UNITED STATES

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

☒ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
FOR THE QUARTERLY PERIOD ENDED MAY 3, 2014

OR

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

Commission file number 001-35641

SEARS HOMETOWN AND OUTLET STORES, INC.
(Exact name of registrant as specified in its charter)

DELAWARE	**80-0808358**
(State or Other Jurisdiction of Incorporation or Organization)	**(I.R.S. Employer Identification No.)**
5500 TRILLIUM BOULEVARD, SUITE 501 **HOFFMAN ESTATES, ILLINOIS**	**60192**
(Address of principal executive offices)	**(Zip Code)**

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

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 June 5, 2014, the registrant had 22,749,936 shares of common stock, par value $0.01 per share, outstanding.

SEARS HOMETOWN AND OUTLET STORES, INC.
INDEX TO QUARTERLY REPORT ON FORM 10-Q
13 Weeks Ended May 3, 2014 and May 4, 2013

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

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

Thousands, except per share amounts	13 Weeks Ended May 3, 2014	13 Weeks Ended May 4, 2013
NET SALES	$ 589,854	$ 601,117
COSTS AND EXPENSES		
Cost of sales and occupancy	445,955	446,869
Selling and administrative	135,279	127,188
Depreciation	2,288	2,341
Total costs and expenses	583,522	576,398
Operating income	6,332	24,719
Interest income (expense)	(934)	(589)
Other income	680	415
Income before income taxes	6,078	24,545
Income tax expense	(2,399)	(9,548)
NET INCOME	$ 3,679	$ 14,997
NET INCOME PER COMMON SHARE ATTRIBUTABLE TO STOCKHOLDERS		
Basic:	$ 0.16	$ 0.65
Diluted:	$ 0.16	$ 0.65
Basic weighted average common shares outstanding	22,666	23,100
Diluted weighted average common shares outstanding	22,666	23,100

See Notes to Condensed Consolidated Financial Statements.

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

Thousands	May 3, 2014	May 4, 2013	February 1, 2014
ASSETS			
CURRENT ASSETS			
Cash and cash equivalents	$ 23,145	$ 27,465	$ 23,475
Accounts receivable	23,233	14,105	19,252
Merchandise inventories	493,203	464,576	482,107
Prepaid expenses and other current assets	13,146	11,013	13,216
Total current assets	552,727	517,159	538,050
PROPERTY AND EQUIPMENT, net	50,303	50,782	48,973
GOODWILL	167,000	167,000	167,000
LONG-TERM DEFERRED TAXES	50,489	67,534	52,672
OTHER ASSETS	42,668	25,818	40,490
TOTAL ASSETS	$ 863,187	$ 828,293	$ 847,185
LIABILITIES			
CURRENT LIABILITIES			
Short-term borrowings	$ 98,100	$ 47,300	$ 99,100
Payable to Sears Holdings Corporation	86,170	88,794	68,396
Accounts payable	21,038	25,424	24,129
Other current liabilities	59,090	80,404	60,319
Current portion of capital lease obligations	490	1,257	662
Total current liabilities	264,888	243,179	252,606
CAPITAL LEASE OBLIGATIONS	62	516	95
OTHER LONG-TERM LIABILITIES	4,047	3,314	4,259
TOTAL LIABILITIES	268,997	247,009	256,960
COMMITMENTS AND CONTINGENCIES (Note 7)			
STOCKHOLDERS' EQUITY			
TOTAL STOCKHOLDERS' EQUITY	594,190	581,284	590,225
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$ 863,187	$ 828,293	$ 847,185

See Notes to Condensed Consolidated Financial Statements.

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

Thousands	13 Weeks Ended May 3, 2014	13 Weeks Ended May 4, 2013
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	$ 3,679	$ 14,997
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation	2,288	2,341
Share-based compensation	286	—
Change in operating assets and liabilities:		
Accounts receivable	(6,340)	(6,478)
Merchandise inventories	(11,096)	(36,139)
Payable to Sears Holdings Corporation	17,774	9,303
Accounts payable	(3,091)	(6,406)
Customer deposits	(1,685)	5,030
Deferred income taxes	2,440	4,843
Other operating assets	317	1,347
Other operating liabilities	210	(7,316)
Net cash provided by (used in) operating activities	4,782	(18,478)
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchases of property and equipment	(3,940)	(1,009)
Net cash used in investing activities	(3,940)	(1,009)
CASH FLOWS FROM FINANCING ACTIVITIES		
Payments of capital lease obligations	(172)	(416)
Net short-term borrowings (payments)	(1,000)	27,300
Net cash provided by (used in) financing activities	(1,172)	26,884
NET CHANGE IN CASH AND CASH EQUIVALENTS	(330)	7,397
CASH AND CASH EQUIVALENTS—Beginning of period	23,475	20,068
CASH AND CASH EQUIVALENTS—End of period	$ 23,145	$ 27,465
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION		
Cash paid for interest	$ 822	$ 589
Cash paid for income taxes	$ 105	$ 3,595

See Notes to Condensed Consolidated Financial Statements.

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

Thousands	Number of Shares of Common Stock	Common Stock	Capital in Excess of Par Value	Retained Earnings	Total Stockholders' Equity
Balance at February 2, 2013	23,100	$ 231	$ 556,575	$ 9,481	$ 566,287
Net income	—	—	—	14,997	14,997
Balance at May 4, 2013	23,100	$ 231	$ 556,575	$ 24,478	$ 581,284
Balance at February 1, 2014	22,753	228	547,021	42,976	590,225
Net income		—	—	3,679	3,679
Share-based compensation	(3)	(1)	287	—	286
Balance at May 3, 2014	22,750	$ 227	$ 547,308	$ 46,655	$ 594,190

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 May 3, 2014 the Company and its dealers and franchisees operated 1,250 stores across all 50 states and in Puerto Rico and Bermuda. In these notes and in the other items of 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 on August 31, 2012, 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 SHO, which was formed on April 23, 2012 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 the Company 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. 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 May 3, 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 first fiscal quarter end is the Saturday closest to April 30 each year.

Fair Value of Financial Instruments

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

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

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 risk and default rates.

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

Cash and cash equivalents (level 1), accounts 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 rate is a significant input in our fair value assessments.

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

The Company was not required to measure any other significant non-financial asset or liability at fair value as of May 3, 2014.

Recent Accounting Pronouncements

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

In April 2014, the Financial Accounting Standards Board ("FASB") issued an accounting standards update which modifies the requirements for disposals to qualify as discontinued operations and expands related disclosure requirements. The update will be effective in the first quarter of 2015 and is not expected to have a material impact on our consolidated financial position, results of operations, or cash flows.

Revenue from Contracts with Customers

In May 2014, the FASB issued an accounting standards update which establishes a comprehensive revenue recognition standard for virtually all industries in U.S. GAAP, including those that previously followed industry-specific guidance such as the real estate, construction and software industries. The update is effective in 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—OTHER CURRENT AND LONG-TERM LIABILITIES

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

Thousands	May 3, 2014	May 4, 2013	February 1, 2014
Customer deposits	33,862	39,945	35,547
Sales and other taxes	13,690	15,142	11,403
Accrued expenses	8,551	23,068	9,523
Payroll and related items	7,034	5,563	8,105
Total Other current and long-term liabilities	$ 63,137	$ 83,718	$ 64,578

NOTE 3—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 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 is responsible for any federal, state, or foreign tax liability. Current income taxes payable for any federal, state, or foreign income tax returns is reported in the period incurred.

We account for uncertainties in income taxes according to accounting standards for uncertain tax positions. The Company is present in a large number of taxable jurisdictions and, at any point in time, can have audits underway at various stages of completion in one or more of these jurisdictions. We evaluate our tax positions and establish liabilities for uncertain tax positions that may be challenged by local authorities and may not be fully sustained, despite our belief that the underlying tax positions are fully supportable. Unrecognized tax benefits are reviewed on an ongoing basis and are adjusted in light of changing facts and circumstances, including progress of tax audits, developments in case law, and closings of statutes of limitation. Such adjustments are reflected in the tax provision as appropriate. Pursuant to the Tax Sharing Agreement, Sears Holdings is responsible for any unrecognized tax liability or benefit through the date of the Separation and the Company is responsible for any uncertain tax position after the Separation. For the 13 weeks ended May 3, 2014 and May 4, 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 income.

As part of the Separation on August 31, 2012, 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 the Sears Outlet businesses to SHO. In connection with the intercompany transactions, for tax purposes the transferred assets and liabilities were stepped up to their estimated fair market values as of August 31, 2012, but for financial statement purposes the book value of the assets and liabilities remained unchanged at their historical cost bases. As of May 3, 2014 the Company's net deferred tax asset balance was $55.6 million compared to $71.8 million as of May 4, 2013 and $58.0 million as of February 1, 2014.

NOTE 4—RELATED-PARTY AGREEMENTS AND TRANSACTIONS

According to publicly available information ESL Investments, Inc. and its investment affiliates, including Edward S. Lampert (collectively, “ESL”), beneficially owned on the filing date approximately 49.8% of our outstanding shares of common stock. According to publicly available information, ESL beneficially owns approximately 48.4% 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 following the Separation, (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 providing the applicable services itself. The Company engages in frequent discussions 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. These discussions from time to time result in adjustments to the relationships that the Company believes together are in Company's best interests.

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 and 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 certain transactions SHO pays a commission to Sears Holdings.
- We obtain a significant amount of our merchandise inventories from Sears Holdings, leveraging the benefit of the Sears Holdings purchasing activities. 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.
- We have also entered into agreements with Sears Holdings for logistics, handling, warehouse, and transportation services, the charges for which are based on merchandise inventory units.
- Sears Holdings provides the Company with specified corporate services. These services include accounting and finance, human resources, information technology, and real estate. Sears Holdings charges the Company for these corporate services based on actual usage or a pro rata charge based upon sales, head count, or square footage.

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

	13 Weeks Ended	
Thousands	May 3, 2014	May 4, 2013
Net Commissions from Sears Holdings Corporation (1)	$ 28,169	$ 22,766
Purchases related to cost of sales and occupancy	407,510	428,496
Services	5,415	5,126

(1) We reduced the amount previously presented for the 13 weeks ended May 4, 2013 to exclude all transactions in which SHO received the entire sales revenue for on-line sales made to unrelated third-parties that were generated through Sears Holdings' websites. The excluded amount for the 13 weeks ended May 4, 2013 was $16.6 million.

We incur payables to Sears Holdings for merchandise inventory purchases and service and occupancy charges (net of commissions) based on our Separation agreements. Amounts due to or from Sears Holdings are non-interest bearing, settled on a net basis, and have payments terms of 10 days after the invoice date.

NOTE 5—FINANCING ARRANGEMENT

As of May 3, 2014 we had $98.1 million outstanding under the Senior ABL Facility, which approximated the fair value of these borrowings. The Senior ABL Facility provides (subject to availability under a borrowing base) for maximum borrowings up to the aggregate commitments of all of the lenders, which as of May 3, 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 May 3, 2014 was $146.3 million, with $5.6 million of letters of credit outstanding under the facility.

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

Senior ABL Facility

Maturity; Amortization and Prepayments

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

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

Guarantees; Security

The obligations under the Senior ABL Facility are guaranteed by us and each of our existing and future direct and indirect wholly owned domestic subsidiaries (subject to certain exceptions). The Senior ABL Facility and the guarantees thereunder are secured by a first priority security interest in certain assets of the borrowers and guarantors consisting primarily of accounts 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, approximately 2.40% at May 3, 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, approximately 4.50% at May 3, 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, and change of control.

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

NOTE 6—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." The Outlet reportable segment also represents an operating 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 $3.3 million and $5.2 million for the 13 weeks ended May 3, 2014 and May 4, 2013, respectively).

	13 Weeks Ended May 3, 2014		
Thousands	Hometown	Outlet	Total
Net sales			
Appliances	$ 245,526	$ 137,528	$ 383,054
Lawn and garden	95,340	4,891	100,231
Tools and paint	46,137	4,491	50,628
Other	31,533	24,408	55,941
Total	418,536	171,318	589,854
Costs and expenses			
Cost of sales and occupancy	312,154	133,801	445,955
Selling and administrative	98,837	36,442	135,279
Depreciation	651	1,637	2,288
Total	411,642	171,880	583,522
Operating income (loss)	$ 6,894	$ (562)	$ 6,332
Total assets	$ 658,267	$ 204,920	$ 863,187
Capital expenditures	$ 679	$ 3,261	$ 3,940

	13 Weeks Ended May 4, 2013		
Thousands	Hometown	Outlet	Total
Net sales			
Appliances	$ 275,407	$ 124,263	$ 399,670
Lawn and garden	96,008	5,946	101,954
Tools and paint	47,691	3,443	51,134
Other	25,697	22,662	48,359
Total	444,803	156,314	601,117
Costs and expenses			
Cost of sales and occupancy	333,884	112,985	446,869
Selling and administrative	100,141	27,047	127,188
Depreciation	866	1,475	2,341
Total	434,891	141,507	576,398
Operating income	$ 9,912	$ 14,807	$ 24,719
Total assets	$ 666,132	$ 162,161	$ 828,293
Capital expenditures	$ 624	$ 385	$ 1,009

NOTE 7—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 8—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.

Thousands except income per common share	13 Weeks Ended May 3, 2014	13 Weeks Ended May 4, 2013
Basic weighted average shares	22,666	23,100
Dilutive effect of restricted stock	—	—
Diluted weighted average shares	22,666	23,100
Net income	$ 3,679	$ 14,997
Income per common share:		
Basic	$ 0.16	$ 0.65
Diluted	$ 0.16	$ 0.65

NOTE 9—EQUITY

Stock-based Compensation

At the Company's Annual Meeting of Stockholders held on May 14, 2013 the stockholders approved the Sears Hometown and Outlet Stores, Inc. Amended and Restated 2012 Stock Plan. Four million shares of the Company's common stock are reserved for issuance under the plan. A total of 89,221 shares of restricted stock were granted in the second quarter of 2013 under the plan 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. 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. The Company has made no stock-option or other 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 quarter of 2014 we recorded $0.3 million in total compensation expense related to the 84,334 shares of restricted stock (none of which had vested and excluding 4,887 shares forfeited as of May 3, 2014). At May 3, 2014, we had $2.6 million in total unrecognized compensation cost related to the 84,334 shares of non-vested restricted stock, which cost we expect to recognize over approximately the next two years.

The 84,334 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:

	13 Weeks Ended May 3, 2014	
(Shares in Thousands)	Shares	Weighted-Average Fair Value on Date of Grant
Beginning of year balance	87	44.45
Granted	—	$ —
Vested	—	—
Forfeited	(3)	44.45
Balance at 5/3/2014	84	$ 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 13 weeks ended May 3, 2014. At May 3, 2014 we had $12.5 million of remaining authorization under the repurchase program.

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

The following discussion should be read in conjunction with the Consolidated Financial Statements and notes contained in our Annual Report on Form 10-K for the fiscal year ended February 1, 2014. 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 May 3, 2014, we and our dealers and franchisees operated 1,250 stores across all 50 states, Puerto Rico, and Bermuda. In the first quarter of 2014, the Company opened 8 new stores and closed 18 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 May 3, 2014, Hometown consisted of 1,105 stores as follows:

- 921 Sears Hometown Stores—Primarily independently owned 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.
- 84 Sears Hardware Stores—Hardware 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.
- 100 Sears Home Appliance Showrooms—Stores that have a simple, primarily appliance showroom design that are positioned in metropolitan areas.

As of May 3, 2014, Hometown operated through 918 dealer-operated stores, 158 franchisee-operated stores, and 29 Company-operated stores. The business model and economic structure of the dealer-operated and franchisee-operated stores, which are independently owned, are substantially similar to Company-operated stores. The Company requires all stores to operate according to the Company's standards. 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 on the owners. The Company owns the merchandise, 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 when the dealers and franchisees sell the merchandise and provide services.

Historically, all of the Company's Outlet stores have been owned by the Company. The Company began a trial program for franchising Outlet stores in late 2012. The initial franchise transfers under this program were completed in the first quarter of 2013 and, since that time, the Company has continued to franchise Outlet stores. As of May 3, 2014, 35 of the 145 Sears Outlet stores were operated by franchisees.

Dealers and franchisees exercise control over the day-to-day operations of their stores, including supervising management and employees and making capital decisions.

The primary difference between Company-operated stores and dealer/franchisee-operated stores is that the Company is responsible for occupancy and payroll costs associated with Company-owned stores. Dealers and franchisees are responsible for the occupancy costs in their stores and the payrolls of their employees, and we pay commissions to the 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 store locations may be identified by the Company, an existing dealer or franchisee, or a potential dealer or franchisee. If the Company identifies and develops a location, it will generally seek to transfer that store to a dealer or franchisee. When a dealer or franchisee exits a location, the Company may take over the operation of a store, generally on an interim basis, until the location can be transferred 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 locations due to the expected short-term nature of transition operation.

The Company's sale of a store to a franchisee generally will increase the Company's gross margin and increase the Company's selling and administrative expense, as the Company's cost of occupancy, which is reflected in cost of sales and occupancy, will be reduced, while the Company's commission payments, which are reflected in selling and administrative expense, will increase. The increase in commission payments will be partially offset by lower payroll and benefits expense.

Initial franchise revenues consist of franchise fees paid with respect to new and existing Company-operated stores that we transfer to franchisees plus the net gain or loss on any related transfer 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 is driven by 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 returns on new store development and the number of Company-operated locations available for sale to franchisees. Initial franchise revenues were $3.3 million and $5.2 million in the first quarter of 2014 and 2013, respectively.

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. Additional data on the revenue, cost, and net income seasonality of the business is available in the Quarterly Financial Data in Note 9 to our Annual Report on Form 10-K for the fiscal year ended February 1, 2014.

Results of Operations

The following table sets forth items derived from our consolidated results of operations for the 13 weeks ended May 3, 2014 and May 4, 2013.

	13 Weeks Ended	
Thousands	**May 3, 2014**	**May 4, 2013**
NET SALES	$ 589,854	$ 601,117
COSTS AND EXPENSES		
Cost of sales and occupancy	445,955	446,869
Gross margin dollars	143,899	154,248
Margin rate	*24.4%*	*25.7%*
Selling and administrative	135,279	127,188
Selling and administrative expense as a percentage of net sales	*22.9%*	*21.2%*
Depreciation	2,288	2,341
Total costs and expenses	583,522	576,398
Operating income	6,332	24,719
Interest income (expense)	(934)	(589)
Other income	680	415
Income before income taxes	6,078	24,545
Income tax expense	(2,399)	(9,548)
NET INCOME	$ 3,679	$ 14,997

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 recorded by SHO and also include 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 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 only received commissions. 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 and that were fulfilled and recorded by Sears Holdings.
- During the first quarter of 2014, these sales fulfilled and recorded by Sears Holdings increased significantly to $29.4 million compared to $7.7 million in the first quarter of 2013.
- Unadjusted comparable store sales, which do not include in-store sales that were transacted by SHO through www.sears.com and that were fulfilled and recorded by Sears Holding, understates what SHO believes to be its effective comparable store sales performance.

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

SEARS HOMETOWN AND OUTLET STORES, INC.
13 Weeks Ended May 3, 2014 and May 4, 2013

	13 Weeks Ended May 3, 2014		
Thousands	**Hometown**	**Outlet**	**Total**
Net sales	$ 418,536	$ 171,318	$ 589,854
Less: Non-comparable store sales	(48,416)	(36,921)	(85,337)
Comparable store sales recorded by SHO	370,120	134,397	504,517
SHO in-store sales through www.sears.com fulfilled and recorded by Sears Holdings (1)	22,692	4,015	26,707
Adjusted comparable store sales	$ 392,812	$ 138,412	$ 531,224

	13 Weeks Ended May 4, 2013		
Thousands	**Hometown**	**Outlet**	**Total**
Net sales	$ 444,803	$ 156,314	$ 601,117
Less: Non-comparable store sales	(44,811)	(18,325)	(63,136)
Comparable store sales recorded by SHO	399,992	137,989	537,981
SHO in-store sales through www.sears.com recorded by Sears Holdings (1)	6,815	662	7,477
Adjusted comparable store sales	$ 406,807	$ 138,651	$ 545,458

	13 Weeks Ended May 3, 2014 vs. 13 Weeks Ended May 4, 2013		
	Hometown	**Outlet**	**Total**
Comparable store sales recorded by SHO	(7.5)%	(2.6)%	(6.2)%
Adjusted comparable store sales	(3.4)%	(0.2)%	(2.6)%

(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, total sales are $29.4 million in the first quarter of 2014 and $7.7 million in the first quarter of 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.

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:

SEARS HOMETOWN AND OUTLET STORES, INC.
13 Weeks Ended May 3, 2014 and May 4, 2013

	13 Weeks Ended	
Thousands	May 3, 2014	May 4, 2013
Net income	$ 3,679	$ 14,997
Income tax expense	2,399	9,548
Other income	(680)	(415)
Interest expense	934	589
Operating income	6,332	24,719
Depreciation	2,288	2,341
Adjusted EBITDA	$ 8,620	$ 27,060

13-Week Period Ended May 3, 2014 Compared to the 13-Week Period Ended May 4, 2013

Net Sales

Net sales in the first quarter of 2014 decreased $11.3 million, or 1.9%, to $589.9 million from the first quarter of 2013. This decrease was driven primarily by a 6.2% decrease in comparable store sales, lower initial franchise revenues (which were $3.3 million in the first quarter of 2014 compared to $5.2 million in the first quarter of 2013), and lower liquidation revenues on end-of-season markout apparel merchandise received from Sears Holdings. Partially offsetting these declines were sales from 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 ($9.0 million in the first quarter of 2014 compared to $2.3 million in the first quarter 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 through www.sears.com and recorded and fulfilled by Sears Holdings during the first quarter of 2014 were $29.4 million compared to $7.7 million in the first 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 first quarter of 2014 decreased 2.6% primarily due to lower home appliances sales. Comparable store sales in the Hometown segment were down 7.5% while comparable store sales in the Outlet segment were down 2.6%. Adjusted comparable store sales were down 3.4% in Hometown and down 0.2% in Outlet. In-store sales transacted by SHO through www.sears.com and recorded by Sears Holdings are not expected to continue at the same rate in future quarters.

Gross Margin

Gross margin was $143.9 million, or 24.4% of net sales, in the first quarter of 2014 compared to $154.2 million, or 25.7% of net sales, in the first quarter of 2013. The decrease in gross margin rate was primarily driven by (1) lower margins on merchandise sales, (2) $3.5 million of higher inventory shrinkage in Outlet, (3) a decrease in initial franchise revenues, (4) $2.1 million of additional Outlet distribution center costs, and (5) lower Outlet apparel liquidation income. These declines were partially offset by the increase in online commissions, lower occupancy costs resulting from the conversion of Company-operated stores to franchisee-operated stores, and higher delivery income. Excluding the impact of online commissions, gross margin was 23.2% of net sales in the first quarter of 2014 compared to 25.4% of net sales in the first quarter of 2013.

Selling and Administrative Expenses

Selling and administrative expenses increased to $135.3 million, or 22.9% of net sales, in the first quarter of 2014 from $127.2 million, or 21.2% of net sales, in the prior-year quarter. The increase was primarily due to higher owner commissions in both Hometown and Outlet (primarily related to the conversion of Company-operated stores to franchisee-operated stores), new stores opened since the first quarter of 2013, and higher marketing costs partially offset by lower payroll and benefits costs resulting from the conversion of Company-operated stores and a reduction of $2.1 million of Outlet distribution center costs.

Operating Income

We recorded operating income of $6.3 million and $24.7 million in the first quarters of 2014 and 2013, respectively. The $18.4 million decrease in operating income was driven by the above-mentioned lower net sales, lower gross margin rate, and higher selling and administrative expenses.

Income Taxes

Income tax expense of $2.4 million and $9.5 million was recorded in the first quarters of 2014 and 2013, respectively. The effective tax rate was 39.5% and 38.9% in the first quarter of 2014 and 2013, respectively.

Net Income

We recorded net income of $3.7 million for the first quarter of 2014 compared to $15.0 million for the prior-year quarter. 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	
Thousands, except for number of stores	May 3, 2014	May 4, 2013
Net sales	$ 418,536	$ 444,803
Comparable store sales % (1)	*(7.5)%*	*(6.9)%*
Cost of sales and occupancy	312,154	333,884
Gross margin dollars	106,382	110,919
Margin rate	*25.4 %*	*24.9 %*
Selling and administrative	98,837	100,141
Selling and administrative expense as a percentage of net sales	*23.6 %*	*22.5 %*
Depreciation	651	866
Total costs and expenses	411,642	434,891
Operating income	$ 6,894	$ 9,912
Total Hometown stores	1,105	1,126

(1) Adjusted comparable store sales for the 13 weeks ended May 3, 2014 were (3.4)%.

13-Week Period ended May 3, 2014 Compared to the 13-Week Period Ended May 4, 2013

Net Sales

Hometown net sales decreased $26.3 million, or 5.9%, to $418.5 million in the first quarter of 2014 from $444.8 million in the first quarter of 2013. The decrease was primarily due to a 7.5% decrease in comparable store sales and a reduction in initial franchise revenues partially offset by an increase in online commissions ($7.7 million in the first quarter of 2014 compared to $2.1 million in the first quarter of 2013). Adjusted comparable store sales for the first quarter of 2014, which includes in-store sales transacted through www.sears.com that were fulfilled and recorded by Sears Holdings, decreased 3.4% primarily due to declines in major appliances.

Gross Margin

Gross margin was $106.4 million, or 25.4% of net sales, in the first quarter of 2014 compared to $110.9 million, or 24.9% of net sales, in the prior-year quarter. The increase in gross margin rate was primarily driven by higher online commissions, higher delivery income, and lower occupancy costs resulting from the conversion of Company-owned stores to franchisee-owned stores. Partially offsetting these increases are lower margins on merchandise sales and lower initial franchise revenues. Excluding the impact of online commissions, gross margin was 24.0% of net sales in the first quarter of 2014 compared to 24.6% of net sales in the first quarter of 2013.

Selling and Administrative Expenses

Selling and administrative expenses decreased to $98.8 million, or 23.6% of net sales, in the first quarter of 2014 from $100.1 million, or 22.5% of net sales, in the prior-year quarter. The decrease was primarily due to a reduction in payroll and benefits related to the conversion of Company-operated stores to franchisee-operated stores partially offset by higher owner commissions mainly related to the Company-operated store conversions.

Operating Income

We recorded operating income of $6.9 million in the first quarter of 2014 and operating income of $9.9 million in the first quarter of 2013. The overall decrease in operating income of $3.0 million was driven by the decrease in sales partially offset by an increase in the gross margin rate and a reduction in selling and administrative expenses.

Outlet

Outlet results and key statistics were as follows:

	13 Weeks Ended	
Thousands, except for number of stores	May 3, 2014	May 4, 2013
Net sales	$ 171,318	$ 156,314
Comparable store sales % (1)	*(2.6)%*	*1.2%*
Cost of sales and occupancy	133,801	112,985
Gross margin dollars	37,517	43,329
Margin rate	*21.9 %*	*27.7%*
Selling and administrative	36,442	27,047
Selling and administrative expense as a percentage of net sales	*21.3 %*	*17.3%*
Depreciation	1,637	1,475
Total costs and expenses	171,880	141,507
Operating income (loss)	$ (562)	$ 14,807
Total Outlet stores	145	127

(1) Adjusted comparable store sales for the 13 weeks ended May 3, 2014 were (0.2)%.

13-Week Period ended May 3, 2014 Compared to the 13-Week Period Ended May 4, 2013

Net Sales

Outlet net sales increased $15.0 million, or 9.6%, to $171.3 million in the first quarter of 2014 from $156.3 million in the first quarter of 2013. The increase was primarily due to new store sales (net of closures), higher online commissions ($1.3 million in the first quarter of 2014 compared to $0.2 million in the first quarter of 2013), higher protection agreement sales, and higher initial franchise revenues. These increases were partially offset by a 2.6% decrease in comparable store sales and lower apparel liquidation revenues. Adjusted comparable store sales for the first quarter of 2014, which includes in-store sales transacted through www.sears.com that were fulfilled and recorded by Sears Holdings, decreased 0.2%. The decline was driven by lower sales in apparel due to inventory availability and reduction of floor space resulting from expansion in other categories, lower sales in lawn and garden and in sporting goods due to the availability of opportunity buys and inventory flow, and lower sales in mattresses primarily due to pricing and promotional changes and inventory flow. These decreases were partially offset by increases in major appliances driven by the cooking and refrigeration categories and higher sales in furniture due to category expansion.

Gross Margin

Gross margin was $37.5 million, or 21.9% of net sales, in the first quarter of 2014 compared to $43.3 million, or 27.7% of net sales, in the prior-year quarter. The gross margin rate decreased in the first quarter of 2014 compared to the prior-year quarter primarily due to lower margins on merchandise sales, $3.5 million of higher inventory shrinkage, $2.1 million of additional distribution center costs, and lower Outlet apparel liquidation income. These declines were partially offset by lower occupancy costs resulting from the conversion of Company-operated stores to franchisee-operated stores and higher online commissions. Excluding the impact of online commissions, gross margin was 21.3% of net sales in the first quarter of 2014 compared to 27.6% of net sales in the first quarter of 2013.

Selling and Administrative Expenses

Selling and administrative expenses increased to $36.4 million, or 21.3% of net sales, in the first quarter of 2014 from $27.0 million, or 17.3% of net sales, in the prior-year quarter. The increase in selling and administrative expenses is primarily due to higher franchisee commissions for stores that we converted from Company-operated to franchisee-operated, new stores opened since the first 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 and a reduction of $2.1 million of distribution center costs.

Operating Income

We recorded an operating loss of $0.6 million in the first quarter of 2014 compared to recording operating income of $14.8 million in the first quarter of 2013. The decrease in operating income of $15.4 million was driven primarily by a lower gross profit rate and higher selling and administrative expenses partially offset by higher sales.

Analysis of Financial Condition

Cash and Cash Equivalents

We had cash and cash equivalents of $23.1 million as of May 3, 2014, $27.5 million as of May 4, 2013, and $23.5 million as of February 1, 2014.

For the first 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, capital expenditures and for general corporate purposes.

Cash Flows from Operating Activities

For the quarter ended May 3, 2014 cash provided by operating activities was $4.8 million compared to $18.5 million used in the quarter ended May 4, 2013. The increase in operating cash flows compared to 2013 was due predominately to a reduction in investments in inventory and an increase in payables in the first quarter of 2014 compared to the first quarter of 2013 partially offset by a lower net income.

Total merchandise inventories were $493.2 million at May 3, 2014 and $464.6 million at May 4, 2013. Merchandise inventories increased primarily due to a $27.6 million increase in Outlet and a $1.0 million increase in Hometown. The increase in Outlet was primarily due to (1) higher home appliance inventories; (2) an increased store count due to new store openings; (3) an increase in furniture inventory due to category expansion and (4) higher apparel inventory as stores returned to more customary inventory levels.

We obtain our merchandise through agreements with Sears Holdings and with other vendors. For the quarter ended May 3, 2014, merchandise acquired from subsidiaries of Sears Holdings (including Kenmore, Craftsman, DieHard, and other products) accounted for approximately 84% of total purchases of all inventory from all vendors. 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.

In addition, our merchandise-vendor arrangements generally are not long-term agreements (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 on maintaining good relations with our existing vendors and on developing relationships with new vendors, especially with respect to merchandise inventory to be sold by Outlet. If we fail to maintain our relations with our existing vendors or 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 would have a negative impact on our competitive position. 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 $3.9 million for the first quarter of 2014 compared to $1.0 million for the first quarter 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 $1.2 million for the 13 weeks ended May 3, 2014 compared to $26.9 million provided during the 13 weeks ended May 4, 2013. The decrease of $28.1 million in cash provided by financing activities was primarily due to a reduction of $1.0 million in net borrowings under our Senior ABL Facility in the first quarter of 2014 compared to an increase of $27.3 million in the first quarter of 2013.

Financing Arrangements

As of May 3, 2014, we had $98.1 million outstanding under the Senior ABL Facility, which approximated the fair value of these borrowings. The Senior ABL Facility provides (subject to availability under a borrowing base) for maximum borrowings up to the aggregate commitments of all of the lenders, which as of May 3, 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 May 3, 2014 was $146.3 million with $5.6 million of letters of credit outstanding under the facility.

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

Senior ABL Facility

Maturity; Amortization and Prepayments

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

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

Guarantees; Security

The obligations under the Senior ABL Facility are guaranteed by us and each of our existing and future direct and indirect wholly owned domestic subsidiaries (subject to certain exceptions). The Senior ABL Facility and the guarantees thereunder are secured by a first priority security interest in certain assets of the borrowers and guarantors consisting primarily of accounts 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 2.40% at May 3, 2014, or (2) an alternate base rate plus a borrowing margin, approximately 4.50% at May 3, 2014, with the borrowing margin subject to adjustment based on the average excess availability under the 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 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 May 3, 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.

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 May 3, 2014, we had cash and cash equivalents of $23.1 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 May 3, 2014 and May 4, 2013 were $0.6 million and $1.8 million, respectively.

Off-Balance Sheet Arrangements

As of May 3, 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.

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, could cause our actual results, performance or achievements to differ from those set forth in the forward-looking statements:

- our continued reliance on Sears Holdings for most products and services that are important to the successful operation of our business;
- our continuing dependence on Sears Holdings subsequent to the Separation, and our potential need to depend on Sears Holdings beyond the expiration or earlier termination by Sears Holdings of certain of our agreements with Sears Holdings;
- 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:");
- our merchandising agreement with Sears Holdings 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 and the occurrence of which could have a material adverse effect on our ability to operate our business and a material adverse effect on our results of operations and financial condition;
- the possible material adverse 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;
- 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 that were associated with having been wholly owned by Sears Holdings and its subsidiaries;
- our agreements related to the Separation and our continuing relationship with Sears Holdings were negotiated while we were a subsidiary of Sears Holdings and we may have received different terms from unaffiliated third parties (including with respect to merchandise-vendor and service-provider

indemnification and defense for negligence claims and claims arising out of failure to comply with contractual obligations);

- our reliance on Sears Holdings to provide computer systems to process transactions with our customers (including the point-of-sale system for the stores we operate and the stores that our independent dealers and franchisees operate, which point-of-sale system captures, among other things, credit-card information supplied by our customers) and others, quantify our results of operations, and manage our business ("SHO's SHC-Supplied Systems");
- SHO's SHC-Supplied Systems 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, which could have one or more material adverse effects on us;
- the ability and willingness of Sears Holdings to perform its contractual obligations to us;
- our ability to successfully resolve existing and, if any arise, future contractual disputes with Sears Holdings;
- 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 goodwill or 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 an independent company;
- our ability to maintain effective internal controls as a public company;
- our ability to realize the benefits that we expect to achieve from the Separation;
- 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 other filings with the Securities and Exchange Commission and our other public announcements. While we believe that our forecasts and assumptions are reasonable, we caution that actual results may differ materially. If one or more of these or other risks or uncertainties materialize, or if our underlying assumptions prove to be incorrect, actual results may vary materially from what we projected. Consequently, actual events and results may vary significantly from those included in or contemplated or implied by our forward-looking statements. The forward-looking statements included in this Quarterly Report on Form 10-Q are made only as of the date of this Quarterly Report on Form 10-Q, and 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 principal financial officer, we conducted an evaluation of our disclosure controls and procedures, as such term is defined under 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 May 3, 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, employment discrimination, unlawful employment practices, Americans with Disabilities Act claims, product liability claims as a result of the sale of merchandise and services, claims with respect to franchise and dealer transactions and relationships, as well as various legal and governmental proceedings. 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" 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 our Annual Report on Form 10-K for the fiscal year ended February 1, 2014. However, the risks described in “Risk Factors” beginning on page 8 of our Annual Report on Form 10-K for the fiscal year ended February 1, 2014 should be carefully considered. Those risks could materially affect our business, results of operations, or financial condition. 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.

No shares were repurchased during the 13 weeks ended May 3, 2014.

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.

SIGNATURE

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

Sears Hometown and Outlet Stores, Inc.

By:	/s/ STEVEN D. BARNHART
Name:	**Steven D. Barnhart**
Title:	**Senior Vice President and Chief Financial Officer (Principal Financial Officer and Principal Accounting Officer)**

Date: June 5, 2014

SEARS HOMETOWN AND OUTLET STORES, INC.
EXHIBIT INDEX

Exhibit Number	Document Description
*10	Amendment No. 2 to Services Agreement dated April 23, 2014 between Sears Holdings Management Corporation and Sears Hometown and Outlet Stores, Inc.
*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 May 3, 2014, formatted in XBRL (eXtensible Business Reporting Language) and furnished electronically herewith: (i) the Condensed Consolidated Statements of Income (Unaudited) for the 13 Weeks Ended May 3, 2014 and May 4, 2013; (ii) the Condensed Consolidated Balance Sheets (Unaudited) at May 3, 2014, May 4, 2013, and February 1, 2014; (iii) the Condensed Consolidated Statements of Cash Flows (Unaudited) for the 13 Weeks Ended May 3, 2014 and May 4, 2013; (iv) the Condensed Combined Statements of Stockholders' Equity (Unaudited) for the 13 Weeks Ended May 3, 2014 and May 4, 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.