
UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 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 JULY 30, 2016

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
(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

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 August 31, 2016, the registrant had 22,716,132 shares of common stock, par value \$0.01 per share, outstanding.

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

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

	13 Weeks Ended		26 Weeks Ended	
	July 30, 2016	August 1, 2015	July 30, 2016	August 1, 2015
<i>Thousands, except per share amounts</i>				
NET SALES	\$ 556,388	\$ 619,610	\$ 1,093,369	\$ 1,202,379
COSTS AND EXPENSES				
Cost of sales and occupancy	441,508	478,250	862,298	920,660
Selling and administrative	118,808	138,920	236,800	274,630
Depreciation and amortization	3,293	2,164	6,550	4,025
Gain on the sale of assets	(25,269)	—	(25,269)	—
Total costs and expenses	538,340	619,334	1,080,379	1,199,315
Operating income	18,048	276	12,990	3,064
Interest expense	(886)	(614)	(1,652)	(1,395)
Other income	378	560	775	1,242
Income before income taxes	17,540	222	12,113	2,911
Income tax expense	(6,898)	(627)	(5,042)	(2,024)
NET INCOME (LOSS)	\$ 10,642	\$ (405)	\$ 7,071	\$ 887
NET INCOME (LOSS) PER COMMON SHARE				
ATTRIBUTABLE TO STOCKHOLDERS				
Basic:	\$ 0.47	\$ (0.02)	\$ 0.31	\$ 0.04
Diluted:	\$ 0.47	\$ (0.02)	\$ 0.31	\$ 0.04
Basic weighted average common shares outstanding	22,696	22,666	22,681	22,666
Diluted weighted average common shares outstanding	22,699	22,666	22,682	22,666

See Notes to Condensed Consolidated Financial Statements.

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

<i>Thousands</i>	<u>July 30, 2016</u>	<u>August 1, 2015</u>	<u>January 30, 2016</u>
ASSETS			
CURRENT ASSETS			
Cash and cash equivalents	\$ 18,690	\$ 23,390	\$ 18,244
Accounts and franchisee receivables, net	17,017	13,583	11,753
Merchandise inventories	427,234	431,376	434,846
Prepaid expenses and other current assets	18,562	17,550	22,176
Total current assets	<u>481,503</u>	<u>485,899</u>	<u>487,019</u>
PROPERTY AND EQUIPMENT, net	50,898	48,936	49,315
INTANGIBLE ASSETS, net	2,376	—	4,377
LONG-TERM DEFERRED TAXES	74,984	53,904	79,141
OTHER ASSETS, net	13,117	43,395	13,981
TOTAL ASSETS	<u><u>\$ 622,878</u></u>	<u><u>\$ 632,134</u></u>	<u><u>\$ 633,833</u></u>
LIABILITIES			
CURRENT LIABILITIES			
Short-term borrowings	\$ 70,400	\$ 10,100	\$ 68,300
Payable to Sears Holdings Corporation	34,868	91,778	54,126
Accounts payable	38,418	29,463	39,762
Other current liabilities	66,667	75,755	66,466
Total current liabilities	<u>210,353</u>	<u>207,096</u>	<u>228,654</u>
OTHER LONG-TERM LIABILITIES	2,868	2,264	2,670
TOTAL LIABILITIES	<u>213,221</u>	<u>209,360</u>	<u>231,324</u>
COMMITMENTS AND CONTINGENCIES (Note 10)			
STOCKHOLDERS' EQUITY			
TOTAL STOCKHOLDERS' EQUITY	<u>409,657</u>	<u>422,774</u>	<u>402,509</u>
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	<u><u>\$ 622,878</u></u>	<u><u>\$ 632,134</u></u>	<u><u>\$ 633,833</u></u>

See Notes to Condensed Consolidated Financial Statements.

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

<i>Thousands</i>	26 Weeks Ended	
	July 30, 2016	August 1, 2015
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	\$ 7,071	\$ 887
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	6,550	4,025
Share-based compensation	77	(399)
Deferred income taxes	4,158	2,635
Gain on the sale of assets	(25,269)	—
(Recoveries) provision for losses on franchisee receivables	(483)	364
Change in operating assets and liabilities:		
Accounts and franchisee receivables	(4,165)	1,231
Merchandise inventories	7,612	11,367
Payable to Sears Holdings Corporation	(19,258)	30,689
Accounts payable	(1,344)	14,575
Customer deposits	1,091	2,610
Other operating assets	1,441	154
Other operating liabilities	1,298	12,049
Net cash (used) provided by operating activities	(21,221)	80,187
CASH FLOWS FROM INVESTING ACTIVITIES		
Proceeds from the sale of assets	26,073	—
Purchases of property and equipment	(6,838)	(2,543)
Net cash provided (used) in investing activities	19,235	(2,543)
CASH FLOWS FROM FINANCING ACTIVITIES		
Net borrowings from capital lease obligations	332	—
Net short-term borrowings (payments)	2,100	(74,000)
Net cash provided (used) in financing activities	2,432	(74,000)
NET CHANGE IN CASH AND CASH EQUIVALENTS	446	3,644
CASH AND CASH EQUIVALENTS—Beginning of period	18,244	19,746
CASH AND CASH EQUIVALENTS—End of period	\$ 18,690	\$ 23,390
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION		
Cash paid for interest	\$ 1,678	\$ 1,457
Cash refunded for income taxes	\$ (1,845)	\$ (2,484)

See Notes to Condensed Consolidated Financial Statements.

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

<i>Thousands</i>	Number of Shares of Common Stock	Common Stock/Par Value	Capital in Excess of Par Value	Accumulated Deficit	Total Stockholders' Equity
Balance at January 31, 2015	22,736	\$ 227	\$ 547,888	\$ (125,829)	\$ 422,286
Net income		—	—	887	887
Share-based compensation	(14)	—	(399)	—	(399)
Balance at August 1, 2015	<u>22,722</u>	<u>\$ 227</u>	<u>\$ 547,489</u>	<u>\$ (124,942)</u>	<u>\$ 422,774</u>
Balance at January 30, 2016	22,722	\$ 227	\$ 555,372	\$ (153,090)	\$ 402,509
Net income		—	—	7,071	7,071
Share-based compensation	(6)	—	77	—	77
Balance at July 30, 2016	<u>22,716</u>	<u>\$ 227</u>	<u>\$ 555,449</u>	<u>\$ (146,019)</u>	<u>\$ 409,657</u>

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 July 30, 2016 the Company or its dealers and franchisees operated a total of 1,123 stores across all 50 states and in Puerto Rico and Bermuda. In these notes and elsewhere in this Quarterly Report on Form 10-Q the terms “we,” “us,” “our,” “SHO,” and the “Company” refer to Sears Hometown and Outlet Stores, Inc. and its subsidiaries.

The Separation

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

Basis of Presentation

These unaudited condensed consolidated financial statements include the accounts of Sears Hometown and Outlet Stores, Inc. and its subsidiaries, all of which are wholly owned. These unaudited condensed consolidated financial statements do not include all of the information and footnotes required in annual consolidated financial statements prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”). In the opinion of management, all adjustments (which include normal recurring adjustments) considered necessary for a fair presentation have been included. Operating results for the first and second quarters ended July 30, 2016 are not necessarily indicative of the results that may be expected for the full fiscal year. These financial statements and related notes should be read in conjunction with the audited consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the fiscal year ended January 30, 2016 (the “2015 10-K”).

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

Our second fiscal-quarter end is the Saturday closest to July 31 each year. Our fiscal-year end is the Saturday closest to January 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 (“VIE”) as well as the methods permitted for determining the primary beneficiary of a variable interest entity. In addition, this guidance requires ongoing reassessments as to whether a reporting company is the primary beneficiary of a variable interest entity and disclosures regarding the reporting company’s involvement with a variable interest entity.

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

Fair Value of Financial Instruments

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

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

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

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

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

Cash and cash equivalents, merchandise payables, accrued expenses (level 1), accounts and notes receivable, and short-term debt (level 2) 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 nonrecurring basis.

The Company was not required to measure any other significant non-financial asset or liability at fair value as of July 30, 2016.

Recent Accounting Pronouncements

Stock-based Compensation

In March 2016, the FASB issued ASU 2016-09, Compensation—Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting, which makes several modifications to the accounting for employee share-based payment transactions, including the requirement to recognize the income tax effects of awards that vest or settle as income tax expense. This guidance also clarifies the presentation of certain components of share-based awards in the statement of cash flows. This guidance is effective for annual reporting periods beginning after December 15, 2016, and interim periods within those annual periods, and early adoption is permitted. We are currently evaluating the effect the update will have on our consolidated financial statements and related disclosures.

Leases

In February 2016, the FASB issued an accounting standards update which replaces the current lease accounting standard. The update will require, among other items, lessees to recognize a right-of-use asset and a lease liability for most leases. Extensive quantitative and qualitative disclosures, including significant judgments made by management, will be required to provide greater insight into the extent of revenue and expense recognized and expected to be recognized from existing contracts. The update is effective for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years, with early adoption permitted. The new standard must be adopted using a modified retrospective transition, and provides for certain practical expedients. Transition will require application of the new guidance at the beginning of the earliest comparative period presented. We are currently evaluating the effect the update will have on our consolidated financial statements and related disclosures.

Balance Sheet Classification of Deferred Taxes

In November 2015, the FASB issued an accounting standards update which simplifies the presentation of deferred income taxes by requiring that deferred income tax liabilities and assets be classified as non-current in a classified statement of financial position. As permitted, the Company early adopted the update beginning in the fourth quarter of our fiscal year ended January 30, 2016 ("2015") utilizing prospective application and prior periods were not retrospectively adjusted. The impact of this update was a reclassification of \$11.0 million of short-term deferred income tax assets from Prepaid expenses and other current assets to Long-term deferred tax assets as of January 30, 2016.

Customer's Accounting for Fees Paid in a Cloud Computing Arrangement

In April 2015, the FASB issued ASU 2015-05, Intangibles-Goodwill and Other-Internal-Use Software (Subtopic 350-40), Customer's Accounting for Fees Paid in a Cloud Computing Arrangement. This ASU provides guidance to customers about whether a cloud computing arrangement includes a software license. If the arrangement includes a software license, the customer would account for fees related to the software license element consistent with accounting for the acquisition of other acquired software licenses. If the arrangement does not contain a software license, the customer would account for the

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

arrangement as a service contract. As permitted, the Company early adopted this update prospectively beginning in the fourth quarter of fiscal 2015. As discussed in Note 10 to the audited consolidated financial statements in the 2015 10-K, in the fourth quarter of 2015, the Company reevaluated its accounting for the previously announced IT transformation project that began in the first quarter of 2015, by considering the existing literature in ASC 350-40, "Goodwill - Intangibles and Other - Internal - Use Software," and the recently issued FASB update, ASU 2015-05, "Intangibles -- Goodwill and Other - Internal Use Software, Customer's Accounting For Fees Paid in a Cloud Computing Arrangement." Based on this evaluation the Company determined that the IT transformation costs are accounted for under a service model, where costs are expensed as services are provided rather than capitalized.

Accordingly, in the fourth quarter of 2015 the Company expensed \$6.3 million of IT transformation costs that had been previously capitalized during the first three quarters of 2015. Transformation costs capitalized in each of the first, second and third quarters of 2015 were \$1.2 million, \$2.7 million and \$2.4 million respectively; no similar costs were incurred in prior years. In accordance with the SEC's Staff Accounting Bulletin ("SAB") No. 99, the Company assessed the materiality of these items and determined that for each of the quarters in 2015 the items were immaterial.

The unaudited quarterly condensed consolidated statements of operations and cash flows for the thirteen and twenty six weeks ended August 1, 2015 and the condensed consolidated balance sheet as of August 1, 2015 reflect the changes as disclosed in Note 10 to the audited consolidated financial statements in the 2015 10-K.

Debt Issuance Costs

In April 2015, the FASB issued an accounting standards update which simplifies the presentation of debt issuance costs by requiring that debt issuance costs be presented in the balance sheet as a direct deduction from the carrying amount of the debt liability, consistent with discounts or premiums. In August 2015, the FASB issued an accounting standards update about the presentation and subsequent measurement of debt issuance costs associated with line-of-credit arrangements, and allows for the presentation of debt issuance costs as an asset regardless of whether or not there is an outstanding balance on the line-of-credit arrangement. The Company continued to report unamortized debt issuance costs related to the Senior ABL Facility of \$0.8 million, \$1.5 million and \$1.1 million at July 30, 2016, August 1, 2015 and January 30, 2016, respectively, within other assets.

Presentation of Financial Statements - Going Concern

In August 2014, the FASB issued an accounting standards update which requires management to assess whether there are conditions or events, considered in the aggregate, that raise substantial doubt about the entity's ability to continue as a going concern within one year after the financial statements are issued. If substantial doubt exists, additional disclosures are required. This update will be effective for the Company in the fourth quarter of our fiscal year ending January 28, 2017 ("2016"). The adoption of the new standard is not expected to have a material impact on the Company's consolidated financial position, results of operations, cash flows or disclosures.

Revenue from Contracts with Customers

In May 2014, the FASB issued an accounting standards update which replaces the current revenue recognition standards. The new revenue recognition standard provides a five-step analysis of transactions to determine when and how revenue is recognized. The core principle is that a company should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. This update will be effective for the Company in the first quarter of 2018 and may be applied retrospectively for each period presented or as a cumulative-effect adjustment at the date of adoption. The Company is evaluating the effect of adopting this new standard and has not yet determined the method by which the standard will be adopted.

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

NOTE 2—ACCOUNTS AND FRANCHISEE RECEIVABLES AND OTHER ASSETS

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

<i>Thousands</i>	July 30, 2016	August 1, 2015	January 30, 2016
Short-term franchisee receivables	\$ 2,262	\$ 5,443	\$ 2,376
Miscellaneous receivables	16,018	8,532	10,754
Long-term franchisee receivables	20,971	45,453	23,068
Other assets	1,446	1,871	1,677
Allowance for losses on short-term franchisee receivables (1)	(1,263)	(392)	(1,377)
Allowance for losses on long-term franchisee receivables (1)	(9,300)	(3,929)	(10,764)
Total Accounts and franchisee receivables and other assets	\$ 30,134	\$ 56,978	\$ 25,734

(1) The Company recognizes an allowance for losses on franchisee receivables (which consist primarily of franchisee promissory notes) in an amount equal to estimated probable losses net of recoveries. The allowance 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 allowance for losses on franchisee receivables is recognized as selling and administrative expense. Most of our franchisee promissory notes authorize us to deduct debt service from our commissions otherwise due and payable to the franchisees, and we routinely make those deductions to the extent of available commissions payable.

NOTE 3—ALLOWANCE FOR LOSSES ON FRANCHISEE RECEIVABLES

The allowance for losses on franchisee receivables consists of the following:

<i>Thousands</i>	26 Weeks Ended July 30, 2016	26 Weeks Ended August 1, 2015	52 Weeks Ended January 30, 2016
Allowance for losses on franchisee receivables, beginning of period	\$ 12,141	\$ 11,368	\$ 11,368
Expense (recoveries) during the period	(483)	364	25,426
Write off of franchisee receivables	(1,220)	(7,411)	(24,653)
Other	125	—	—
Allowance for losses on franchisee receivables, end of period	\$ 10,563	\$ 4,321	\$ 12,141

NOTE 4—OTHER CURRENT AND LONG-TERM LIABILITIES

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

<i>Thousands</i>	July 30, 2016	August 1, 2015	January 30, 2016
Customer deposits	\$ 25,350	\$ 32,850	\$ 24,259
Sales and other taxes	11,753	15,547	12,880
Accrued expenses	26,335	21,502	23,865
Payroll and related items	5,203	5,580	6,563
Severance and executive transition costs	894	2,540	1,569
Total Other current and long-term liabilities	\$ 69,535	\$ 78,019	\$ 69,136

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

NOTE 5—INTANGIBLE ASSETS

Intangible assets consist of the following:

<i>Thousands</i>	July 30, 2016	August 1, 2015	January 30, 2016
Reacquisition rights	\$ 4,377	\$ —	\$ 6,100
Less: accumulated amortization expense	(2,001)	—	(1,723)
Total Intangible assets, net	<u>\$ 2,376</u>	<u>\$ —</u>	<u>\$ 4,377</u>

In the fourth quarter of 2015 the Company repurchased 58 franchised locations. In the first two quarters of 2016 the Company repurchased 9 franchised locations. These repurchase transactions included the execution of definitive asset purchase and termination agreements which terminated the franchise agreements and sublease arrangements for those locations. These definitive agreements also required the Company to purchase store furniture, fixtures, and equipment. The franchisees of the affected locations were obligors on promissory notes payable to the Company and, as part of the definitive agreements, the Company wrote off the franchisee note receivable balances net of the value of the reacquisition rights and the value of the furniture, fixtures, and equipment that the Company purchased. Reacquisition rights were recorded at estimated fair value using the income approach.

Reacquisition rights are definite-life assets and, as such, we record amortization expense based on a method that most appropriately reflects our expected cash flows from these assets with a weighted-average amortization period of 2.3 years. Amortization expense for reacquisition rights was \$0.9 million and \$0 for the quarters ended July 30, 2016 and August 1, 2015, respectively. Amortization expense is estimated to be \$0.7 million for the remainder of 2016, \$1.3 million in 2017, \$0.3 million in 2018, and \$0.1 million in 2019.

NOTE 6—INCOME TAXES

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

We account for uncertainties in income taxes according to accounting standards for uncertain tax positions. The Company is present in a large number of taxable jurisdictions and, at any point in time, can have tax 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 13 and 26 weeks ended July 30, 2016 and August 1, 2015, 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 July 30, 2016 the Company's net deferred tax asset balance was \$75.0 million compared to \$62.5 million as of August 1, 2015 and \$79.1 million as of January 30, 2016. At July 30, 2016, August 1, 2015, and January 30, 2016, the Company had a valuation allowance of \$0.8 million, \$0.1 million and \$0.8 million, respectively, to record only the portion of the deferred tax asset that more likely than not will be realized. The valuation allowance reduces the US foreign tax credit and Puerto Rico AMT credit based on the determination that it is no longer probable that sufficient future foreign source income and Puerto Rico taxable income would be available to realize these deferred tax assets. Management assesses the available evidence to estimate if sufficient future taxable income will be generated to use the existing deferred tax assets. For the remaining deferred tax assets, management continues to monitor the Company's operating performance and currently believes that the Company's achievement of future taxable income necessary to realize these deferred assets is more likely than not. Key

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

considerations in this assessment include our cumulative pre-tax profit (loss) during the prior three years (excluding non-deductible goodwill) and the period of time available to generate future taxable income. We will continue to evaluate our valuation allowance during the remainder of the fiscal year for any change in circumstances that causes a change in judgment about the realization of the deferred tax asset. A change in management's assessment regarding a need for a valuation allowance will result in a non-cash income tax charge.

NOTE 7—RELATED-PARTY AGREEMENTS AND TRANSACTIONS

According to publicly available information ESL Investments, Inc. and investment affiliates including Edward S. Lampert (collectively, "ESL") beneficially own approximately 51% of our outstanding shares of common stock and approximately 50% of Sears Holdings' outstanding shares of common stock. Mr. Lampert is the Chairman of the Board and Chief Executive Officer of Sears Holdings.

SHO and Sears Holdings have entered into various agreements (as amended, the "SHO-Sears Holdings Agreements") that, among other things, (1) govern specified aspects of our relationship with Sears Holdings, (2) establish terms under which subsidiaries of Sears Holdings provide services to us, and (3) establish terms pursuant to which subsidiaries of Sears Holdings obtain merchandise inventories for us. The terms of the SHO-Sears Holdings Agreements were agreed to prior to the Separation (except for amendments entered into after the Separation that were approved by the Audit Committee of SHO's Board of Directors) 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 has engaged in frequent discussions, and has resolved 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 had not been addressed by the terms and conditions of the SHO-Sears Holdings Agreements or, if addressed, in the past were, and in the future could be, 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. On May 11, 2016 SHO and Sears Holdings entered into amendments to most of the SHO-Sears Holdings Agreements.

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 specified transactions SHO pays a commission to Sears Holdings.
- We obtain a significant amount of our merchandise inventories from Sears Holdings. We have a retailer's customary rights to return to Sears Holdings merchandise that is defective (except with respect to agreed-upon amounts of defective apparel that we purchase and then liquidate) or otherwise does not meet contract requirements. In addition, we may determine that an item of Outlet merchandise (usually merchandise that is not new in-box) we have received from Sears Holdings cannot be refurbished or reconditioned or is otherwise not in a physical condition to offer for sale to our customers. We and Sears Holdings (and our Outlet vendors generally) refer to an item of merchandise in this condition as "not saleable" or "non-saleable," and in the normal course we can return the item to Sears Holdings. We generally have comparable return rights with our other Outlet vendors.
- We pay royalties related to our sale of products branded with the KENMORE®, CRAFTSMAN®, and DIEHARD® marks (which marks are owned by subsidiaries of Sears Holdings, together the "KCD Marks"). The royalty rates vary but none exceed 6%.
- We pay fees for participation in Sears Holdings' SHOP YOUR WAY REWARDS® program.
- We have also entered into agreements with Sears Holdings for logistics, handling, warehouse, and transportation services, the charges for which are based generally on merchandise inventory units.
- Sears Holdings provides the Company with specified corporate services. These services include accounting and finance, human resources, and information technology, among other services. Sears Holdings charges the Company for these corporate services based on actual usage or pro rata charges based upon sales, head count, or other measurements.

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- 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:

	13 Weeks Ended		26 Weeks Ended	
	July 30, 2016	August 1, 2015	July 30, 2016	August 1, 2015
<i>Thousands</i>				
Net Commissions from Sears Holdings	\$ 22,818	\$ 24,170	\$ 44,392	\$ 48,566
Purchases related to cost of sales and occupancy	302,554	375,440	616,088	734,794
Services included in selling and administrative	18,864	22,938	40,312	46,316

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, except as provided in the following sentences of this paragraph, are settled on a net basis and have payment terms of 10 days after the invoice date. In accordance with the SHO-Sears Holdings Agreements, from May 1, 2016 through July 31, 2016 the Company paid invoices on three-day terms and deducted from each invoice an early-payment discount of 37 basis points. While we are continuing this three-day payment arrangement, we can in our sole discretion revert to ten-day, no-discount payment terms at any time. The three-day payment arrangement, less incremental interest expense, has resulted in a net financial benefit to the Company.

We recorded real estate occupancy payments of \$0.2 million and \$0.2 million for the second quarters of 2016 and 2015, respectively, to Seritage Growth Properties, a real estate investment trust. ESL owns approximately 9.8% of the total voting power of Seritage. Edward S. Lampert is the Chairman of the Board of Trustees of Seritage.

NOTE 8—FINANCING ARRANGEMENT

As of July 30, 2016 we had \$70.4 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 for maximum borrowings (subject to availability under a borrowing base) up to the aggregate commitments of all of the lenders, which as of July 30, 2016 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 July 30, 2016 was \$173.9 million, with \$5.7 million of letters of credit outstanding under the facility.

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

Senior ABL Facility

Maturity; Amortization and Prepayments

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

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

Guarantees; Security

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

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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 2.48% at July 30, 2016 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 July 30, 2016.

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. At July 30, 2016 we did not meet either of the foregoing conditions and as a result the Senior ABL Facility does not permit us to pay cash dividends or repurchase our common stock.

The Senior ABL Facility also contains affirmative covenants, including financial and other reporting requirements. As of July 30, 2016, SHO was in compliance with all covenants under the Senior ABL Facility.

Events of Default

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

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NOTE 9—SUMMARY OF SEGMENT DATA

The Hometown reportable segment consists of the aggregation of our Hometown Stores, Hardware Stores, and Home Appliance Showrooms business formats described in "Item 2 Management's Discussion and Analysis of Financial Condition and Results of Operations-Executive Overview" of this Quarterly Report on Form 10-Q. The Outlet reportable segment also represents a business format. These segments are evaluated by our Chief Operating Decision Maker to make decisions about resource allocation and to assess performance. Each of these segments derives its revenues from the sale of merchandise and related services to customers, primarily in the U.S. The net sales categories include appliances, lawn and garden, tools and paint, and other (which includes initial franchise revenue of \$0.0 million and \$(0.2) million for the 13 weeks ended July 30, 2016 and August 1, 2015, respectively). Initial franchise revenue consists of franchise fees paid with respect to new or existing Company-operated stores that we transfer to franchisees plus the net gain or loss on any related transfer of assets to the franchisees.

<i>Thousands</i>	13 Weeks Ended July 30, 2016		
	Hometown	Outlet	Total
Net sales			
Appliances	\$ 259,446	\$ 129,719	\$ 389,165
Lawn and garden	91,196	6,871	98,067
Tools and paint	31,369	4,355	35,724
Other	14,603	18,829	33,432
Total	<u>396,614</u>	<u>159,774</u>	<u>556,388</u>
Costs and expenses			
Cost of sales and occupancy	313,231	128,277	441,508
Selling and administrative	83,554	35,254	118,808
Depreciation and amortization	1,507	1,786	3,293
Gain on the sale of assets	—	(25,269)	(25,269)
Total	<u>398,292</u>	<u>140,048</u>	<u>538,340</u>
Operating income (loss)	<u>\$ (1,678)</u>	<u>\$ 19,726</u>	<u>\$ 18,048</u>
Total assets	<u>\$ 415,501</u>	<u>\$ 207,377</u>	<u>\$ 622,878</u>
Capital expenditures	<u>\$ 3,268</u>	<u>\$ 1,280</u>	<u>\$ 4,548</u>

<i>Thousands</i>	13 Weeks Ended August 1, 2015		
	Hometown	Outlet	Total
Net sales			
Appliances	\$ 287,026	\$ 124,214	\$ 411,240
Lawn and garden	114,570	8,263	122,833
Tools and paint	39,362	4,311	43,673
Other	19,789	22,075	41,864
Total	<u>460,747</u>	<u>158,863</u>	<u>619,610</u>
Costs and expenses			
Cost of sales and occupancy	357,533	120,717	478,250
Selling and administrative	99,958	38,962	138,920
Depreciation and amortization	883	1,281	2,164
Total	<u>458,374</u>	<u>160,960</u>	<u>619,334</u>
Operating income (loss)	<u>\$ 2,373</u>	<u>\$ (2,097)</u>	<u>\$ 276</u>
Total assets	<u>\$ 434,220</u>	<u>\$ 197,914</u>	<u>\$ 632,134</u>
Capital expenditures	<u>\$ —</u>	<u>\$ 1,673</u>	<u>\$ 1,673</u>

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(Unaudited)

	26 Weeks Ended July 30, 2016		
<i>Thousands</i>	Hometown	Outlet	Total
Net sales			
Appliances	\$ 490,380	\$ 271,767	\$ 762,147
Lawn and garden	169,613	11,559	181,172
Tools and paint	67,486	8,969	76,455
Other	35,714	37,881	73,595
Total	<u>763,193</u>	<u>330,176</u>	<u>1,093,369</u>
Costs and expenses			
Cost of sales and occupancy	597,369	264,929	862,298
Selling and administrative	164,407	72,393	236,800
Depreciation and amortization	3,076	3,474	6,550
Gain on the sale of assets	—	(25,269)	(25,269)
Total	<u>764,852</u>	<u>315,527</u>	<u>1,080,379</u>
Operating income (loss)	<u>\$ (1,659)</u>	<u>\$ 14,649</u>	<u>\$ 12,990</u>
Total assets	<u>\$ 415,501</u>	<u>\$ 207,377</u>	<u>\$ 622,878</u>
Capital expenditures	<u>\$ 4,574</u>	<u>\$ 2,264</u>	<u>\$ 6,838</u>
	26 Weeks Ended August 1, 2015		
<i>Thousands</i>	Hometown	Outlet	Total
Net sales			
Appliances	\$ 541,938	\$ 264,979	\$ 806,917
Lawn and garden	204,546	12,694	217,240
Tools and paint	81,674	8,642	90,316
Other	43,249	44,657	87,906
Total	<u>871,407</u>	<u>330,972</u>	<u>1,202,379</u>
Costs and expenses			
Cost of sales and occupancy	668,620	252,040	920,660
Selling and administrative	194,580	80,050	274,630
Depreciation and amortization	1,536	2,489	4,025
Total	<u>864,736</u>	<u>334,579</u>	<u>1,199,315</u>
Operating income (loss)	<u>\$ 6,671</u>	<u>\$ (3,607)</u>	<u>\$ 3,064</u>
Total assets	<u>\$ 434,220</u>	<u>\$ 197,914</u>	<u>\$ 632,134</u>
Capital expenditures	<u>\$ —</u>	<u>\$ 2,543</u>	<u>\$ 2,543</u>

SEARS HOMETOWN AND OUTLET STORES, INC.
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NOTE 10—COMMITMENTS AND CONTINGENCIES

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

NOTE 11— INCOME PER COMMON SHARE

Basic income per common share is calculated by dividing net income by the weighted average number of common shares outstanding for each period.

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

	<u>26 Weeks Ended</u> <u>July 30, 2016</u>	<u>26 Weeks Ended</u> <u>August 1, 2015</u>
<i>Thousands except income per common share</i>		
Basic weighted average shares	22,681	22,666
Diluted weighted average shares	22,682	22,666
Net income	\$ 7,071	\$ 887
Income per common share:		
Basic	\$ 0.31	\$ 0.04
Diluted	\$ 0.31	\$ 0.04

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NOTE 12—EQUITY

Stock-based Compensation

Four million shares of the Company's common stock are reserved for issuance under the Company's Amended and Restated 2012 Stock Plan (the "Plan"). A total of 89,221 shares of restricted stock were granted under the Plan in the second quarter of 2013 (the "2013 Grants") to a group of eligible individuals (as defined in the Plan) and 14,000 shares of restricted stock were granted under the Plan to an eligible individual in the second quarter of 2015 (the "2015 Grant").

As of May 16, 2016 52,691 shares of restricted stock comprising the 2013 Grants had been forfeited. On that date the remaining 36,530 shares of restricted stock comprising the 2013 Grants vested in accordance with the terms and conditions of the governing restricted-stock agreements and the Plan. The 14,000 shares of restricted stock comprising the 2015 Grant will vest, if at all, on July 10, 2017 in accordance with and subject to the terms and conditions of the governing restricted-stock agreement (including forfeiture conditions) and the Plan. The fair value of these awards will vary based on changes in our stock price at each reporting period.

During the first quarter of 2015 the Company granted a total of 159,475 stock units under the Plan (all of which stock units are payable solely in cash based on our stock price at the vesting date) to a group of eligible individuals, all of whom were employees of the Company at the time of the grants. As of July 30, 2016, 28,237 of these stock units had been forfeited. The remaining 131,238 stock units will vest, if at all, on April 13, 2018 in accordance with and subject to the terms and conditions of governing stock unit agreements, including forfeiture conditions, and the Plan.

We are authorized to grant stock options and to make other awards (in addition to restricted stock and stock units) to eligible participants pursuant to the Plan. The Company has made no stock-option awards under the Plan. Except for the 103,221 shares of restricted stock and the 159,475 stock units, the Company has not made any grant or award under the Plan. We do not currently have a broad-based program that provides for awards under the Plan on an annual basis.

We account for stock-based compensation using the fair value method in accordance with accounting standards regarding share-based payment transactions. During the first and second quarters of 2016, we recorded \$0.1 million in total compensation expense for 50,530 shares of restricted stock (of which 36,530 shares had vested as of May 16, 2016) and 131,238 stock units. At July 30, 2016 we had \$0.1 million in total unrecognized compensation cost related to the remaining non-vested restricted stock, which cost we expect to recognize over the next year. At July 30, 2016, we had \$0.5 million in total unrecognized compensation cost related to the remaining non-vested stock units, which cost we expect to recognize over approximately the next year.

The fair value of our outstanding restricted stock is equal to the market price of our common stock on the date of grant. Changes in restricted-stock awards for 2016 were as follows:

<i>(Shares in Thousands)</i>	26 Weeks Ended July 30, 2016	
	Shares	Weighted-Average Fair Value on Date of Grant
Beginning of year balance	56	\$ 35.68
Granted	—	—
Vested	(36)	44.45
Forfeited	(6)	44.45
Balance at 7/30/2016	14	\$ 9.38

The fair value of our outstanding stock units will vary based on changes in our stock price at each reporting period.

Share Repurchase Program

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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. At July 30, 2016, the Senior ABL Facility prohibited cash dividends and the repurchase of our common stock.

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

No shares were repurchased during the 26 weeks ended July 30, 2016. At July 30, 2016, we had approximately \$12.5 million of remaining authorization under the repurchase program.

NOTE 13—SALE OF ASSETS

On July 27, 2016, we completed the sale of an owned property located in San Leandro, California. Net proceeds from the sale were \$26.1 million, and we recorded a gain on the sale of \$25.3 million when the sale was completed in accordance with the terms and conditions of the Purchase and Sale Agreement.

**SEARS HOMETOWN AND OUTLET STORES, INC.
13 and 26 Weeks Ended July 30, 2016 and August 1, 2015**

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

The following discussion should be read in conjunction with the Condensed Consolidated Financial Statements and notes contained in this Quarterly Report on Form 10-Q and the Consolidated Financial Statements and notes contained in our Annual Report on Form 10-K for the fiscal year ended January 30, 2016 (the "2015 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 July 30, 2016, we or our dealers and franchisees operated a total of 1,123 stores across all 50 states, Puerto Rico, and Bermuda. In the second quarter of 2016, the Company closed 22 stores.

In addition to merchandise, we provide our customers with access to a suite of services, including home delivery, installation, and extended service contracts.

Our Hometown 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 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 July 30, 2016 Hometown consisted of 964 stores as follows:

- 837 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 Kenmore, Craftsman, and DieHard brand products as well as a wide assortment of other national brand products.
- 47 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.
- 80 Sears Home Appliance Showrooms—Stores that have a simple, primarily appliance showroom design that are positioned in metropolitan areas.

As of July 30, 2016, Hometown consisted of 830 dealer-operated stores, 63 franchisee-operated stores, and 71 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 our dealers and franchisees and pays commissions to them when they sell the Company's merchandise and provide services.

As of July 30, 2016, 38 of the Company's 159 Outlet stores were operated by franchisees.

Dealers and franchisees exercise control over the day-to-day operations of their stores, make capital decisions regarding their stores, and exclusively make all hiring, compensation, benefits, termination, and other decisions regarding the terms and conditions of employment, and exclusively establish all employment policies, procedures, and practices, with respect to employees.

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

SEARS HOMETOWN AND OUTLET STORES, INC.
13 and 26 Weeks Ended July 30, 2016 and August 1, 2015

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 has been highly variable from quarter to quarter. The variation has resulted from a number of factors, including general economic conditions, which have influenced 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 has impacted the expected financial returns to the Company from new store development, which in turn has impacted the number of Company-operated stores that the Company has decided from time to time to make available for transfer to franchisees. Beginning in the second quarter of 2015 the Company indefinitely suspended its franchising of additional stores except to existing Company franchisees, and the suspension continued through the second quarter of 2016. Initial franchise revenues, which include the net gain or loss on related transfers of assets to franchisees, were (\$0.2) million in the first two quarters of 2016 and \$0.3 million in the first two quarters of 2015.

<i>Thousands</i>	13 Weeks Ended		26 Weeks Ended	
	July 30, 2016	August 1, 2015	July 30, 2016	August 1, 2015
Hometown	\$ —	\$ (102)	\$ —	\$ (108)
Outlet	—	(60)	(200)	436
Total initial franchise revenues	\$ —	\$ (162)	\$ (200)	\$ 328

Amendments to Agreements with Sears Holdings

On May 11, 2016 the Company and Sears Holdings executed and delivered to each other amendments to most of the SHO-Sears Holdings Agreements including an amendment to our Merchandising Agreement with Sears Holdings (the "Merchandising Amendment"). The Merchandising Amendment provides that (a) SHO will pay Sears Holdings \$0.6 million and SHO waives claims against Sears Holdings relating to product repair claims and (b) Sears Holdings waives claims against SHO relating to alleged KCD warranty fee underpayments and other IT and service-order transfer related claims. The net benefit to SHO of the Merchandising Amendment is \$2.8 million, which amount (the "Merchandising Net Benefit") we recorded in the first quarter of 2016 as a reduction to cost of sales and occupancy expenses. For additional information regarding the amendments to the SHO-Sears Holdings Agreements see the Company's Current Report on Form 8-K filed with the Securities and Exchange Commission on May 17, 2016 (File No. 001-35641).

Shared Vendor Funds

In accordance with the Merchandising Agreement, SHO receives from Sears Holdings specified portions of merchandise subsidies collected by Sears Holdings from its merchandise vendors. During the second quarter of 2016 Sears Holdings' subsidy collections were higher compared to the second quarter of 2015 and SHO's portion of the collected subsidies during the second quarter of 2016 were favorably impacted by \$1.3 million. Also in accordance with the Merchandising Agreement, SHO receives from Sears Holdings specified portions of cash discounts earned by Sears Holdings as a result of its early payment of merchandise-vendor payables. During the second quarter of 2016 Sears Holdings earned higher cash discounts compared to the second quarter of 2015, and SHO's portion of the earned cash discounts during the second quarter of

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2016 were favorably impacted by \$1.3 million. Sears Holdings is responsible for the collection of the merchandise subsidies that it has negotiated with its merchandise vendors, and Sears Holdings determines the extent to which it will earn cash discounts. As a consequence we cannot provide any assurance that SHO's portion of merchandise subsidies collected by Sears Holdings and SHO's portion of Sears Holdings' earned cash discounts will not decline, stay the same, or continue to increase. If SHO's portion of merchandise subsidies collected by Sears Holdings were to decline, and if at the same time SHO's portion of Sears Holdings' earned cash discounts were to decline, SHO's results of operations could be adversely affected to a material extent.

Seasonality

Our business is not concentrated in the holiday season, as the majority of the products we sell are not typically thought of as holiday gifts. Lawn and Garden sales generally peak in our second quarter as customers prepare for and execute outdoor projects during the spring and early summer. See Note 10 to the Consolidated Financial Statements included in the 2015 10-K for our quarterly financial results (unaudited) for our 2015 and 2016 fiscal years.

Results of Operations

The following table sets forth items derived from our consolidated results of operations for the 13 and 26 weeks ended July 30, 2016 and August 1, 2015.

<i>Thousands</i>	13 Weeks Ended		26 Weeks Ended	
	July 30, 2016	August 1, 2015	July 30, 2016	August 1, 2015
NET SALES	\$ 556,388	\$ 619,610	\$ 1,093,369	\$ 1,202,379
COSTS AND EXPENSES				
Cost of sales and occupancy	441,508	478,250	862,298	920,660
Gross margin dollars	114,880	141,360	231,071	281,719
<i>Margin rate</i>	20.6%	22.8%	21.1%	23.4%
Selling and administrative	118,808	138,920	236,800	274,630
<i>Selling and administrative expense as a percentage of net sales</i>	21.4%	22.4%	21.7%	22.8%
Depreciation and amortization	3,293	2,164	6,550	4,025
Gain on the sale of assets	(25,269)	—	(25,269)	—
Total costs and expenses	538,340	619,334	1,080,379	1,199,315
Operating income	18,048	276	12,990	3,064
Interest expense	(886)	(614)	(1,652)	(1,395)
Other income	378	560	775	1,242
Income before income taxes	17,540	222	12,113	2,911
Income tax expense	(6,898)	(627)	(5,042)	(2,024)
NET INCOME (LOSS)	\$ 10,642	\$ (405)	\$ 7,071	\$ 887

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 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 and discussed below. Our management uses Adjusted EBITDA, among other factors, for evaluating

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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, we believe it is an important indicator of operating performance for investors 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. These items may also include cash charges such as severance and executive transition costs and IT transformation investments that make it difficult for investors to assess the Company's core operating performance.

Starting with the second quarter of 2015 the Company is excluding initial franchise revenues from Adjusted EBITDA. This change is based on (1) the Company's decision to indefinitely suspend its franchising of additional stores except to existing Company franchisees and (2) to better align Adjusted EBITDA for purposes of incentive compensation.

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

<i>Thousands</i>	13 Weeks Ended		26 Weeks Ended	
	July 30, 2016	August 1, 2015	July 30, 2016	August 1, 2015
Net income (loss)	\$ 10,642	\$ (405)	\$ 7,071	\$ 887
Income tax expense	6,898	627	5,042	2,024
Other income	(378)	(560)	(775)	(1,242)
Interest expense	886	614	1,652	1,395
Operating income	18,048	276	12,990	3,064
Depreciation and amortization	3,293	2,164	6,550	4,025
Gain on the sale of assets	(25,269)	—	(25,269)	—
Severance and executive transition costs	—	(305)	—	1,066
Initial franchise revenues net of (recoveries of) provision for losses	(251)	162	(283)	36
IT transformation investments	3,323	3,185	6,473	4,645
Adjusted EBITDA	<u>\$ (856)</u>	<u>\$ 5,482</u>	<u>\$ 461</u>	<u>\$ 12,836</u>

13-Week Period Ended July 30, 2016 Compared to the 13-Week Period Ended August 1, 2015

Net Sales

Net sales in the second quarter of 2016 decreased \$63.2 million, or 10.2%, to \$556.4 million from the second quarter of 2015. This decrease was driven primarily by the impact of closed stores (net of new store openings) and a 4.9% decrease in comparable store sales.

Comparable store sales were down 6.5% and 0.5% in Hometown and Outlet, respectively. The consolidated comparable store sales decrease of 4.9% was primarily due to lower sales in lawn and garden impacted by unfavorable weather conditions, lower Hometown home appliance sales due to softness during the July 4th promotional period and industry-wide selling price erosion resulting from an aggressive promotional environment, and lower Outlet apparel and mattress sales due to a decrease in product supply from Sears Holdings. These decreases were partially offset by higher Outlet home appliance sales driven by an increase in inventory position compared to the second quarter of 2015.

Gross Margin

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Gross margin was \$114.9 million, or 20.6% of net sales, in the second quarter of 2016 compared to \$141.4 million, or 22.8% of net sales, in the second quarter of 2015. The decrease in gross margin rate was primarily driven by lower margin on merchandise sales, higher occupancy costs due to a higher number of Company-operated locations, and \$2.1 million higher shrink resulting from a \$2.3 million physical inventory gain in Hometown in the second quarter of 2015. The total impact of occupancy costs and shrink reduced gross margin 360 basis points in the second quarter of 2016 compared to a reduction of 243 basis points in the second quarter of 2015.

Selling and Administrative Expenses

Selling and administrative expenses decreased to \$118.8 million, or 21.4% of net sales, in the second quarter of 2016 from \$138.9 million, or 22.4% of net sales, in the prior-year comparable quarter. The decrease was primarily due to lower commissions paid to dealers and franchisees on lower sales volume from operating a higher number of company operated stores in 2016 and lower expenses due to stores closed (net of new store openings) since the third quarter of 2015. These declines were partially offset by higher payroll and benefits due to a higher number of Company-operated stores.

Gain on Sale of Assets

During the second quarter of 2016, we completed the sale of an owned property located in San Leandro, California. Net proceeds from the sale were \$26.1 million, and we recorded a gain on the sale of \$25.3 million.

Operating Income

We recorded operating income of \$18.0 million and \$0.3 million in the second quarters of 2016 and 2015, respectively. The increase in operating income was primarily due to the \$25.3 million gain on sale of assets and lower selling and administrative expenses partially offset by lower gross margin (including the impact of lower volume and a lower gross margin rate driven partially by higher shrink).

Income Taxes

Income tax expense of \$6.9 million and \$0.6 million were recorded in the second quarters of 2016 and 2015, respectively. The effective tax rates were 39.3% in the second quarter of 2016 and 282.4% in the second quarter of 2015.

Net Income (Loss)

We recorded net income of \$10.6 million for the second quarter of 2016 compared to a net loss of \$0.4 million for the prior-year comparable quarter. The increase in our net income was primarily attributable to the factors discussed above.

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26-Week Period Ended July 30, 2016 Compared to the 26-Week Period Ended August 1, 2015

Net Sales

Net sales in the first two quarters of 2016 decreased \$109.0 million, or 9.1%, to \$1,093.4 million from the first two quarters of 2015. This decrease was driven primarily by the impact of closed stores (net of new store openings) and a 3.8% decrease in comparable store sales.

Comparable store sales were down 4.6% and 1.9% in Hometown and Outlet, respectively. The consolidated comparable store sales decrease of 3.8% was primarily due to the impact of selling price erosion on Hometown home appliance sales from an aggressive promotional environment, lower lawn and garden sales in Hometown and Outlet primarily impacted by unfavorable weather conditions, and lower Outlet apparel and mattress sales due to a decrease in product supply from Sears Holdings. These decreases were partially offset by improved Outlet home appliance sales driven by an increase in inventory position.

Gross Margin

Gross margin was \$231.1 million, or 21.1% of net sales, in the first two quarters of 2016 compared to \$281.7 million, or 23.4% of net sales, in the first two quarters of 2015. The decrease in gross margin rate was primarily driven by higher occupancy costs due to a higher number of Company-operated locations, lower margin on merchandise sales, and \$7.6 million higher shrink resulting from a \$3.4 million physical inventory charge to Outlet in the first quarter of 2016 and \$4.8 million of physical inventory gains in Hometown in the first two quarters of 2015. These declines were partially offset by the Merchandising Net Benefit, all of which was included in first two quarters 2016 gross margin. The total impact of occupancy costs, shrink, the Merchandising Net Benefit, and closed stores reduced gross margin 387 basis points in the first two quarters of 2016 compared to a reduction of 253 basis points in the first two quarters of 2015.

Selling and Administrative Expenses

Selling and administrative expenses decreased to \$236.8 million, or 21.7% of net sales, in the first two quarters of 2016 from \$274.6 million, or 22.8% of net sales, in the prior-year comparable period. The decrease was primarily due to lower commissions paid to dealers and franchisees on lower sales volume from operating a higher number of Company-operated stores in 2016, lower expenses due to stores closed (net of new store openings) since the second quarter of 2015, and actions taken in 2015 to reduce overall payroll and benefits costs at our support center and in our field organization. These decreases were partially offset by higher payroll and benefits due to a higher number of Company-operated stores.

Gain on Sale of Assets

During the second quarter of 2016, we completed the sale of an owned property located in San Leandro, California. Net proceeds from the sale were \$26.1 million, and we recorded a gain on the sale of \$25.3 million.

Operating Income

We recorded operating income of \$13.0 million and \$3.1 million in the first two quarters of 2016 and 2015, respectively. The increase in operating income was primarily due to the \$25.3 million gain on the sale of assets, lower selling and administrative expenses, and the \$2.8 million Merchandising Net Benefit. This favorability was partially offset by lower gross margin (including the impact of lower volume and a lower gross margin rate partially driven by higher shrink).

Income Taxes

Income tax expense of \$5.0 million and \$2.0 million were recorded in the first two quarters of 2016 and 2015, respectively. The effective tax rate was 41.6% in the first two quarters of 2016 and 69.5% in the first two quarters of 2015.

Net Income

We recorded net income of \$7.1 million for the first two quarters of 2016 compared to net income of \$0.9 million for the prior-year comparable period. The increase in our net income was primarily attributable to the factors discussed above.

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Business Segment Results
Hometown

Hometown results and key statistics were as follows:

<i>Thousands, except for number of stores</i>	<u>13 Weeks Ended</u>		<u>26 Weeks Ended</u>	
	<u>July 30, 2016</u>	<u>August 1, 2015</u>	<u>July 30, 2016</u>	<u>August 1, 2015</u>
Net sales	\$ 396,614	\$ 460,747	\$ 763,193	\$ 871,407
Comparable store sales %	(6.5)%	(1.1)%	(4.6)%	(0.8)%
Cost of sales and occupancy	313,231	357,533	597,369	668,620
Gross margin dollars	83,383	103,214	165,824	202,787
Margin rate	21.0 %	22.4 %	21.7 %	23.3 %
Selling and administrative	83,554	99,958	164,407	194,580
<i>Selling and administrative expense as a percentage of net sales</i>	21.1 %	21.7 %	21.5 %	22.3 %
Depreciation and amortization	1,507	883	3,076	1,536
Total costs and expenses	398,292	458,374	764,852	864,736
Operating income	\$ (1,678)	\$ 2,373	\$ (1,659)	\$ 6,671
Total Hometown stores			964	1,057

13-Week Period ended July 30, 2016 Compared to the 13-Week Period Ended August 1, 2015
Net Sales

Hometown net sales decreased \$64.1 million, or 13.9%, to \$396.6 million in the second quarter of 2016 from \$460.7 million in the second quarter of 2015. The decrease was primarily due to the impact of closed stores (net of new stores) and a 6.5% comparable store sales decrease.

The Comparable store sales decrease of 6.5% was primarily due to lower lawn and garden sales that were impacted by unfavorable weather conditions and lower home appliance sales due to softness during the July 4th promotional period and industry-wide selling price erosion resulting from an aggressive promotional environment. These declines were partially offset by increased sales in mattresses due to product transition and updated floor models.

Gross Margin

Gross margin was \$83.4 million, or 21.0% of net sales, in the second quarter of 2016 compared to \$103.2 million, or 22.4% of net sales, in the second quarter of 2015. The decrease in gross margin rate was primarily driven by lower margin on merchandise sales, higher occupancy costs due to a higher number of Company-operated locations, and \$1.4 million higher shrink resulting from a \$2.3 million physical inventory gain in the second quarter of 2015. The combined impact of occupancy costs and shrink reduced gross margin 165 basis points in the second quarter of 2016 compared to a 95 basis points reduction in the second quarter of 2015.

Selling and Administrative Expenses

Selling and administrative expenses decreased to \$83.6 million, or 21.1% of net sales, in the second quarter of 2016 from \$100.0 million, or 21.7% of net sales, in the prior-year comparable quarter. The decrease was primarily due to lower commissions paid to dealers and franchisees on lower sales volume from operating a higher number of Company-operated stores in 2016 and lower expenses due to stores closed (net of new store openings) since the second quarter of 2015.

Since the Separation we have included an allocation of Home Office overhead expenses in selling and administrative expenses for Hometown and Outlet. Home Office overhead expenses are primarily comprised of corporate headquarters payroll, benefits, and other costs and include charges related to our Services Agreement with Sears Holdings. In the first quarter of 2016 we adjusted the allocation of these Home Office overhead expenses between Hometown and Outlet to reflect our expected allocation of resources between Hometown and Outlet during 2016. If the allocation weighting for the second quarter of 2016 had been similar to the weighting for the prior-year comparable quarter we would have allocated an additional

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\$0.3 million of Home Office overhead expenses to Hometown's selling and administrative expenses. We will continue to evaluate the allocation of Home Office overhead expenses on an annual basis.

Operating Income

We recorded an operating loss of \$1.7 million and a operating income of \$2.4 million in the second quarters of 2016 and 2015, respectively. The reduction in operating income was primarily due to lower gross margin (including the impact of lower volume and a lower gross margin rate partially driven by higher shrink) partially offset by favorability in selling and administrative expenses as disclosed above.

26-Week Period ended July 30, 2016 Compared to the 26-Week Period Ended August 1, 2015

Net Sales

Hometown net sales decreased \$108.2 million, or 12.4%, to \$763.2 million in the first two quarters of 2016 from \$871.4 million in the first two quarters of 2015. The decrease was primarily due to the impact of closed stores (net of new stores) and a 4.6% comparable store sales decrease.

The Comparable store sales decrease of 4.6% was primarily due the impact of selling price erosion on home appliance sales from an aggressive promotional environment and lower lawn and garden sales primarily impacted by unfavorable weather conditions. These declines were partially offset by increased sales in mattresses due to product transitions and updated floor models.

Gross Margin

Gross margin was \$165.8 million, or 21.7% of net sales, in the first two quarters of 2016 compared to \$202.8 million, or 23.3% of net sales, in the first two quarters of 2015. The decrease in gross margin rate was primarily driven by lower margin on merchandise sales, higher occupancy costs due to a higher number of Company-operated locations, and \$3.1 million higher shrink resulting from \$4.8 million of physical inventory gains in the first two quarters of 2015. These increases were partially offset by \$0.4 million from the Merchandising Net Benefit included in first quarter gross margin. The combined impact of occupancy costs, the Merchandising Net Benefit, closed stores, and shrink reduced gross margin 184 basis points in the first two quarters of 2016 compared to a 103 basis points reduction in the first two quarters of 2015.

Selling and Administrative Expenses

Selling and administrative expenses decreased to \$164.4 million, or 21.5% of net sales, in the first two quarters of 2016 from \$194.6 million, or 22.3% of net sales, in the prior-year comparable quarters. The decrease was primarily due to lower commissions paid to dealers and franchisees on lower sales volume from operating a higher number of company operated stores in 2016 and lower expenses due to stores closed (net of new store openings) since the second quarter of 2015.

Since the Separation we have included an allocation of Home Office overhead expenses in selling and administrative expenses for Hometown and Outlet. Home Office overhead expenses are primarily comprised of corporate headquarters payroll, benefits, and other costs and include charges related to our Services Agreement with Sears Holdings. In the first quarter of 2016 we adjusted the allocation of these Home Office overhead expenses between Hometown and Outlet to reflect our expected allocation of resources between Hometown and Outlet during the 2016 fiscal year. If the allocation weighting for the first two quarters of 2016 had been similar to the weighting for the prior-year comparable quarter we would have allocated an additional \$0.6 million of Home Office overhead expenses to Hometown's selling and administrative expenses. We will continue to evaluate the allocation of Home Office overhead expenses on an annual basis.

Operating Income

We recorded an operating loss of \$1.7 million and operating income of \$6.7 million in the first two quarters of 2016 and 2015, respectively. The reduction in operating income was primarily due to lower gross margin (including the impact of lower volume and a lower gross margin rate partially driven by higher shrink), which were partially offset by favorability in selling and administrative expenses.

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Outlet

Outlet results and key statistics were as follows:

<i>Thousands, except for number of stores</i>	13 Weeks Ended		26 Weeks Ended	
	July 30, 2016	August 1, 2015	July 30, 2016	August 1, 2015
Net sales	\$ 159,774	\$ 158,863	\$ 330,176	\$ 330,972
Comparable store sales %	(0.5)%	(2.2)%	(1.9)%	(2.6)%
Cost of sales and occupancy	128,277	120,717	264,929	252,040
Gross margin dollars	31,497	38,146	65,247	78,932
Margin rate	19.7 %	24.0 %	19.8 %	23.8 %
Selling and administrative	35,254	38,962	72,393	80,050
<i>Selling and administrative expense as a percentage of net sales</i>	22.1 %	24.5 %	21.9 %	24.2 %
Depreciation and amortization	1,786	1,281	3,474	2,489
Gain on the sale of assets	(25,269)	—	(25,269)	—
Total costs and expenses	140,048	160,960	315,527	334,579
Operating income (loss)	\$ 19,726	\$ (2,097)	\$ 14,649	\$ (3,607)
Total Outlet stores			159	158

13-Week Period ended July 30, 2016 Compared to the 13-Week Period Ended August 1, 2015
Net Sales

Outlet net sales increased \$0.9 million, or 0.6%, to \$159.8 million in the second quarter of 2016 from \$158.9 million in the second quarter of 2015. The increase was primarily due to new store sales (net of closures) partially offset by a 0.5% comparable stores sales decrease.

The Comparable store sales decrease of 0.5% was primarily due to lower sales in apparel and mattresses due to a decrease in product supply from Sears Holdings and lower lawn and garden sales primarily impacted by unfavorable weather conditions. These declines were partially offset by improved home appliance sales driven by an increase in inventory position.

Gross Margin

Gross margin was \$31.5 million, or 19.7% of net sales, in the second quarter of 2016 compared to \$38.1 million, or 24.0% of net sales, in the second quarter of 2015. The decrease in gross margin rate was primarily driven by lower margin on merchandise sales and higher occupancy costs due to more Company-operated stores. The impact of occupancy costs reduced the gross margin rate 797 basis points in the second quarter of 2016 compared to a reduction of 664 basis points in the second quarter of 2015.

Selling and Administrative Expenses

Selling and administrative expenses decreased to \$35.3 million, or 22.1% of net sales, in the second quarter of 2016 from \$39.0 million, or 24.5% of net sales, in the prior-year comparable quarter. The decrease was primarily due to the impact of operating a higher number of company operated stores resulting in lower commissions paid to franchisees partially offset by higher payroll and benefits expense.

Gain on Sale of Assets

During the second quarter of 2016, we completed the sale of an owned property located in San Leandro, California. Net proceeds from the sale were \$26.1 million, and we recorded a gain on the sale of \$25.3 million.

Operating Loss

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We recorded operating income of \$19.7 million and an operating loss of \$2.1 million in the second quarters of 2016 and 2015, respectively. The increase in operating income was primarily due to the \$25.3 million gain on the sale of assets and lower selling and administrative expenses partially offset by lower gross margin.

26-Week Period ended July 30, 2016 Compared to the 13-Week Period Ended August 1, 2015

Net Sales

Outlet Net sales decreased \$0.8 million, or 0.2%, to \$330.2 million in the first two quarters of 2016 from \$331.0 million in the first two quarters of 2015. The decrease was primarily due to a 1.9% comparable store sales decrease, \$0.6 million lower initial franchise revenues, and lower delivery revenues, partially offset by the impact of new stores (net of closed stores).

The Comparable store sales decrease of 1.9% was primarily due to lower sales in apparel and mattresses due to a decrease in product supply from Sears Holdings and lower lawn and garden sales primarily impacted by unfavorable weather conditions. These declines were partially offset by higher sales in home furnishings and higher sales in home appliances driven by an increase in inventory position.

Gross Margin

Gross margin was \$65.2 million, or 19.8% of net sales, in the first two quarters of 2016 compared to \$78.9 million, or 23.8% of net sales, in the first two quarters of 2015. The decrease in gross margin rate was primarily driven by lower margin on merchandise sales, higher occupancy costs due to a higher number of Company-operated locations, and \$4.5 million higher shrink resulting from a \$3.4 million physical inventory charge in the first quarter of 2016. These increases were partially offset by \$2.4 million from the Merchandising Net Benefit included in first quarter 2016 gross margin. The combined impact of occupancy costs, the Merchandising Net Benefit, and shrink reduced the gross margin rate 846 basis points in the first two quarters of 2016 compared to a reduction of 633 basis points in the first two quarters of 2015.

Selling and Administrative Expenses

Selling and administrative expenses decreased to \$72.4 million, or 21.9% of net sales, in the first two quarters of 2016 from \$80.1 million, or 24.2% of net sales, in the prior-year comparable quarter. The decrease was primarily due to the impact of operating a higher number of Company-operated stores resulting in lower commissions paid to franchisees partially offset by higher payroll and benefits expense.

Gain on Sale of Assets

During the second quarter of 2016, we completed the sale of an owned property located in San Leandro, California. Net proceeds from the sale were \$26.1 million, and we recorded a gain on the sale of \$25.3 million.

Operating Income (Loss)

We recorded operating income of \$14.6 million and an operating loss of \$3.6 million in the first two quarters of 2016 and 2015, respectively. The increase in operating income was primarily due to the \$25.3 million gain on the sale of assets, lower selling and administrative expenses, and the \$2.4 million Merchandising Net Benefit partially offset by lower gross margin (including the impact of a lower gross margin rate and higher shrink).

Analysis of Financial Condition

Cash and Cash Equivalents

We had cash and cash equivalents of \$18.7 million as of July 30, 2016, \$23.4 million as of August 1, 2015, and \$18.2 million as of January 30, 2016.

For the first two quarters of 2016 we funded ongoing operations with cash on-hand, proceeds from asset sales and cash provided by financing activities. Our primary needs for liquidity are to fund inventory purchases, IT transformation and capital expenditures and for general corporate purposes.

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Cash Flows from Operating Activities

For the 26 weeks ended July 30, 2016 cash used in operating activities was \$21.2 million compared to \$80.2 million generated for the 26 weeks ended August 1, 2015. The decrease in operating cash flow was due predominately to a decrease in Payables to Sears Holdings (primarily driven by accelerated payment terms in exchange for early payment cash discounts) and a decrease Merchandise payables along with lower net income excluding the \$25.3 million gain on asset sale.

Total merchandise inventories were \$427.2 million at July 30, 2016 and \$431.4 million at August 1, 2015. Merchandise inventories declined \$25.3 million in Hometown and increased \$21.1 million in Outlet. The decrease in Hometown was primarily due to store closures. Outlet's increase was primarily driven by growth in sourcing relationships for out-of-box appliances from sources other than Sears Holdings, which was partially offset by reduced apparel and mattress receipts from Sears Holdings.

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 78% and 84% of total purchases of all inventory from all vendors for the 26 weeks ended July 30, 2016 and August 1, 2015, respectively. The loss of, or a material reduction in the amount of, merchandise made available to us by Sears Holdings could have a material adverse effect on our business and results of operations. See also "Cautionary Statement Regarding Forward-Looking Information " in this Quarterly Report on Form 10-Q.

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

Cash Flows from Investing Activities

Cash provided by investing activities was \$19.2 million for the 26 weeks ended July 30, 2016 compared to \$2.5 million used for the 26 weeks ended August 1, 2015. Both periods included purchases of property and equipment along with \$26.1 million in proceeds from asset sales in the second quarter of 2016.

Cash Flows from Financing Activities

Cash provided by financing activities was \$2.4 million for the 26 weeks ended July 30, 2016 compared to \$74.0 million used during the 26 weeks ended August 1, 2015. The increase of \$76.4 million in cash provided by financing activities was primarily due to an increase of \$2.1 million in net borrowings under our Senior ABL Facility in 2016 compared to a \$74.0 million of payments in 2015.

Financing Arrangement

As of July 30, 2016 we had \$70.4 million outstanding under the Senior ABL Facility, which approximated the fair value of these borrowings. The Senior ABL Facility provides for maximum borrowings (subject to availability under a borrowing base) up to the aggregate commitments of all of the lenders, which as of July 30, 2016 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 July 30, 2016 was \$173.9 million with \$5.7 million of letters of credit outstanding under the facility.

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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 2.48% at July 30, 2016, or (2) an alternate base rate plus a borrowing margin, approximately 4.50% at July 30, 2016, 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 under the Senior ABL Facility for the 120-day period following the declaration and payment of the cash dividend or the stock repurchase. No default or event of default presently exists. At July 30, 2016 we did not meet either of the foregoing conditions and as a result the Senior ABL Facility does not permit us to pay cash dividends or repurchase our common stock.

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The Senior ABL Facility also contains certain affirmative covenants, including financial and other reporting requirements. As of July 30, 2016 we were in compliance with all covenants under the Senior ABL Facility.

Events of Default

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

Uses and Sources of Liquidity

We believe that our existing cash and cash equivalents, cash flows from our operating activities, and, to the extent necessary, availability under the Senior ABL Facility will be sufficient to meet our anticipated liquidity needs for at least the next 12 months. As of July 30, 2016, we had cash and cash equivalents of \$18.7 million. The adequacy of our available funds will depend on many factors, including the macroeconomic environment and the operating performance of our stores. We have entered into discussions with the Administrative Agent/Collateral Agent for the Senior ABL Facility regarding its extension, on terms and conditions to be negotiated, beyond its current maturity. While we believe that the outcome of these discussions and negotiations will be beneficial to the Company, we cannot predict the end results with any certainty.

Capital lease obligations as of July 30, 2016 and August 1, 2015 were \$0.8 million and \$0.3 million, respectively.

Off-Balance Sheet Arrangements

As of July 30, 2016, we had no off-balance sheet arrangements as defined in Item 303(a)(4) of the Securities and Exchange Commission's Regulation S-K.

Recent Accounting Pronouncements

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

Business Process Outsourcing and Information Systems

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

Our plan and expectation is that the new infrastructure and systems will be fully operational before the end of our 2017 fiscal year. The new infrastructure and systems will enable us, and we currently intend, to replace many of the corporate services provided by Sears Holdings with services provided by Capgemini, other third-party providers, and, on a limited-basis, internally by SHO. The replaced services could include tax, accounting, non-merchandise procurement, risk management and insurance, advertising and marketing, human resources, loss prevention, environmental, product and human safety, facilities, information technology, online, payment clearing, and other financial, real estate management, merchandising, and other support services.

We expect to incur increases in corporate expenses in 2016 and in fiscal 2017 as a result of the BPO. As we report our results, we intend to report on the expenses related to the migration when we believe that disclosure will aid the understanding of our financial condition and results of operations. Selling and administrative expenses related to the BPO ("IT transformation investments") were \$6.5 million and \$4.6 million in the first two quarters of 2016 and 2015, respectively.

The migration to the new infrastructure and systems involves significant risks for us, such as with respect to, among other things, the following: conversion and migration of data; availability and customization of solutions; availability of Company

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personnel and other resources to manage and implement the project; expansion of migration, implementation, and operational scope, cost, and timing; significant current disagreements with Capgemini regarding its and our contractual rights and obligations (about which we are currently in negotiations) and the contractual rights and obligations of Capgemini's contractors (such as NetSuite Inc.); the amount, quality, and timing of cooperation that we receive from Sears Holdings with respect to the migration; and disruption of our day-to-day business activities. These risks and other risks with respect to the project could have a material adverse effect on our business and results of operations.

CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING INFORMATION

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

The following factors, among others, could cause our actual results, performance, and achievements to differ materially from those expressed in the forward-looking statements, and one or more of the differences could have a material adverse effect on our ability to operate our business and could have a material adverse effect on our results of operations, financial condition, liquidity, and cash flows: the possible material adverse effects on SHO if Sears Holdings' financial condition were to significantly deteriorate, including if as a consequence Sears Holdings were to choose to seek the protection of the U.S. bankruptcy laws; our ability to offer merchandise and services that our customers want, including those under the KCD Marks; the Merchandising Agreement provides that (1) if a third party that is not an affiliate of Sears Holdings acquires the rights to one or more (but less than all) of the KCD Marks Sears Holdings may terminate our rights to buy merchandise branded with any of the acquired KCD Marks and (2) if a third party that is not an affiliate of Sears Holdings acquires the rights to all of the KCD Marks Sears Holdings may terminate the Merchandising Agreement in its entirety, over which events we have no control; the sale by Sears Holdings and its subsidiaries to other retailers that compete with us of major home appliances and other products branded with one of the KCD Marks; on May 26, 2016 Sears Holdings announced that it would explore alternatives for its Kenmore, Craftsman, and Diehard businesses and further expand the presence of these brands and on August 25, 2016 Sears Holdings announced that it was continuing to explore alternatives for these businesses by evaluating potential partnerships or other transactions; the willingness and ability of Sears Holdings to fulfill its contractual obligations to us; our ability to successfully manage our inventory levels and implement initiatives to improve inventory management and other capabilities; competitive conditions in the retail industry; worldwide economic conditions and business uncertainty, the availability of consumer and commercial credit, changes in consumer confidence, tastes, preferences and spending, and changes in vendor relationships; the fact that our past performance generally, as reflected on our historical financial statements, may not be indicative of our future performance as a result of, among other things, the consolidation of Hometown and Outlet into a single business entity, the Separation, and operating as a standalone business entity; the impact of increased costs due to a decrease in our purchasing power following the Separation, and other losses of benefits (such as a more effective and productive business relationship with Sears Holdings) that were associated with having been wholly owned by Sears Holdings and its subsidiaries prior to the Separation; our continuing reliance on Sears Holdings for most products and services that are important to the successful operation of our business, and our potential need to rely on Sears Holdings for some products and services beyond the expiration, or earlier termination by Sears Holdings, of our agreements with Sears Holdings; the willingness of Sears Holdings' appliance, lawn and garden, tools, and other vendors to continue to supply to Sears Holdings, on terms (including vendor payment terms for Sears Holdings' merchandise purchases) that are acceptable to it and to us, merchandise that we would need to purchase from Sears Holdings to ensure continuity of merchandise supplies for our businesses; the willingness of Sears Holdings' appliance, lawn and garden, tools, and other vendors to continue to pay to Sears Holdings merchandise-related subsidies and allowances and cash discounts (some of which Sears Holdings is obligated to pay to us); our ability to resolve, on commercially reasonable terms, future disputes with Sears Holdings regarding the material terms and conditions of our agreements with Sears Holdings; our ability to establish information, merchandising, logistics, and other systems separate from Sears Holdings that would be necessary to ensure continuity of merchandise supplies for our businesses if vendors were to reduce, or cease, their merchandise sales to Sears Holdings or if Sears Holdings were to reduce, or cease, its merchandise sales to us; if Sears Holdings' sales of major appliances and lawn and garden merchandise to its retail

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customers decline Sears Holdings' sales to us of outlet-value merchandise could decline; our ability to establish a more effective and productive business relationship with Sears Holdings, particularly if future disputes were to arise with respect to the terms and conditions of our agreements with Sears Holdings; most of our agreements related to the Separation and our continuing relationship with Sears Holdings were negotiated while we were a subsidiary of Sears Holdings (except for amendments agreed to after the Separation), 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 independent franchisees operate, which point-of-sale system captures, among other things, credit-card information supplied by our customers) and others, quantify our results of operations, and manage our business ("SHO's SHC-Supplied Systems"); SHO's SHC-Supplied Systems could be subject to disruptions and data/security breaches (Kmart, owned by Sears Holdings, announced in October 2014 that its payment-data systems had been breached), and Sears Holdings could be unwilling or unable to indemnify and defend us against third-party claims and other losses resulting from such disruptions and data/security breaches, which could have one or more material adverse effects on SHO; our ability to implement the BPO in accordance with our plans and expectations (see the risks described in "Business Process Outsourcing and Information Systems" in this Item 2); limitations and restrictions in the Senior ABL Facility and related agreements governing our indebtedness and our ability to service our indebtedness; our ability to obtain additional financing on acceptable terms; our dependence on the ability and willingness of our independent dealers and independent franchisees to operate their stores profitably and in a manner consistent with our concepts and standards; our ability to sell profitably online all of our merchandise and services; our dependence on sources outside the U.S. for significant amounts of our merchandise inventories; fixed-asset impairment for long-lived assets; our ability to attract, motivate, and retain key executives and other employees; our ability to maintain effective internal controls as a publicly held company; our ability to realize the benefits that we expect to achieve from the Separation; litigation and regulatory trends challenging various aspects of the franchisor-franchisee relationship could expand to challenge or adversely affect our relationships with our independent dealers and independent franchisees; low trading volume of our common stock due to limited liquidity or a lack of analyst coverage; and the impact on our common stock and our overall performance as a result of our principal stockholders' ability to exert control over us.

The foregoing factors should not be understood as exhaustive and should be read in conjunction with the other cautionary statements, including the "Risk Factors," that are included in this Quarterly Report on Form 10-Q and in the 2015 10-K and in our other filings with the Securities and Exchange Commission and our other public announcements. While we believe that our forecasts and assumptions are reasonable, we caution that actual results may differ materially. If one or more of these or other risks or uncertainties materialize, or if our underlying assumptions prove to be incorrect, actual results may vary materially from what we projected. Consequently, actual events and results may vary significantly from those included in or contemplated or implied by our forward-looking statements. The forward-looking statements included in this Quarterly Report on Form 10-Q are made only as of the date of this Quarterly Report on Form 10-Q. We undertake no obligation to publicly update or review any forward-looking statement made by us or on our behalf, whether as a result of new information, future developments, subsequent events or circumstances, or otherwise, except as required by law.

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 and 26 weeks ended July 30, 2016 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

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

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

Item 1A. Risk Factors

There have been no material changes from the risk factors previously disclosed in the 2015 10-K, which risks 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. At July 30, 2016 the Senior ABL Facility prohibited cash dividends and the repurchase of our common stock.

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

The Company did not repurchase any shares during the 13 weeks ended July 30, 2016. As of July 30, 2016 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.
EXHIBIT INDEX

Exhibit Number	Exhibit Description
10.1	Amended and Restated Merchandising Agreement dated May 11, 2016 between (1) Sears, Roebuck and Co., Sears Holdings Corporation, and Kmart Corporation, and (2) Registrant, Sears Authorized Hometown Stores, LLC, and Sears Outlet Stores, L.L.C. (incorporated by reference to Exhibit 10.1 to Registrant's Current Report on Form 8-K filed May 17, 2016 (File No. 001-35641)).
10.2	Amendment No. 4 to Merchandising Agreement dated May 11, 2016 between (1) Sears, Roebuck and Co., Sears Holdings Corporation, and Kmart Corporation, and (2) Registrant, Sears Authorized Hometown Stores, LLC, and Sears Outlet Stores, L.L.C. (incorporated by reference to Exhibit 10.2 to Registrant's Current Report on Form 8-K filed May 17, 2016 (File No. 001-35641)).
10.3	Amendment No. 4 to Services Agreement dated May 11, 2016 between Registrant and Sears Holdings Management Corporation (incorporated by reference to Exhibit 10.3 to Registrant's Current Report on Form 8-K filed May 17, 2016 (File No. 001-35641)).
*10.4	Amendment No. 5 to Services Agreement dated July 25, 2016 between Registrant and Sears Holdings Management Corporation.
10.5	Amendment No. 1 to Supplemental Agreement dated May 11, 2016 between Registrant and Sears Holdings Corporation. (incorporated by reference to Exhibit 10.4 to Registrant's Current Report on Form 8-K filed May 17, 2016 (File No. 001-35641)).
10.6	Amendment No. 1 to Employee Transition and Administrative Services Agreement dated May 11, 2016 between (1) Registrant, Sears Authorized Hometown Stores, LLC, and Sears Outlet Stores, L.L.C. (2) and Sears Holdings Management Corporation (incorporated by reference to Exhibit 10.5 to Registrant's Current Report on Form 8-K filed May 17, 2016 (File No. 001-35641)).
10.7	Amendment No. 2 to Store License Agreement (Outlet) dated May 11, 2016 between Sears, Roebuck and Co. and Sears Outlet Stores, L.L.C. (incorporated by reference to Exhibit 10.6 to Registrant's Current Report on Form 8-K filed May 17, 2016 (File No. 001-35641)).
10.8	Amendment No. 1 to Shop Your Way Rewards Retail Establishment Agreement dated May 11, 2016 between Registrant and Sears Holdings Management Corporation (incorporated by reference to Exhibit 10.7 to Registrant's Current Report on Form 8-K filed May 17, 2016 (File No. 001-35641)).
*10.9	Amendment No. 1 to Trademark License Agreement dated May 11, 2016 between Registrant and Sears, Roebuck and Co.
10.10	Agreement of Purchase and Sale dated May 19, 2016 between Sears Outlet Stores, L.L.C. and LIT-Acquisitions, L.L.C. (incorporated by reference to Exhibit 10.1 to Registrant's Current Report on Form 8-K filed May 25, 2016 (File No. 001-35641)).
*10.11	First Amendment to Agreement of Purchase and Sale dated July 1, 2016 between Sears Outlet Stores, L.L.C. and LIT-Acquisitions, L.L.C.
*10.12	Second Amendment to Agreement of Purchase and Sale dated July 20, 2016 between Sears Outlet Stores, L.L.C. and LIT-Acquisitions, L.L.C.
*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 July 30, 2016, formatted in XBRL (eXtensible Business Reporting Language) and furnished electronically herewith: (i) the Condensed Consolidated Statements of Operations (Unaudited) for the 13 and 26 Weeks Ended July 30, 2016 and August 1, 2015; (ii) the Condensed Consolidated Balance Sheets (Unaudited) at July 30, 2016, August 1, 2015, and January 30, 2016; (iii) the Condensed Consolidated Statements of Cash Flows (Unaudited) for the 13 and 26 Weeks Ended July 30, 2016 and August 1, 2015; (iv) the Condensed Combined Statements of Stockholders' Equity (Unaudited) for the 26 Weeks Ended July 30, 2016 and August 1, 2015; and (v) the Notes to the Condensed Consolidated Financial Statements (Unaudited).

* Filed herewith.

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

** 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.