Share-based compensation   | 606                 | 598                 |
| Gain on the sale of assets   | (155)               | (1,567)             |
| Impairment of goodwill   | 167,000             | —                   |
| Provision for losses on franchisee receivables   | 11,526              | —                   |
| Change in operating assets and liabilities:  |                     |                     |
| Accounts and franchisee receivables  | (14,517)            | (16,216)            |
| Merchandise inventories  | 19,881              | (60,189)            |
| Payable to Sears Holdings Corporation  | 11,544              | (22,077)            |
| Accounts payable   | (3,891)             | (103)               |
| Customer deposits  | (3,225)             | 5,998               |
| Deferred income taxes  | 785                 | 15,520              |
| Other operating assets   | 2,639               | 1,246               |
| Other operating liabilities  | 1,673               | (15,767)            |
| Net cash provided by (used in) operating activities  | 36,085              | (54,162)            |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES</b>  |                     |                     |
| Proceeds from sales of property and investments  | 155                 | 2,641               |
| Purchases of property and equipment  | (10,039)            | (5,995)             |
| Net cash used in investing activities  | (9,884)             | (3,354)             |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES</b>  |                     |                     |
| Common stock repurchased and retired   | —                   | (8,369)             |
| Payments of capital lease obligations  | (587)               | (596)               |
| Net short-term borrowings (payments)   | (25,900)            | 67,900              |
| Net cash provided by (used in) financing activities  | (26,487)            | 58,935              |
| <b>NET CHANGE IN CASH AND CASH EQUIVALENTS</b>   | <b>(286)</b>        | <b>1,419</b>        |
| CASH AND CASH EQUIVALENTS—Beginning of period  | 23,475              | 20,068              |
| CASH AND CASH EQUIVALENTS—End of period  | \$ 23,189           | \$ 21,487           |
| <b>SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION</b>   |                     |                     |
| Cash paid for interest   | \$ 2,466            | \$ 2,012            |
| Cash paid for income taxes   | \$ 246              | \$ 19,355           |

See Notes to Condensed Consolidated Financial Statements.

**SEARS HOMETOWN AND OUTLET STORES, INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY**  
**(Unaudited)**

| <i>Thousands</i>                     | <b>Number of<br/>Shares of<br/>Common<br/>Stock</b> | <b>Common<br/>Stock/Par<br/>Value</b> | <b>Capital in<br/>Excess of Par<br/>Value</b> | <b>Retained<br/>Earnings<br/>(Deficit)</b> | <b>Total<br/>Stockholders'<br/>Equity</b> |
|--------------------------------------|---|---------------------------------------|---|--|---|
| Balance at February 2, 2013          | 23,100  | 231                                   | 556,575                                       | 9,481                                      | 566,287                                   |
| Net income                           |   | —                                     | —   | 31,826                                     | 31,826                                    |
| Share-based compensation             | 88  | 1                                     | 597   | —  | 598                                       |
| Common stock repurchased and retired | (279)   | (3)                                   | (6,728)                                       | (1,638)                                    | (8,369)                                   |
| Balance at November 2, 2013          | 22,909  | \$ 229                                | \$ 550,444                                    | \$ 39,669                                  | \$ 590,342                                |
| Balance at February 1, 2014          | 22,753  | 228                                   | 547,021                                       | 42,976                                     | 590,225                                   |
| Net income (loss)                    |   | —                                     | —   | (164,171)                                  | (164,171)                                 |
| Share-based compensation             | (17)  | (1)                                   | 607   | —  | 606                                       |
| Balance at November 1, 2014          | 22,736  | \$ 227                                | \$ 547,628                                    | \$ (121,195)                               | \$ 426,660                                |

See Notes to Condensed Consolidated Financial Statements.

**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 November 1, 2014 the Company and its dealers and franchisees operated 1,257 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.

**Description of the Separation**

On October 11, 2012, Sears Holdings Corporation (“Sears Holdings”) completed the separation of its Sears Hometown and Hardware and Sears Outlet businesses (the “Separation”). As part of the Separation, through a series of intercompany transactions, Sears Holdings and several of its subsidiaries transferred the assets and liabilities comprising the Sears Hometown and Hardware and Sears Outlet businesses to Sears Hometown and Outlet Stores, Inc., which was formed prior to the Separation as a wholly owned subsidiary of Sears Holdings. 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 fiscal quarter ended November 1, 2014 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 February 1, 2014.

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 third fiscal-quarter end is the Saturday closest to October 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 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:

**SEARS HOMETOWN AND OUTLET STORES, INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**(Unaudited)**

*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.

*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 and notes receivable, 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. As disclosed in Note 4, the Company recorded a goodwill impairment charge during the quarter ended November 1, 2014. The Company utilized Level 3 inputs to measure the fair value of goodwill.

### **Recent Accounting Pronouncements**

#### *Revenue from Contracts with Customers*

In May 2014, the FASB issued an accounting standards update which establishes a comprehensive revenue recognition standard in U.S. GAAP for virtually all industries, including those that previously followed industry-specific guidance such as the real estate, construction, and software industries. The update is effective in fiscal 2017, and we are currently evaluating the potential impact. Accordingly, we cannot estimate the effect on our consolidated financial position, results of operations, or cash flows.

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

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

|   | <b>November 1,<br/>2014</b> |                  |                  |
|---|-----------------------------|------------------|------------------|
| <i>Thousands</i>  | <b>Hometown</b>             | <b>Outlet</b>    | <b>Total</b>     |
| Short-term franchisee receivables                             | \$ 8,129                    | \$ 4,463         | \$ 12,592        |
| Miscellaneous receivables                                     | 7,609                       | 2,112            | 9,721            |
| Long-term franchisee receivables                              | 21,246                      | 27,688           | 48,934           |
| Other assets  | 2,112                       | 282              | 2,394            |
| Provision for losses on short-term franchisee receivables (1) | (1,383)                     | —                | (1,383)          |
| Provision for losses on long-term franchisee receivables (1)  | (10,143)                    | —                | (10,143)         |
| Total Accounts and franchisee receivables and other assets    | <u>\$ 27,570</u>            | <u>\$ 34,545</u> | <u>\$ 62,115</u> |



**SEARS HOMETOWN AND OUTLET STORES, INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**(Unaudited)**

|  | November 2,<br>2013 |                 |                  |
|--|---------------------|-----------------|------------------|
| <i>Thousands</i>   | Hometown            | Outlet          | Total            |
| Short-term franchisee receivables                          | \$ 2,676            | \$ 896          | \$ 3,572         |
| Miscellaneous receivables                                  | 13,198              | 437             | 13,635           |
| Long-term franchisee receivables                           | 21,090              | 7,974           | 29,064           |
| Other assets   | 2,844               | 207             | 3,051            |
| Total Accounts and franchisee receivables and other assets | <u>\$ 39,808</u>    | <u>\$ 9,514</u> | <u>\$ 49,322</u> |

|  | February 1,<br>2014 |                  |                  |
|--|---------------------|------------------|------------------|
| <i>Thousands</i>   | Hometown            | Outlet           | Total            |
| Short-term franchisee receivables                          | \$ 2,748            | \$ 1,844         | \$ 4,592         |
| Miscellaneous receivables                                  | 13,029              | 1,631            | 14,660           |
| Long-term franchisee receivables                           | 21,207              | 16,409           | 37,616           |
| Other assets   | 2,662               | 212              | 2,874            |
| Total Accounts and franchisee receivables and other assets | <u>\$ 39,646</u>    | <u>\$ 20,096</u> | <u>\$ 59,742</u> |

(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, general, 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 deductions to the extent of available commissions payable. We established the provision for losses on franchisee receivables in the third quarter of fiscal 2014 based on our receivable-by-receivable assessment during the quarter that some of the Hometown 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 quarter of one of our Hometown franchisees to continue to operate its franchise stores in accordance with the franchisee's agreements with us. Based on our assessment during the quarter we made no provision for losses on Outlet franchisee receivables.

**NOTE 3—OTHER CURRENT AND LONG-TERM LIABILITIES**

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

| <i>Thousands</i>                              | November 1,<br>2014 | November 2,<br>2013 | February 1,<br>2014 |
|---|---------------------|---------------------|---------------------|
| Customer deposits                             | \$ 32,322           | \$ 40,913           | \$ 35,547           |
| Sales and other taxes                         | 14,052              | 14,072              | 11,403              |
| Accrued expenses                              | 10,617              | 13,267              | 9,523               |
| Payroll and related items                     | 5,996               | 11,193              | 8,105               |
| Total Other current and long-term liabilities | <u>\$ 62,987</u>    | <u>\$ 79,445</u>    | <u>\$ 64,578</u>    |

**NOTE 4—GOODWILL**

Goodwill allocated to our Hometown and Outlet segments as of November 1, 2014, and changes in the carrying amount of goodwill for the nine months ended November 1, 2014, are as follows:

**SEARS HOMETOWN AND OUTLET STORES, INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**(Unaudited)**

*Thousands*

|                                     | Hometown   | Outlet | Total      |
|-------------------------------------|------------|--------|------------|
| Balance (gross) at February 1, 2014 | \$ 167,000 | \$ —   | \$ 167,000 |
| Impairment Loss                     | (167,000)  | —      | (167,000)  |
| Balance at November 1, 2014         | \$ —       | \$ —   | \$ —       |

For the first nine months of fiscal 2014, the decrease in goodwill is due entirely to the non-cash impairment loss with respect to the Hometown Reporting Unit as discussed further below.

We review 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 indicate the carrying value of goodwill may not be recoverable. The goodwill impairment test involves a two-step process. In the first step, SHO compares the fair value of the Hometown Reporting Unit to its carrying value. If the fair value of the Hometown Reporting Unit exceeds its carrying value, goodwill is not impaired and no further testing is required. If the fair value of the Hometown Reporting Unit is less than its carrying value, SHO must perform 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 is 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 is less than its carrying value, the difference is 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 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 a \$167.0 million non-cash goodwill impairment charge in the third quarter of fiscal 2014, which is 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 corresponding impact beyond those periods.

#### **NOTE 5—INCOME TAXES**

In connection with the Separation, SHO and Sears Holdings 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.

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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 39 Weeks ended November 1, 2014 and November 2, 2013, 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 November 1, 2014 the Company's net deferred tax asset balance was \$57.2 million compared to \$61.1 million as of November 2, 2013 and \$58.0 million as of February 1, 2014.

**NOTE 6—RELATED-PARTY AGREEMENTS AND TRANSACTIONS**

According to publicly available information ESL Investments, Inc. and its investment affiliates beneficially own approximately 47% of our outstanding shares of common stock and approximately 56% of Sears Holdings' outstanding shares of common stock.

In connection with the Separation, we entered into various agreements with Sears Holdings (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 in the context of a parent-subsidiary 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).
- We pay fees for participation in Sears Holdings' SHOP YOUR WAY REWARDS® program.

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- 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:

| <i>Thousands</i>                                     | 13 Weeks Ended      |                     | 39 Weeks Ended      |                     |
|--|---------------------|---------------------|---------------------|---------------------|
|  | November 1,<br>2014 | November 2,<br>2013 | November 1,<br>2014 | November 2,<br>2013 |
| Net Commissions from Sears Holdings                  | \$ 22,069           | \$ 21,424           | \$ 76,808           | \$ 68,327           |
| Purchases related to cost of sales and occupancy (1) | 351,935             | 395,178             | 1,156,632           | 1,224,254           |
| Services (1)   | 23,302              | 29,410              | 73,089              | 85,655              |

(1) Amounts previously presented for the 13 and 39 Weeks ended November 2, 2013 and for the 13 weeks ended May 3, 2014 within "Purchases related to cost of sales and occupancy" have been reclassified into "Services." The reclassified items were primarily costs associated with marketing. The reclassified amount for the 13 weeks ended November 2, 2013 was \$23.8 million. The reclassified amounts for the 39 Weeks ended November 2, 2013 and November 1, 2014 were \$69.6 million and \$20.3 million, respectively.

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 7—FINANCING ARRANGEMENT**

As of November 1, 2014 we had \$73.2 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 November 1, 2014 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 November 1, 2014 was \$171.2 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") 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*

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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 2.41% at November 1, 2014 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 4.50% at November 1, 2014.

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 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.

The Senior ABL Facility also contains certain 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 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.



**SEARS HOMETOWN AND OUTLET STORES, INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**(Unaudited)**

**NOTE 8—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 \$6.5 million and \$7.8 million for the 13 weeks ended November 1, 2014 and the 13 weeks ended November 2, 2013, respectively). For the 39 Weeks ended November 1, 2014, initial franchise revenue (which 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) was \$15.2 million compared to \$14.8 million in the 39 Weeks ended November 2, 2013.

|                             | 13 Weeks Ended November 1, 2014 |               |              |
|-----------------------------|---------------------------------|---------------|--------------|
| <i>Thousands</i>            | <b>Hometown</b>                 | <b>Outlet</b> | <b>Total</b> |
| <b>Net sales</b>            |                                 |               |              |
| Appliances                  | \$ 261,645                      | \$ 139,519    | \$ 401,164   |
| Lawn and garden             | 59,447                          | 7,065         | 66,512       |
| Tools and paint             | 41,736                          | 4,649         | 46,385       |
| Other                       | 24,915                          | 26,171        | 51,086       |
| Total                       | 387,743                         | 177,404       | 565,147      |
| <b>Costs and expenses</b>   |                                 |               |              |
| Cost of sales and occupancy | 299,013                         | 131,072       | 430,085      |
| Selling and administrative  | 103,395                         | 36,371        | 139,766      |
| Impairment of goodwill      | 167,000                         | —             | 167,000      |
| Depreciation                | 746                             | 1,289         | 2,035        |
| Gain on the sale of assets  | (155)                           | —             | (155)        |
| Total                       | 569,999                         | 168,732       | 738,731      |
| Operating income (loss)     | \$ (182,256)                    | \$ 8,672      | \$ (173,584) |
| Total assets                | \$ 455,112                      | \$ 208,124    | \$ 663,236   |
| Capital expenditures        | \$ 579                          | \$ 2,410      | \$ 2,989     |

|                             | 13 Weeks Ended November 2, 2013 |               |              |
|-----------------------------|---------------------------------|---------------|--------------|
| <i>Thousands</i>            | <b>Hometown</b>                 | <b>Outlet</b> | <b>Total</b> |
| <b>Net sales</b>            |                                 |               |              |
| Appliances                  | \$ 289,834                      | \$ 115,386    | \$ 405,220   |
| Lawn and garden             | 59,049                          | 5,843         | 64,892       |
| Tools and paint             | 44,516                          | 3,458         | 47,974       |
| Other                       | 19,772                          | 23,210        | 42,982       |
| Total                       | 413,171                         | 147,897       | 561,068      |
| <b>Costs and expenses</b>   |                                 |               |              |
| Cost of sales and occupancy | 318,362                         | 107,234       | 425,596      |
| Selling and administrative  | 94,818                          | 26,880        | 121,698      |
| Depreciation                | 760                             | 1,417         | 2,177        |
| Gain on the sale of assets  | —                               | (1,567)       | (1,567)      |
| Total                       | 413,940                         | 133,964       | 547,904      |
| Operating income (loss)     | \$ (769)                        | \$ 13,933     | \$ 13,164    |
| Total assets                | \$ 657,019                      | \$ 190,989    | \$ 848,008   |
| Capital expenditures        | \$ 1,341                        | \$ 2,259      | \$ 3,600     |

**SEARS HOMETOWN AND OUTLET STORES, INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**(Unaudited)**

| 39 Weeks Ended November 1, 2014 |                 |               |              |
|---------------------------------|-----------------|---------------|--------------|
| <i>Thousands</i>                | <b>Hometown</b> | <b>Outlet</b> | <b>Total</b> |
| <b>Net sales</b>                |                 |               |              |
| Appliances                      | \$ 795,919      | \$ 398,299    | \$ 1,194,218 |
| Lawn and garden                 | 278,305         | 19,546        | 297,851      |
| Tools and paint                 | 132,470         | 13,566        | 146,036      |
| Other                           | 79,838          | 75,751        | 155,589      |
| Total                           | 1,286,532       | 507,162       | 1,793,694    |
| <b>Costs and expenses</b>       |                 |               |              |
| Cost of sales and occupancy     | 983,214         | 384,430       | 1,367,644    |
| Selling and administrative      | 307,747         | 106,524       | 414,271      |
| Impairment of goodwill          | 167,000         | —             | 167,000      |
| Depreciation                    | 2,127           | 4,263         | 6,390        |
| Gain on the sale of assets      | (155)           | —             | (155)        |
| Total                           | 1,459,933       | 495,217       | 1,955,150    |
| Operating income (loss)         | \$ (173,401)    | \$ 11,945     | \$ (161,456) |
| Total assets                    | \$ 455,112      | \$ 208,124    | \$ 663,236   |
| Capital expenditures            | \$ 2,509        | \$ 7,530      | \$ 10,039    |

| 39 Weeks Ended November 2, 2013 |                 |               |              |
|---------------------------------|-----------------|---------------|--------------|
| <i>Thousands</i>                | <b>Hometown</b> | <b>Outlet</b> | <b>Total</b> |
| <b>Net sales</b>                |                 |               |              |
| Appliances                      | \$ 868,489      | \$ 362,600    | \$ 1,231,089 |
| Lawn and garden                 | 280,029         | 20,938        | 300,967      |
| Tools and paint                 | 138,996         | 10,063        | 149,059      |
| Other                           | 74,394          | 63,575        | 137,969      |
| Total                           | 1,361,908       | 457,176       | 1,819,084    |
| <b>Costs and expenses</b>       |                 |               |              |
| Cost of sales and occupancy     | 1,040,750       | 340,216       | 1,380,966    |
| Selling and administrative      | 299,175         | 80,640        | 379,815      |
| Depreciation                    | 2,372           | 4,197         | 6,569        |
| Gain on the sale of assets      | —               | (1,567)       | (1,567)      |
| Total                           | 1,342,297       | 423,486       | 1,765,783    |
| Operating income                | \$ 19,611       | \$ 33,690     | \$ 53,301    |
| Total assets                    | \$ 657,019      | \$ 190,989    | \$ 848,008   |
| Capital expenditures            | \$ 2,711        | \$ 3,284      | \$ 5,995     |

**SEARS HOMETOWN AND OUTLET STORES, INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**(Unaudited)**

**NOTE 9—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 10—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.

|   | <b>13 Weeks Ended</b>   | <b>13 Weeks Ended</b>   | <b>39 Weeks Ended</b>   | <b>39 Weeks Ended</b>   |
|---|-------------------------|-------------------------|-------------------------|-------------------------|
|   | <b>November 1, 2014</b> | <b>November 2, 2013</b> | <b>November 1, 2014</b> | <b>November 2, 2013</b> |
| <i>Thousands except income per common share</i> |                         |                         |                         |                         |
| Basic weighted average shares                   | 22,666                  | 22,999                  | 22,666                  | 23,066                  |
| Dilutive effect of restricted stock             | —                       | —                       | —                       | 4                       |
| Diluted weighted average shares                 | 22,666                  | 22,999                  | 22,666                  | 23,070                  |
| Net income (loss)                               | \$ (171,210)            | \$ 7,695                | \$ (164,171)            | \$ 31,826               |
| Income (loss) per common share:                 |                         |                         |                         |                         |
| Basic   | \$ (7.55)               | \$ 0.33                 | \$ (7.24)               | \$ 1.38                 |
| Diluted   | \$ (7.55)               | \$ 0.33                 | \$ (7.24)               | \$ 1.38                 |



**SEARS HOMETOWN AND OUTLET STORES, INC.**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
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**NOTE 11—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. 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), all of whom were employees of the Company at the time of the grant. As of November 1, 2014, 18,974 shares of the original grant of 89,221 shares of restricted stock had been forfeited. We are authorized to grant stock options and to make other awards to eligible plan participants pursuant to the Amended and Restated 2012 Stock Plan. Except for the 89,221 shares of restricted stock, the Company has made no stock-option or other grants or awards under the plan.

We account for stock-based compensation using the fair value method in accordance with accounting standards regarding share-based payment transactions. During the first three quarters of 2014 we recorded \$0.6 million in total compensation expense for the remaining 70,247 shares of restricted stock (none of which had vested as of November 1, 2014). At November 1, 2014, we had \$1.6 million in total unrecognized compensation cost related to the 70,247 shares of non-vested restricted stock, which cost we expect to recognize over approximately the next 1.5 years.

The 70,247 shares of restricted stock will vest, if at all, on May 16, 2016 in accordance with and subject to the terms and conditions of restricted-stock agreements, including forfeiture conditions, and the Amended and Restated 2012 Stock Plan. The fair value of these awards is equal to the market price of our common stock on the date of grant. We do not currently have a broad-based program that provides for restricted-stock awards on an annual basis. Changes in restricted-stock awards for 2014 were as follows:

|                              | 39 Weeks Ended November 1, 2014 |  |
|------------------------------|---------------------------------|--|
|                              | Shares                          | Weighted-Average<br>Fair Value on Date<br>of Grant |
| <i>(Shares in Thousands)</i> |                                 |  |
| Beginning of year balance    | 87                              | 44.45  |
| Granted                      | —                               | \$ —   |
| Vested                       | —                               | —  |
| Forfeited                    | (17)                            | 44.45  |
| Balance at 11/1/2014         | 70                              | \$ 44.45   |

**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 Company may suspend or terminate the repurchase program at any time.

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 39 Weeks ended November 1, 2014. At November 1, 2014 we had approximately \$12.5 million of remaining authorization under the repurchase program.

**SEARS HOMETOWN AND OUTLET STORES, INC.**  
**13 and 39 Weeks Ended November 1, 2014 and November 2, 2013**

**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 February 1, 2014 (the "2013 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 November 1, 2014, we and our dealers and franchisees operated 1,257 stores across all 50 states, Puerto Rico, and Bermuda. In the third quarter of 2014, the Company opened nine new stores and closed three stores.

In addition to merchandise, we provide our customers with access to a full 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 November 1, 2014, Hometown consisted of 1,108 stores as follows:

- 922 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.
- 81 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.
- 105 Sears Home Appliance Showrooms—Stores that have a simple, primarily appliance showroom design that are positioned in metropolitan areas.

As of November 1, 2014, Hometown operated through 917 dealer-operated stores, 160 franchisee-operated stores, and 31 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 began a trial program for franchising Outlet stores in late 2012 and completed the first Outlet store franchise transactions in the first quarter of 2013 and, since that time, the Company has continued to franchise Outlet stores. As of November 1, 2014, 58 of the 149 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 their 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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**13 and 39 Weeks Ended November 1, 2014 and November 2, 2013**

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. Initial franchise revenues were \$6.5 million and \$7.8 million in the third quarter of 2014 and 2013, respectively.

|                                  | 13 Weeks Ended      |                     | 39 Weeks Ended      |                     |
|----------------------------------|---------------------|---------------------|---------------------|---------------------|
|                                  | November 1,<br>2014 | November 2,<br>2013 | November 1,<br>2014 | November 2,<br>2013 |
| <i>Thousands</i>                 |                     |                     |                     |                     |
| Hometown                         | \$ 336              | \$ 1,608            | \$ 313              | \$ 4,629            |
| Outlet                           | 6,159               | 6,175               | 14,877              | 10,128              |
| Total initial franchise revenues | <u>\$ 6,495</u>     | <u>\$ 7,783</u>     | <u>\$ 15,190</u>    | <u>\$ 14,757</u>    |

## Online

We believe that the results of operations for our businesses in the third quarter were 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 grew in the third quarter, our rights to engage in our own online initiatives that would leverage www.sears.com, and our rights to engage in our own online initiatives that would be independent of www.sears.com, are constrained by the SHO-Sears Holdings Agreements. We believe that these constraints will continue to adversely affect our ability to conduct online business and, as a consequence, will continue to adversely affect the results of operations for our businesses. These adverse effects may grow over time. We are engaging in discussions with Sears Holdings regarding the elimination of these constraints, but we are unable to determine the outcome of these discussions.

## Goodwill

We review 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 indicate the carrying value of goodwill may not be recoverable. The goodwill impairment test involves a two-step process. In the first step, SHO compares the fair value of the Hometown Reporting Unit to its carrying value. If the fair value of the Hometown Reporting Unit exceeds its carrying value, goodwill is not impaired and no further testing is required. If the fair value of the Hometown Reporting Unit is less than its carrying value, SHO must perform 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 is 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

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business combination. If the implied fair value of the Hometown Reporting Unit's goodwill is less than its carrying value, the difference is 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 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 a \$167.0 million non-cash goodwill impairment charge in the third quarter of fiscal 2014, which is 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 corresponding impact beyond those periods.

### **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 9 to the Consolidated Financial Statements included in the 2013 10-K for our quarterly financial results (unaudited) for our 2012 and 2013 fiscal years.

### **Results of Operations**

The following table sets forth items derived from our consolidated results of operations for the 13 and 39 Weeks ended November 1, 2014 and November 2, 2013.

**SEARS HOMETOWN AND OUTLET STORES, INC.**  
**13 and 39 Weeks Ended November 1, 2014 and November 2, 2013**

| <i>Thousands</i>   | 13 Weeks Ended      |                     | 39 Weeks Ended      |                     |
|--|---------------------|---------------------|---------------------|---------------------|
|  | November 1,<br>2014 | November 2,<br>2013 | November 1,<br>2014 | November 2,<br>2013 |
| <b>NET SALES</b>   | <b>\$ 565,147</b>   | <b>\$ 561,068</b>   | <b>\$1,793,694</b>  | <b>\$1,819,084</b>  |
| <b>COSTS AND EXPENSES</b>  |                     |                     |                     |                     |
| Cost of sales and occupancy  | 430,085             | 425,596             | 1,367,644           | 1,380,966           |
| Gross margin dollars   | 135,062             | 135,472             | 426,050             | 438,118             |
| <i>Margin rate</i>   | 23.9%               | 24.1%               | 23.8%               | 24.1%               |
| Selling and administrative   | 139,766             | 121,698             | 414,271             | 379,815             |
| <i>Selling and administrative expense as a percentage of net sales</i> | 24.7%               | 21.7%               | 23.1%               | 20.9%               |
| Impairment of goodwill   | 167,000             | —                   | 167,000             | —                   |
| Depreciation   | 2,035               | 2,177               | 6,390               | 6,569               |
| Gain on the sale of assets   | (155)               | (1,567)             | (155)               | (1,567)             |
| Total costs and expenses   | 738,731             | 547,904             | 1,955,150           | 1,765,783           |
| Operating income (loss)  | (173,584)           | 13,164              | (161,456)           | 53,301              |
| Interest expense   | (915)               | (738)               | (2,754)             | (1,969)             |
| Other income   | 888                 | 460                 | 2,366               | 1,306               |
| Income (loss) before income taxes                                      | (173,611)           | 12,886              | (161,844)           | 52,638              |
| Income tax benefit (expense)   | 2,401               | (5,191)             | (2,327)             | (20,812)            |
| <b>NET INCOME (LOSS)</b>   | <b>\$ (171,210)</b> | <b>\$ 7,695</b>     | <b>\$ (164,171)</b> | <b>\$ 31,826</b>    |

### 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 through [www.sears.com](http://www.sears.com) and that were fulfilled and recorded by Sears Holdings. 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 sales that were not fulfilled and recorded by SHO 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:

- SHO receives commissions on all in-store sales that were transacted by SHO through [www.sears.com](http://www.sears.com) and that were fulfilled and recorded by Sears Holdings.
- During the third quarter of 2014, these sales fulfilled and recorded by Sears Holdings increased significantly to \$14.3 million compared to \$6.5 million in the third quarter of 2013. During the 39 weeks ended November 1, 2014, these sales fulfilled and recorded by Sears Holdings increased significantly to \$62.4 million compared to \$20.7 million in the 39 weeks ended November 2, 2013.
- Unadjusted comparable store sales, which do not include in-store sales that were transacted by SHO through [www.sears.com](http://www.sears.com) and that were fulfilled and recorded by Sears Holdings, understates what SHO believes to be its effective comparable store sales performance.

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**13 and 39 Weeks Ended November 1, 2014 and November 2, 2013**

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:

| <i>thousands</i>  | 13 Weeks Ended November 1, 2014 |                   |                   | 39 Weeks Ended November 1, 2014 |                   |                    |
|---|---------------------------------|-------------------|-------------------|---------------------------------|-------------------|--------------------|
|   | Hometown                        | Outlet            | Total             | Hometown                        | Outlet            | Total              |
| Net sales   | \$ 387,743                      | \$ 177,404        | \$ 565,147        | \$1,286,532                     | \$ 507,162        | \$1,793,694        |
| Less: Non-comparable store sales  | (39,062)                        | (39,339)          | (78,401)          | (136,925)                       | (113,530)         | (250,454)          |
| Comparable store sales recorded by SHO                                  | 348,680                         | 138,066           | 486,746           | 1,149,606                       | 393,633           | 1,543,240          |
| SHO in-store sales through www.sears.com recorded by Sears Holdings (1) | 11,761                          | 1,411             | 13,172            | 48,996                          | 8,098             | 57,094             |
| Adjusted comparable store sales   | <u>\$ 360,441</u>               | <u>\$ 139,477</u> | <u>\$ 499,918</u> | <u>\$1,198,602</u>              | <u>\$ 401,731</u> | <u>\$1,600,333</u> |

  

| <i>thousands</i>  | 13 Weeks Ended November 2, 2013 |                   |                   | 39 Weeks Ended November 2, 2013 |                   |                    |
|---|---------------------------------|-------------------|-------------------|---------------------------------|-------------------|--------------------|
|   | Hometown                        | Outlet            | Total             | Hometown                        | Outlet            | Total              |
| Net sales   | \$ 413,171                      | \$ 147,897        | \$ 561,068        | \$1,361,908                     | \$ 457,176        | \$1,819,084        |
| Less: Non-comparable store sales  | (41,446)                        | (21,620)          | (63,066)          | (136,763)                       | (57,938)          | (194,701)          |
| Comparable store sales recorded by SHO                                  | 371,725                         | 126,277           | 498,002           | 1,225,145                       | 399,238           | 1,624,383          |
| SHO in-store sales through www.sears.com recorded by Sears Holdings (1) | 5,360                           | 932               | 6,292             | 17,675                          | 2,394             | 20,069             |
| Adjusted comparable store sales   | <u>\$ 377,085</u>               | <u>\$ 127,209</u> | <u>\$ 504,294</u> | <u>\$1,242,820</u>              | <u>\$ 401,632</u> | <u>\$1,644,452</u> |

  

|  | 13 Weeks Ended November 1, 2014 vs. 13 Weeks Ended November 2, 2013 |        |        | 39 Weeks Ended November 1, 2014 vs. 39 Weeks Ended November 2, 2013 |        |        |
|--|---|--------|--------|---|--------|--------|
|  | Hometown  | Outlet | Total  | Hometown  | Outlet | Total  |
| Comparable store sales recorded by SHO | (6.2)%  | 9.3%   | (2.3)% | (6.2)%  | (1.4)% | (5.0)% |
| Adjusted comparable store sales        | (4.4)%  | 9.6%   | (0.9)% | (3.6)%  | 0.0 %  | (2.7)% |

(1) SHO in-store sales through www.sears.com fulfilled and recorded by Sears Holdings above are for comparable stores only. For all comparable and non-comparable stores, these sales for the 13 weeks and 39 weeks ended November 1, 2014 were \$14.3 million and \$62.4 million compared to \$6.5 million and \$20.7 million for the 13 weeks and 39 weeks ended November 2, 2013.

### 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.



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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
- Other significant items, while periodically affecting our results, may vary significantly from period to period and may have a disproportionate effect in a given period, which affects comparability of results.

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

| <i>Thousands</i>             | <b>13 Weeks Ended</b>   |                         | <b>39 Weeks Ended</b>   |                         |
|------------------------------|-------------------------|-------------------------|-------------------------|-------------------------|
|                              | <b>November 1, 2014</b> | <b>November 2, 2013</b> | <b>November 1, 2014</b> | <b>November 2, 2013</b> |
| Net income (loss)            | \$ (171,210)            | \$ 7,695                | \$ (164,171)            | \$ 31,826               |
| Income tax expense (benefit) | (2,401)                 | 5,191                   | 2,327                   | 20,812                  |
| Other income                 | (888)                   | (460)                   | (2,366)                 | (1,306)                 |
| Interest expense             | 915                     | 738                     | 2,754                   | 1,969                   |
| Operating income (loss)      | (173,584)               | 13,164                  | (161,456)               | 53,301                  |
| Depreciation                 | 2,035                   | 2,177                   | 6,390                   | 6,569                   |
| Gain on the sale of assets   | (155)                   | (1,567)                 | (155)                   | (1,567)                 |
| Impairment of goodwill       | 167,000                 | —                       | 167,000                 | —                       |
| Adjusted EBITDA              | <u>\$ (4,704)</u>       | <u>\$ 13,774</u>        | <u>\$ 11,779</u>        | <u>\$ 58,303</u>        |

**13-Week Period Ended November 1, 2014 Compared to the 13-Week Period Ended November 2, 2013**

*Net Sales*

Net sales in the third quarter of 2014 increased \$4.1 million, or 0.7%, to \$565.1 million from the third quarter of 2013. This increase was driven primarily by new stores (net of closures) and higher online commissions earned by SHO on sales of merchandise for home delivery made through www.sears.com, a website owned by Sears Holdings (\$4.2 million in the third quarter of 2014 compared to \$2.4 million in the third quarter of 2013), partially offset by a 2.3% decrease in comparable store sales and lower initial franchise revenues (which were \$6.5 million in the third quarter of 2014 compared to \$7.8 million in the third quarter of 2013).

In-store sales transacted by SHO and its independent dealers and franchisees through www.sears.com and recorded and fulfilled by Sears Holdings during the third quarter of 2014 were \$14.3 million compared to \$6.5 million in the third quarter of 2013. As a result comparable store sales, which measure the increase in sales on transactions fulfilled and recorded by SHO, were unfavorably impacted. Including total sales for online transactions fulfilled and recorded by Sears Holdings, Adjusted comparable store sales for the third quarter of 2014 decreased 0.9%. Comparable store sales in Hometown were down 6.2% while comparable store sales in Outlet were up 9.3%. Adjusted comparable store sales were down 4.4% in Hometown and up 9.6% in Outlet.

*Gross Margin*

Gross margin was \$135.1 million, or 23.9% of net sales, in the third quarter of 2014 compared to \$135.5 million, or 24.1% of net sales, in the third quarter of 2013. The decrease in gross margin rate was primarily driven by (1) a reduced merchandise margin rate, (2) higher Outlet distribution center costs, (3) lower initial franchise revenues, and (4) a \$0.9 million net payment to Sears Holdings related to the reconciliation of payments between Sears Holdings and SHO. These reductions were partially offset by (1) lower occupancy costs resulting from the conversion of Company-operated stores to franchisee-operated stores, (2) higher online commissions, (3) lower support-services charges from Sears Holdings, and (4) higher delivery income. Excluding the impact of online commissions and initial franchise revenues gross margin was 22.4% of net sales in the third quarter of 2014 compared to 22.8% of net sales in the third quarter of 2013.

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*Selling and Administrative Expenses*

Selling and administrative expenses increased to \$139.8 million, or 24.7% of net sales, in the third quarter of 2014 from \$121.7 million, or 21.7% of net sales, in the prior-year quarter. The increase was primarily due to an \$11.5 million provision for losses on franchisee receivables recognized in the third quarter of 2014, higher owner commissions in Outlet (primarily related to the conversion of Company-operated stores to franchisee-operated stores), and new stores opened since the third quarter of 2013. We established the provision for losses on Hometown franchisee receivables in the third quarter of fiscal 2014 based on our assessment during the quarter that some of the Hometown 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 quarter of one of our Hometown franchisees to continue to operate its franchise stores in accordance with the franchisee's agreements with us. See also Note 2 to the Condensed Consolidated Financial Statements in Item 1 of this Quarterly Report on Form 10-Q. These increases were partially offset by lower payroll and benefits costs resulting from the conversion of Company-operated stores to franchisee-operated stores.

*Impairment of Goodwill*

During the three months ended November 1, 2014, we recorded a non-cash goodwill impairment charge of \$167.0 million associated with the Hometown Reporting Unit. See Note 4 to the Condensed Consolidated Financial Statements in Item 1 of this Quarterly Report on Form 10-Q for further discussion of the impairment of goodwill.

*Operating Income (Loss)*

We recorded an operating loss of \$173.6 million and operating income of \$13.2 million in the third quarters of 2014 and 2013, respectively. The \$186.8 million decrease in operating income was driven by the non-cash goodwill impairment charge, higher selling and administrative expenses, the lower gross margin rate, and a \$1.6 million gain on the sale of an Outlet store in the third quarter of 2013, partially offset by higher net sales.

*Income Taxes*

Income tax benefit of \$2.4 million and income tax expense of \$5.2 million was recorded in the third quarters of 2014 and 2013, respectively. The effective tax rate was 1.4% (benefit) and 40.3% in the third quarters of 2014 and 2013, respectively. The change in the effective tax rate in the third quarter of 2014 compared to the third quarter of 2013 is primarily due to the impact of the goodwill impairment charge, which is not tax deductible.

*Net Income (Loss)*

We recorded net loss of \$171.2 million for the third quarter of 2014 compared to net income of \$7.7 million for the prior-year quarter. The decrease in net income was primarily attributable to the factors discussed above.



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**13 and 39 Weeks Ended November 1, 2014 and November 2, 2013**

**39-Week Period Ended November 1, 2014 Compared to the 39-Week Period Ended November 2, 2013**

*Net Sales*

Net sales in the first three quarters of 2014 decreased \$25.4 million, or 1.4%, to \$1,793.7 million from the first three quarters of 2013. This decrease was driven primarily by a 5.0% decrease in comparable store sales, partially offset by new stores (net of closures) and higher online commissions earned by SHO on sales of merchandise for home delivery made through [www.sears.com](http://www.sears.com) (\$18.4 million in the first three quarters of 2014 compared to \$7.4 million in the first three quarters of 2013). Sears Holdings fulfilled and recorded these online transactions and paid commissions to SHO, which are included in SHO's net sales.

In-store sales transacted by SHO and its independent dealers and franchisees through [www.sears.com](http://www.sears.com) and recorded and fulfilled by Sears Holdings during the first three quarters of 2014 were \$62.4 million compared to \$20.7 million in the first three quarters of 2013. As a result, comparable store sales, which measure the increase in sales on transactions fulfilled and recorded by SHO, were unfavorably impacted. Including total sales for online transactions fulfilled and recorded by Sears Holdings, Adjusted comparable store sales for the first three quarters of 2014 decreased 2.7%. Comparable store sales in Hometown were down 6.2% while comparable store sales in Outlet were down 1.4%. Adjusted comparable store sales were down 3.6% in Hometown and were flat in Outlet. Initial franchise revenues increased \$0.4 million in the first three quarters of 2014 to \$15.2 million compared to \$14.8 million in the first three quarters of 2013.

*Gross Margin*

Gross margin was \$426.1 million, or 23.8% of net sales, in the first three quarters of 2014 compared to \$438.1 million, or 24.1% of net sales, in the first three quarters of 2013. The decrease in gross margin rate was primarily driven by (1) lower margins on merchandise sales, (2) additional Outlet distribution-center costs, (3) higher inventory shrinkage in Outlet, (4) lower Outlet apparel liquidation income, and (5) a \$0.9 million net payment to Sears Holdings related to the reconciliation of payments between Sears Holdings and SHO. These declines were partially offset by (1) the increase in online commissions, (2) lower support services charges from Sears Holdings, (3) lower occupancy costs resulting from the conversion of Company-operated stores to franchisee-operated stores, and (4) higher delivery income. Excluding the impact of online commissions and initial franchise revenues, gross margin was 22.3% of net sales in the first three quarters of 2014 compared to 23.1% of net sales in the first three quarters of 2013.

*Selling and Administrative Expenses*

Selling and administrative expenses increased to \$414.3 million, or 23.1% of net sales, in the first three quarters of 2014 from \$379.8 million, or 20.9% of net sales, in the prior year. The increase was primarily due to (1) higher owner commissions in both Hometown and Outlet (primarily related to the conversion of Company-operated stores to franchisee-operated stores), (2) an \$11.5 million provision for losses on Hometown franchisee receivables recognized in the third quarter of 2014 (see Note 2 to the Condensed Consolidated Financial Statements in Item 1 of this Quarterly Report on 10-Q), (3) new stores opened since the third quarter of 2013, and (4) higher marketing costs, partially offset by lower payroll and benefits costs resulting from the conversion of Company-operated stores to franchisee-operated stores.

*Impairment of Goodwill*

During the three quarters ended November 1, 2014 we recorded a non-cash goodwill impairment charge of \$167.0 million associated with the Hometown Reporting Unit. See Note 4 to the Condensed Consolidated Financial Statements in Item 1 of this Quarterly Report on Form 10-Q for further discussion of the impairment of goodwill.

*Operating Income (Loss)*

We recorded operating loss of \$161.5 million and operating income of \$53.3 million in the first three quarters of 2014 and 2013, respectively. The \$214.8 million decrease in operating income was driven primarily by (1) the non-cash goodwill impairment charge, (2) higher selling and administrative expenses, (3) a lower gross margin rate, (4) lower net sales, and (5) a \$1.6 million gain on the sale of an Outlet store in the third quarter of 2013.

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### *Income Taxes*

Income tax expense of \$2.3 million and \$20.8 million was recorded in the first three quarters of 2014 and 2013, respectively. The effective tax rate was 1.44% and 39.5% in the first three quarters of 2014 and 2013, respectively. The change in the effective tax rate in the first three quarters of 2014 compared to the first three quarters of 2013 is primarily due to the impact of the goodwill impairment charge, which is not tax deductible.

### *Net Income (Loss)*

We recorded net loss of \$164.2 million for the first three quarters of 2014 compared to net income of \$31.8 million for the first three quarters of last year. The decrease in net income was primarily attributable to the factors discussed above.

## **Business Segment Results**

### **Hometown**

Hometown results and key statistics were as follows:

|   | 13 Weeks Ended      |                     | 39 Weeks Ended      |                     |
|---|---------------------|---------------------|---------------------|---------------------|
|   | November 1,<br>2014 | November 2,<br>2013 | November 1,<br>2014 | November 2,<br>2013 |
| <i>Thousands, except for number of stores</i>                   |                     |                     |                     |                     |
| Net sales   | \$ 387,743          | \$ 413,171          | \$1,286,532         | \$1,361,908         |
| Comparable store sales % (1)                                    | (6.2)%              | (1.5)%              | (6.2)%              | (2.9)%              |
| Cost of sales and occupancy                                     | 299,013             | 318,362             | 983,214             | 1,040,750           |
| Gross margin dollars  | 88,730              | 94,809              | 303,318             | 321,158             |
| Margin rate   | 22.9 %              | 22.9 %              | 23.6 %              | 23.6 %              |
| Selling and administrative                                      | 103,395             | 94,818              | 307,747             | 299,175             |
| Selling and administrative expense as a percentage of net sales | 26.7 %              | 22.9 %              | 23.9 %              | 22.0 %              |
| Impairment of goodwill  | 167,000             | —                   | 167,000             | —                   |
| Gain on the sale of assets                                      | (155)               | —                   | (155)               | —                   |
| Depreciation  | 746                 | 760                 | 2,127               | 2,372               |
| Total costs and expenses  | 569,999             | 413,940             | 1,459,933           | 1,342,297           |
| Operating income (loss)   | \$ (182,256)        | \$ (769)            | \$ (173,401)        | \$ 19,611           |
| Total Hometown stores   |                     |                     | 1,108               | 1,108               |

(1) Adjusted comparable store sales for the 13 and 39 Weeks ended November 1, 2014 were (4.4)% and (3.6)% respectively.

### **13-Week Period ended November 1, 2014 Compared to the 13-Week Period Ended November 2, 2013**

#### *Net Sales*

Hometown net sales decreased \$25.4 million, or 6.2%, to \$387.7 million in the third quarter of 2014 from \$413.2 million in the third quarter of 2013. The decrease was primarily due to a 6.2% decrease in comparable store sales and lower initial franchise revenues (which were \$0.3 million in the third quarter of 2014 compared to \$1.6 million in the third quarter of 2013) partially offset by higher online commissions (\$3.7 million in the third quarter of 2014 compared to \$2.1 million in the third quarter of 2013). Adjusted comparable store sales for the third quarter of 2014, which includes in-store sales transacted through www.sears.com that were fulfilled and recorded by Sears Holdings, decreased 4.4% primarily due to declines in major appliances. This segment continues to be affected by the highly promotional environment. We also believe that the results for Hometown were adversely affected by the continuing growth of online sales of merchandise in important product categories, especially home appliances. Our rights to fully engage in the online channel are subject to restrictions in our agreements with Sears Holdings Corporation that were entered into prior to our October 2012 separation.

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*Gross Margin*

Gross margin was \$88.7 million, or 22.9% of net sales, in the third quarter of 2014 compared to \$94.8 million, or 22.9% of net sales, in the prior-year quarter. The flat gross margin rate was primarily due to a \$2.3 million charge as a result of the reconciliation of payments between SHO and Sears Holdings, lower initial franchise revenues, and a lower merchandise margin rate. These reductions were offset by (1) higher online commissions, (2) lower occupancy costs resulting from the conversion of Company-operated stores to franchisee-operated stores, (3) higher delivery income, and (4) lower support services charges from Sears Holdings. Excluding the impact of online commissions and initial franchise revenues, gross margin was 22.1% of net sales in the third quarter of 2014 compared to 22.3% of net sales in the third quarter of 2013.

*Selling and Administrative Expenses*

Selling and administrative expenses increased to \$103.4 million, or 26.7% of net sales, in the third quarter of 2014 from \$94.8 million, or 22.9% of net sales, in the prior-year quarter. The increase was primarily due to an \$11.5 million provision for losses on Hometown franchisee receivables recognized in the third quarter of 2014 (See Note 2 to the Condensed Consolidated Financial Statements in Item 1 of this Quarterly Report on Form 10-Q for further discussion), partially offset by a reduction in payroll and benefits due to Company-operated store conversions.

*Impairment of Goodwill*

During the three months ended November 1, 2014 we recorded a non-cash goodwill impairment charge of \$167.0 million associated with the Hometown Reporting Unit. See Note 4 to the Condensed Consolidated Financial Statements in Item 1 of this Quarterly Report on Form 10-Q for further discussion of the impairment of goodwill.

*Operating Income (Loss)*

We recorded operating losses of \$182.3 million in the third quarter of 2014 and \$0.8 million in the third quarter of 2013. The overall increase in operating loss of \$181.5 million was driven primarily by the non-cash \$167.0 million goodwill impairment charge, the increase in selling and administrative expenses and lower net sales.

**39-Week Period ended November 1, 2014 Compared to the 39-Week Period Ended November 2, 2013***Net Sales*

Hometown net sales decreased \$75.4 million, or 5.5%, to \$1,286.5 million in the first three quarters of 2014 from \$1,361.9 million in the first three quarters of 2013. The decrease was primarily due to a 6.2% decrease in comparable store sales and a reduction in initial franchise revenues (which were \$0.3 million in the first three quarters of 2014 compared to \$4.6 million in the first three quarters of 2013), partially offset by an increase in online commissions (\$15.7 million in the first three quarters of 2014 compared to \$6.6 million in the first three quarters of 2013). Adjusted comparable store sales for the first three quarters of 2014, which include in-store sales transacted through [www.sears.com](http://www.sears.com) that were fulfilled and recorded by Sears Holdings, decreased 3.6% primarily due to declines in major appliances.

*Gross Margin*

Gross margin was \$303.3 million, or 23.6% of net sales, in the first three quarters of 2014 compared to \$321.2 million, or 23.6% of net sales, in the prior year. The flat gross margin rate was primarily driven by (1) increases in online commissions, (2) lower occupancy costs resulting from the conversion of Company-operated stores to franchisee-operated stores, (3) higher delivery income, and (4) lower support services charges from Sears Holdings, offset by lower margins on merchandise sales, lower initial franchise revenues, and a \$2.3 million charge due to the reconciliation of payments between SHO and Sears Holdings. Excluding the impact of online commissions and initial franchise revenues, gross margin was 22.6% of net sales in the first three quarters of 2014 compared to 22.9% of net sales in the first three quarters of 2013.

*Selling and Administrative Expenses*

Selling and administrative expenses were \$307.7 million, or 23.9% of net sales, in the first three quarters of 2014 compared to \$299.2 million, or 22.0% of net sales, in the prior year. The higher selling and administrative expenses were primarily driven by an \$11.5 million provision for losses on franchisee receivables recognized in the third quarter of 2014 (See Note 2 to the Condensed Consolidated Financial Statements in Item 1 of this Quarterly Report on Form 10-Q for further

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discussion), higher owner commissions mainly related to the conversion of Company-operated stores to franchisee-operated stores and higher marketing costs partially offset by a reduction in payroll and benefits due to Company-operated store conversions.

#### *Impairment of Goodwill*

During the three quarters ended November 1, 2014 we recorded a non-cash goodwill impairment charge of \$167.0 million associated with the Hometown Reporting Unit. See Note 4 to the Condensed Consolidated Financial Statements in Item 1 of this Quarterly Report on Form 10-Q for further discussion of the impairment of goodwill.

#### *Operating Income (Loss)*

We recorded an operating loss of \$173.4 million in the first three quarters of 2014 and operating income of \$19.6 million in the first three quarters of 2013. The overall decrease in operating income of \$193.0 million was primarily driven by the non-cash goodwill impairment charge, the decrease in net sales, and the increase in selling and administrative expenses.

#### **Outlet**

Outlet results and key statistics were as follows:

|  | 13 Weeks Ended      |                     | 39 Weeks Ended      |                     |
|--|---------------------|---------------------|---------------------|---------------------|
|  | November 1,<br>2014 | November 2,<br>2013 | November 1,<br>2014 | November 2,<br>2013 |
| <i>Thousands, except for number of stores</i>                          |                     |                     |                     |                     |
| Net sales  | \$ 177,404          | \$ 147,897          | \$ 507,162          | \$ 457,176          |
| Comparable store sales % (1)   | 9.3%                | (3.4)%              | (1.4)%              | 1.9%                |
| Cost of sales and occupancy  | 131,072             | 107,234             | 384,430             | 340,216             |
| Gross margin dollars   | 46,332              | 40,663              | 122,732             | 116,960             |
| Margin rate  | 26.1%               | 27.5 %              | 24.2 %              | 25.6%               |
| Selling and administrative   | 36,371              | 26,880              | 106,524             | 80,640              |
| <i>Selling and administrative expense as a percentage of net sales</i> | 20.5%               | 18.2 %              | 21.0 %              | 17.6%               |
| Depreciation   | 1,289               | 1,417               | 4,263               | 4,197               |
| Gain on the sale of assets   | —                   | (1,567)             | —                   | (1,567)             |
| Total costs and expenses   | 168,732             | 133,964             | 495,217             | 423,486             |
| Operating income   | \$ 8,672            | \$ 13,933           | \$ 11,945           | \$ 33,690           |
| Total Outlet stores  |                     |                     | 149                 | 131                 |

(1) Adjusted comparable store sales for the 13 and 39 Weeks ended November 1, 2014 were 9.6% and 0.0% respectively.

#### **13-Week Period ended November 1, 2014 Compared to the 13-Week Period Ended November 2, 2013**

##### *Net Sales*

Outlet net sales increased \$29.5 million, or 20.0%, to \$177.4 million in the third quarter of 2014 from \$147.9 million in the third quarter of 2013. The increase was primarily due to new store sales (net of closures) and a 9.3% increase in comparable store sales. Adjusted comparable store sales for the third quarter of 2014, which includes in-store sales transacted through [www.sears.com](http://www.sears.com) that were fulfilled and recorded by Sears Holdings, increased 9.6%. The increase was driven by higher major appliances sales due to more effective promotional strategies and higher sales in furniture due to category expansion partially offset by a decrease in apparel sales due to a reduction of floor space (resulting from conversions and closures of apparel-only stores and expansion in other categories) along with a lower mix of wearables in inventory (higher mix of accessories and basics). Initial franchise revenues in the third quarter of 2014 were \$6.2 million, which was flat compared to the third quarter of 2013.

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*Gross Margin*

Gross margin was \$46.3 million, or 26.1% of net sales, in the third quarter of 2014 compared to \$40.7 million, or 27.5% of net sales, in the prior year. The gross margin rate decreased in the third quarter of 2014 compared to the prior-year quarter primarily due to a reduced merchandise margin rate, a lower franchise revenue rate, and higher distribution center costs, partially offset by lower occupancy costs resulting from the conversion of Company-operated stores to franchisee-operated stores and a \$1.4 million expense reduction due to the reconciliation of payments between SHO and Sears Holdings. Excluding the impact of online commissions and initial franchise revenues, gross margin was 23.2% of net sales in the third quarter of 2014 compared to 24.2% of net sales in the third quarter of 2013.

*Selling and Administrative Expenses*

Selling and administrative expenses increased to \$36.4 million, or 20.5% of net sales, in the third quarter of 2014 from \$26.9 million, or 18.2% of net sales, in the prior-year quarter. The increase in selling and administrative expenses was primarily due to higher franchisee commissions for stores that we converted from Company-operated to franchisee-operated and new stores opened since the third quarter of 2013. These increases were partially offset by lower payroll and benefits costs resulting from the conversion of Company-operated stores.

*Operating Income*

We recorded operating income of \$8.7 million in the third quarter of 2014 compared to \$13.9 million in the third quarter of 2013. The decrease in operating income of \$5.2 million was driven primarily by higher selling and administrative expenses, a lower gross margin rate, and a \$1.6 million gain on the sale of an Outlet store in the third quarter of 2013, partially offset by higher net sales.

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**39-Week Period ended November 1, 2014 Compared to the 39-Week Period Ended November 2, 2013**

*Net Sales*

Outlet net sales increased \$50.0 million, or 10.9%, to \$507.2 million in the first three quarters of 2014 from \$457.2 million in the first three quarters of 2013. The increase was primarily due to new store sales (net of closures), higher initial franchise revenues, and higher online commissions (\$2.7 million in the first three quarters of 2014 compared to \$0.8 million in the first three quarters of 2013). These increases were partially offset by a 1.4% decrease in comparable store sales. Adjusted comparable store sales for the first three quarters of 2014, which include in-store sales transacted through [www.sears.com](http://www.sears.com) that were fulfilled and recorded by Sears Holdings, were flat. The flat Adjusted comparable store sales were driven by higher furniture sales due to category expansion and higher major appliances sales due to more effective promotional strategies. These increases were offset by lower apparel sales due to a reduction of floor space (resulting from conversions and closures of apparel-only stores and expansion in other categories), a lower mix of wearables in inventory (higher mix of accessories and basics), and lower sales in both power lawn and garden and fitness (due to the reduced availability of opportunity buys and inventory flow).

*Gross Margin*

Gross margin was \$122.7 million, or 24.2% of net sales, in the first three quarters of 2014 compared to \$117.0 million, or 25.6% of net sales, in the prior year. The gross margin rate decreased primarily due to (1) lower margins on merchandise sales, (2) higher inventory shrinkage, (3) additional distribution center costs, and (4) lower Outlet apparel-liquidation income. These declines were partially offset by (1) lower occupancy costs resulting from the conversion of Company-operated stores to franchisee-operated stores, (2) higher franchise revenues, (3) higher online commissions, and (4) a \$1.4 million expense reduction due to the reconciliation of payments between SHO and Sears Holdings. Excluding the impact of online commissions and initial franchise revenues, gross margin was 21.5% of net sales in the first three quarters of 2014 compared to 23.8% of net sales in the first three quarters of 2013.

*Selling and Administrative Expenses*

Selling and administrative expenses increased to \$106.5 million, or 21.0% of net sales, in the first three quarters of 2014 from \$80.6 million, or 17.6% of net sales, in the prior year. The increase in selling and administrative expenses was primarily due to higher franchisee commissions for stores that we converted from Company-operated to franchisee-operated, new stores opened since the third quarter of 2013, and an increase in marketing costs. These increases were partially offset by lower payroll and benefits costs resulting from the conversion of Company-operated stores.

*Operating Income*

We recorded operating income of \$11.9 million in the first three quarters of 2014 compared to \$33.7 million in the first three quarters of 2013. The decrease in operating income of \$21.8 million was driven primarily by higher selling and administrative expenses, a lower gross margin rate, and a \$1.6 million gain on the sales of an Outlet store in the third quarter of 2013, partially offset by higher net sales.



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## **Analysis of Financial Condition**

### *Cash and Cash Equivalents*

We had cash and cash equivalents of \$23.2 million as of November 1, 2014, \$21.5 million as of November 2, 2013, and \$23.5 million as of February 1, 2014.

For the third quarter of 2014 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 first three quarters ended November 1, 2014 cash provided by operating activities was \$36.1 million compared to \$54.2 million used in the first three quarters ended November 2, 2013. The increase was due predominately to a reduction in investments in inventory and an increase in payables in 2014 compared to 2013, partially offset by lower net income.

Total merchandise inventories were \$462.2 million at November 1, 2014 and \$488.6 million at November 2, 2013. Merchandise inventories decreased \$26.4 million due to an \$18.5 million decrease in Hometown and a \$7.9 million decrease in Outlet. The decrease in Hometown was primarily due to lower home appliances inventory driven by a change in the timing of product transitions and lower tools inventory resulting from the closing of hardware stores. Outlet's reduction, despite a 14% increase in store count, was driven by a shift in the mix of home appliances from "new, in-box" to lower-cost "as-is" merchandise, partially offset by increases in apparel from higher receipts and in furniture due to category expansion.

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 82% and 85% of total purchases of all inventory from all vendors for the 13 and 39 weeks ended November 1, 2014, 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 "Part II, Item 1A, Risk Factors" in this Quarterly Report on Form 10-Q

In addition, our merchandise-vendor arrangements generally are not long-term (except 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 \$9.9 million for the first three quarters of 2014 compared to \$3.4 million for the first three quarters of 2013. 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 \$26.5 million for the 39 Weeks ended November 1, 2014 compared to \$58.9 million provided during the 39 Weeks ended November 2, 2013. The decrease of \$85.4 million in cash provided by financing activities was primarily due to a reduction of \$25.9 million in net borrowings under our Senior ABL Facility in the first three quarters of 2014 compared to an increase of \$67.9 million in the first three quarters of 2013.

### *Financing Arrangements*

As of November 1, 2014 we had \$73.2 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 November 1, 2014 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

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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 November 1, 2014 was \$171.2 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 2.41% at November 1, 2014, or (2) an alternate base rate plus a borrowing margin, approximately 4.50% at November 1, 2014, 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 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



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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 contains certain affirmative covenants, including financial and other reporting requirements. As of November 1, 2014 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, and 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 November 1, 2014, we had cash and cash equivalents of \$23.2 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 November 1, 2014 and November 2, 2013 were \$0.2 million and \$1.2 million, respectively.

**Off-Balance Sheet Arrangements**

As of November 1, 2014, we had no off-balance sheet arrangements as defined in Item 303(a)(4) of the Securities and Exchange Commission's Regulation S-K.

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**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.

*CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING INFORMATION*

Certain statements made in this Quarterly Report on Form 10-Q contain forward-looking statements. Forward-looking statements are subject to risks and uncertainties that may cause our actual results, performance, or achievements to be materially different from any future results, performance, or achievements expressed or implied by these forward-looking statements. Forward-looking statements include without limitation information concerning our future financial performance, business strategy, plans, goals, and objectives.

Statements preceded or followed by, or that otherwise include, the words “believes,” “expects,” “anticipates,” “intends,” “project,” “estimates,” “plans,” “forecast,” “is likely to,” “continue,” 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. Such statements are based upon the current beliefs and expectations of our management and are subject to significant risks and uncertainties. Actual results may differ materially from those set forth in the forward-looking statements.

The following factors, among others, separately or together could cause our actual results, performance, and achievements to differ from those set forth 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:

- our ability to offer merchandise and services that our customers want, including those under the Kenmore, Craftsman, and DieHard brands, which brands are owned by Sears Holdings (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;
- 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) that were associated with having been wholly owned by Sears Holdings and its subsidiaries;
- 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;
- our ability to resolve on commercially reasonable terms existing disputes and, when they arise, future disputes with Sears Holdings regarding many of the material terms and conditions of our agreements with Sears Holdings;

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- 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;
- 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 the SHO-Sears Holdings Agreements;
- the SHO-Sears Holdings Agreements 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 costs and 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 may be subject to disruptions and data/security breaches for which Sears Holdings may be unwilling or unable to indemnify and defend us against third-party claims and other losses resulting from such disruptions and data/security breaches;
- the ability and willingness of Sears Holdings to perform its contractual obligations to us;
- the possible effects on us if Sears Holdings' financial condition were perceived to significantly deteriorate, including if as a consequence Sears Holdings were to choose to seek the protection of the U.S. bankruptcy laws;
- limitations and restrictions in the Senior ABL Facility and our ability to service our indebtedness;
- our ability to obtain additional financing on acceptable terms;
- our dependence on independent dealers and franchisees to operate their stores profitably and in a manner consistent with our concepts and standards;
- our dependence on sources outside the U.S. for significant amounts of our merchandise;
- impairment charges for intangible assets and fixed-asset impairment for long-lived assets;
- our ability to attract, motivate, and retain key executives and other employees;
- the impact of increased costs associated with being a publicly held company;
- our ability to sell profitably online all of our merchandise and services;
- 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 affect our relationships with our independent dealers and 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.

These factors should not be construed as exhaustive and should be read in conjunction with the other cautionary statements, including our "Risk Factors," that are included in our 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.

**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 13 weeks ended November 1, 2014 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 hereof, 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 as previously disclosed in the 2013 10-K with three exceptions.

The first exception is with respect to the risk factor entitled, "*We may not be able to resolve successfully existing and, if they arise, future contractual disputes and other conflicts with Sears Holdings*" that is included in "Risk Factors" in the 2013 10-K. We believe that, generally, we have successfully resolved many disputes with Sears Holdings that have arisen post-Separation with respect to the SHO-Sears Holdings Agreements and related business arrangements. However, many significant disputes with Sears Holdings remain unresolved and are the subject of ongoing discussions. We are unable to determine if, when, or how these disputes will be resolved.

The second exception is with respect to the risk factor entitled, "*If Sears Holdings' perceived financial condition were to significantly deteriorate, our ability to operate our business and our financial performance could be materially and adversely affected*" that is included in "Risk Factors" in the 2013 10-K. At any time one or more of Sears Holdings' vendors could take one or more of the following actions with respect to Sears Holdings based on the vendors' assessments of Sears Holdings' willingness or ability to meet its obligations to pay for merchandise purchases as they become due: (i) reduce or cease altogether the vendors' sales of major home appliances, lawn and garden equipment, tools, and other merchandise, which could reduce or eliminate our purchases from Sears Holdings of the vendors' merchandise; (ii) increase the vendors' merchandise prices, which could result in higher prices for the merchandise to be purchased by us from Sears Holdings; (iii) reduce or cease altogether the vendors' allowances, subsidies, and other vendor promotional support, which could reduce our receipt of vendor promotional support from Sears Holdings; or (iv) take other adverse merchandise-related actions. If one or more of the foregoing events were to occur, the event or events could have a material adverse effect on our results of operations, financial condition, liquidity, and cash flows.

The third exception is with respect to the risk factor entitled, "*Our operating results are tied in part to the success of our dealers and franchisees, and the inability of our dealers and franchisees to continue operating their stores profitably could adversely affect our operating results*" that is included in "Risk Factors" in the 2013 10-K. We may reacquire one or more stores from our franchisees from time to time and establish reserves for, write down, or write off associated franchisee receivables if the franchisees are unable to operate their stores profitably or in a manner consistent with our concepts and standards or are otherwise unwilling to meet their obligations to us.

The risks described in the preceding paragraphs and in "Risk Factors" beginning on page 8 of the 2013 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 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.

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 13 weeks ended November 1, 2014. As of November 1, 2014 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 6. Exhibits**

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

Sears Hometown and Outlet Stores, Inc.

**Name:** Ryan D. Robinson

Date: December 4, 2014

**SEARS HOMETOWN AND OUTLET STORES, INC.**  
**EXHIBIT INDEX**

| <b>Exhibit Number</b> | <b>Document Description</b>   |
|-----------------------|---|
| *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 November 1, 2014, formatted in XBRL (eXtensible Business Reporting Language) and furnished electronically herewith: (i) the Condensed Consolidated Statements of Operations (Unaudited) for the 13 and 39 Weeks Ended November 1, 2014 and November 2, 2013; (ii) the Condensed Consolidated Balance Sheets (Unaudited) at November 1, 2014, November 2, 2013, and February 1, 2014; (iii) the Condensed Consolidated Statements of Cash Flows (Unaudited) for the 39 Weeks Ended November 1, 2014 and November 2, 2013; (iv) the Condensed Combined Statements of Stockholders' Equity (Unaudited) for the 39 Weeks Ended November 1, 2014 and November 2, 2013; 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.