

TILLY'S, INC.  
Form 10-Q  
September 11, 2013  
Table of Contents

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**Washington, DC 20549**

**FORM 10-Q**

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

**For the quarterly period ended August 3, 2013**

**OR**

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

**For the transition period from            to**

**Commission file number: 001-35535**

**TILLY S, INC.**

**(Exact name of Registrant as specified in its charter)**

**Delaware**  
**(State or other jurisdiction of**  
**incorporation or organization)**

**45-2164791**  
**(I.R.S. Employer**  
**Identification No.)**

**10 Whatney**

**Irvine, CA 92618**

**(Address of principal executive offices)**

**(949) 609-5599**

**(Registrant's telephone number, including area code)**

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.

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 Exchange Act Rule 12b-2) Yes  No

As of August 30, 2013, the registrant had the following shares of common stock outstanding:

|  |            |
|--|------------|
| Class A common stock \$0.001 par value | 11,138,654 |
| Class B common stock \$0.001 par value | 16,642,366 |



**Table of Contents**

**TILLY S, INC.**

**FORM 10-Q**

**For the Quarter Ended August 3, 2013**

**Index**

|   | <b>Page</b> |
|---|-------------|
| <b><u>PART I. FINANCIAL INFORMATION</u></b>   | 3           |
| Item 1. <u>Financial Statements (Unaudited)</u>   | 3           |
| <u>Consolidated Balance Sheets as of August 3, 2013 and February 2, 2013</u>  | 3           |
| <u>Consolidated Statements of Operations for the Thirteen and Twenty-Six Weeks Ended August 3, 2013 and July 28, 2012</u>               | 4           |
| <u>Consolidated Statements of Comprehensive Operations for the Thirteen and Twenty-Six Weeks Ended August 3, 2013 and July 28, 2012</u> | 5           |
| <u>Consolidated Statement of Stockholders' Equity as of August 3, 2013</u>  | 6           |
| <u>Consolidated Statements of Cash Flows for the Twenty-Six Weeks Ended August 3, 2013 and July 28, 2012</u>                            | 7           |
| <u>Notes to the Consolidated Financial Statements for the Thirteen and Twenty-Six Weeks Ended August 3, 2013 and July 28, 2012</u>      | 8           |
| Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>                                    | 16          |
| Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>   | 28          |
| Item 4. <u>Controls and Procedures</u>  | 28          |
| <b><u>PART II. OTHER INFORMATION</u></b>  | 29          |
| Item 1. <u>Legal Proceedings</u>  | 29          |
| Item 1A. <u>Risk Factors</u>  | 29          |
| Item 6. <u>Exhibits</u>   | 30          |

**Table of Contents****Part I. Financial Information****Item 1. Financial Statements (Unaudited)****TILLY S, INC.****CONSOLIDATED BALANCE SHEETS**

(In thousands, except per share data)

(Unaudited)

|   | August 3,<br>2013 | February 2,<br>2013 |
|---|-------------------|---------------------|
| <b>ASSETS</b>   |                   |                     |
| Current assets:   |                   |                     |
| Cash and cash equivalents   | \$ 20,883         | \$ 17,314           |
| Marketable securities   | 29,935            | 39,868              |
| Receivables   | 10,913            | 5,934               |
| Merchandise inventories   | 63,399            | 46,595              |
| Prepaid expenses and other current assets                             | 12,230            | 11,387              |
| Total current assets  | 137,360           | 121,098             |
| Property and equipment, net   | 94,568            | 80,926              |
| Other assets  | 3,804             | 3,357               |
| Total assets  | \$ 235,732        | \$ 205,381          |
| <b>LIABILITIES AND STOCKHOLDERS EQUITY</b>                            |                   |                     |
| Current liabilities:  |                   |                     |
| Accounts payable  | \$ 34,825         | \$ 18,261           |
| Deferred revenue  | 4,164             | 5,453               |
| Accrued compensation and benefits                                     | 5,255             | 6,094               |
| Accrued expenses  | 15,918            | 12,132              |
| Current portion of deferred rent                                      | 5,053             | 4,555               |
| Current portion of capital lease obligation/Related party (Note 10)   | 734               | 712                 |
| Total current liabilities   | 65,949            | 47,207              |
| Long-term portion of deferred rent                                    | 40,927            | 37,620              |
| Long-term portion of capital lease obligation/Related party (Note 10) | 2,885             | 3,258               |
| Total long-term liabilities   | 43,812            | 40,878              |
| Total liabilities   | 109,761           | 88,085              |
| Commitments and contingencies (Note 5)                                |                   |                     |

## Stockholders' equity:

|   |                   |                   |
|---|-------------------|-------------------|
| Common stock (Class A), \$0.001 par value; August 3, 2013 - 100,000 shares authorized,<br>11,129 shares issued and outstanding; February 2, 2013 - 100,000 shares authorized,<br>10,772 shares issued and outstanding | 11                | 11                |
| Common stock (Class B), \$0.001 par value; August 3, 2013 - 35,000 shares authorized,<br>16,642 shares issued and outstanding; February 2, 2013 - 35,000 shares authorized,<br>16,920 shares issued and outstanding   | 17                | 17                |
| Preferred stock, \$0.001 par value; August 3, 2013 and February 2, 2013 - 10,000 shares authorized, no shares issued or outstanding   |                   |                   |
| Additional paid-in capital  | 119,498           | 117,391           |
| Retained earnings (deficit)   | 6,435             | (140)             |
| Accumulated other comprehensive income  | 10                | 17                |
| <b>Total stockholders' equity</b>   | <b>125,971</b>    | <b>117,296</b>    |
| <b>Total liabilities and stockholders' equity</b>   | <b>\$ 235,732</b> | <b>\$ 205,381</b> |

*The accompanying notes are an integral part of these consolidated financial statements*

Table of Contents**TILLY'S, INC.****CONSOLIDATED STATEMENTS OF OPERATIONS**

(In thousands, except per share data)

(Unaudited)

|   | <b>Thirteen Weeks</b> |                 | <b>Twenty-Six Weeks Ended</b> |                 |
|---|-----------------------|-----------------|-------------------------------|-----------------|
|   | <b>Ended</b>          |                 |                               |                 |
|   | <b>August 3,</b>      | <b>July 28,</b> | <b>August 3,</b>              | <b>July 28,</b> |
|   | <b>2013</b>           | <b>2012</b>     | <b>2013</b>                   | <b>2012</b>     |
| Net sales   | \$ 123,043            | \$ 105,101      | \$ 232,161                    | \$ 201,625      |
| Cost of goods sold (includes buying, distribution, and occupancy costs) | 84,888                | 73,957          | 161,808                       | 140,063         |
| Gross profit  | 38,155                | 31,144          | 70,353                        | 61,562          |
| Selling, general and administrative expenses                            | 30,956                | 34,462          | 59,237                        | 58,854          |
| Operating income (loss)   | 7,199                 | (3,318)         | 11,116                        | 2,708           |
| Interest income (expense), net  | (47)                  | 40              | (96)                          | (4)             |
| Income (loss) before income taxes                                       | 7,152                 | (3,278)         | 11,020                        | 2,704           |
| Income tax expense (benefit)  | 2,885                 | (2,122)         | 4,445                         | (2,053)         |
| Net income (loss)   | \$ 4,267              | \$ (1,156)      | \$ 6,575                      | \$ 4,757        |
| Basic earnings (loss) per share   | \$ 0.15               | \$ (0.04)       | \$ 0.24                       | \$ 0.20         |
| Diluted earnings (loss) per share                                       | \$ 0.15               | \$ (0.04)       | \$ 0.23                       | \$ 0.20         |
| Weighted average basic shares outstanding                               | 27,727                | 27,280          | 27,710                        | 23,640          |
| Weighted average diluted shares outstanding                             | 28,080                | 27,280          | 28,053                        | 24,097          |
| Pro forma income information (Note 1):                                  |                       |                 |                               |                 |
| Historical income (loss) before income taxes                            |                       | \$ (3,278)      |                               | \$ 2,704        |
| Pro forma income tax expense (benefit)                                  |                       | (1,311)         |                               | 1,082           |
| Pro forma net income (loss)   |                       | \$ (1,967)      |                               | \$ 1,622        |
| Pro forma basic earnings (loss) per share                               |                       | \$ (0.07)       |                               | \$ 0.07         |
| Pro forma diluted earnings (loss) per share                             |                       | \$ (0.07)       |                               | \$ 0.07         |

*The accompanying notes are an integral part of these consolidated financial statements.*

Table of Contents**TILLY S, INC.****CONSOLIDATED STATEMENTS OF COMPREHENSIVE OPERATIONS**

(In thousands)

(Unaudited)

|  | <b>Thirteen Weeks Ended</b> |                          | <b>Twenty-Six Weeks Ended</b> |                          |
|--|-----------------------------|--------------------------|-------------------------------|--------------------------|
|  | <b>August 3,<br/>2013</b>   | <b>July 28,<br/>2012</b> | <b>August 3,<br/>2013</b>     | <b>July 28,<br/>2012</b> |
| Net income (loss)  | \$ 4,267                    | \$ (1,156)               | \$ 6,575                      | \$ 4,757                 |
| Other comprehensive income, net of tax:                    |                             |                          |                               |                          |
| Change in unrealized gain on available-for-sale securities | (21)                        | 48                       | (7)                           | 48                       |
| Other comprehensive income, net of tax:                    | (21)                        | 48                       | (7)                           | 48                       |
| Comprehensive income (loss)                                | \$ 4,246                    | \$ (1,108)               | \$ 6,568                      | \$ 4,805                 |

*The accompanying notes are an integral part of these consolidated financial statements.*



Table of Contents**TILLY'S, INC.****CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY**

(In thousands)

(Unaudited).

|  | Number of Shares |        |        | Additional | Accumulated |               | Total        |
|--|------------------|--------|--------|------------|-------------|---------------|--------------|
|  | Common           | Common | Common | Paid-in    | Retained    | Other         | Stockholders |
|  | Stock            | Stock  | Stock  | Capital    | Earnings    | Comprehensive | Equity       |
|  | (Class           | (Class | Common |            | (Deficit)   | Income        |              |
|  | A)               | B)     | Stock  |            |             |               |              |
| Balance at February 2, 2013                                | 10,772           | 16,920 | \$ 28  | \$ 117,391 | \$ (140)    | \$ 17         | \$ 117,296   |
| Net income   |                  |        |        |            | 6,575       |               | 6,575        |
| Restricted stock   | 31               |        |        |            |             |               |              |
| Shares converted by founders                               | 278              | (278)  |        |            |             |               |              |
| Change in unrealized gain on available-for-sale securities |                  |        |        |            |             | (7)           | (7)          |
| Stock-based compensation expense                           |                  |        |        | 1,655      |             |               | 1,655        |
| Exercise of stock options                                  | 48               |        |        | 452        |             |               | 452          |
| Balance at August 3, 2013                                  | 11,129           | 16,642 | \$ 28  | \$ 119,498 | \$ 6,435    | \$ 10         | \$ 125,971   |

*The accompanying notes are an integral part of these consolidated financial statements.*

Table of Contents**TILLY'S, INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS**

(In thousands)

(Unaudited)

|   | <b>Twenty-Six Weeks Ended</b> |                          |
|---|-------------------------------|--------------------------|
|   | <b>August 3,<br/>2013</b>     | <b>July 28,<br/>2012</b> |
| <b>Cash flows from operating activities</b>                                       |                               |                          |
| Net income  | \$ 6,575                      | \$ 4,757                 |
| Adjustments to reconcile net income to net cash provided by operating activities: |                               |                          |
| Depreciation and amortization   | 9,425                         | 8,029                    |
| Loss on disposal of assets  | 111                           | 38                       |
| Gain on maturities of marketable securities                                       | (119)                         |                          |
| Deferred income taxes   | 558                           | 6,148                    |
| Stock-based compensation expense  | 1,655                         | 8,220                    |
| Excess tax benefit from stock-based compensation                                  | (40)                          | (9)                      |
| Changes in operating assets and liabilities:                                      |                               |                          |
| Receivables   | (4,979)                       | (3,570)                  |
| Merchandise inventories   | (16,804)                      | (18,019)                 |
| Prepaid expenses and other assets   | (1,843)                       | (12,149)                 |
| Accounts payable  | 16,564                        | 15,143                   |
| Accrued expenses  | 4,378                         | 5,530                    |
| Accrued compensation and benefits   | (839)                         | (2,428)                  |
| Deferred rent   | 3,805                         | 5,263                    |
| Deferred revenue  | (1,289)                       | (1,275)                  |
| <b>Net cash provided by operating activities</b>                                  | <b>17,158</b>                 | <b>15,678</b>            |
| <b>Cash flows from investing activities</b>                                       |                               |                          |
| Purchase of property and equipment  | (23,789)                      | (16,449)                 |
| Proceeds from sale of property and equipment                                      | 19                            | 17                       |
| Insurance proceeds from casualty loss   |                               | 799                      |
| Purchases of marketable securities  | (14,960)                      | (35,539)                 |
| Maturities of marketable securities   | 25,000                        | 9,455                    |
| <b>Net cash used in investing activities</b>                                      | <b>(13,730)</b>               | <b>(41,717)</b>          |
| <b>Cash flows from financing activities</b>                                       |                               |                          |
| Payment of capital lease obligation   | (351)                         | (329)                    |
| Net proceeds from initial public offering   |                               | 106,783                  |
| Proceeds from exercise of stock options   | 452                           | 267                      |
| Excess tax benefit from stock-based compensation                                  | 40                            | 9                        |

|  |           |           |
|--|-----------|-----------|
| Distributions  |           | (84,287)  |
| Net cash provided by financing activities                | 141       | 22,443    |
| Change in cash and cash equivalents                      | 3,569     | (3,596)   |
| Cash and cash equivalents, beginning of period           | 17,314    | 25,091    |
| Cash and cash equivalents, end of period                 | \$ 20,883 | \$ 21,495 |
| <b>Supplemental disclosures of cash flow information</b> |           |           |
| Interest paid  | \$ 132    | \$ 156    |
| Income taxes paid  | \$ 4,294  | \$ 11     |
| <b>Supplemental disclosure of non-cash activities</b>    |           |           |
| Unpaid purchases of property and equipment               | \$ 2,284  | \$ 914    |

*The accompanying notes are an integral part of these consolidated financial statements.*

---

**Table of Contents**

**TILLY'S, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Unaudited)

**1. Description of the Company and Basis of Presentation**

Tilly's, Inc. was formed as a Delaware corporation on May 4, 2011 for the purpose of reorganizing the corporate structure of World of Jeans & Tops, a California corporation (WOJT). On May 2, 2012, the shareholders of WOJT contributed all of their shares of common stock to Tilly's, Inc. in return for shares of Tilly's, Inc. Class B common stock on a one-for-one basis. In addition, effective May 2, 2012, WOJT converted from an S Corporation to a C Corporation for income tax purposes. These events are collectively referred to as the Reorganization. As a result of the Reorganization, WOJT became a wholly owned subsidiary of Tilly's, Inc. Except where context requires or where otherwise indicated, the terms Company and Tilly's refers to WOJT before the Reorganization and to Tilly's, Inc. and its subsidiary, WOJT, after the Reorganization.

Tilly's operates a chain of specialty retail stores featuring casual clothing, footwear and accessories for teens and young adults. The Company operated a total of 182 and 168 stores as of August 3, 2013 and February 2, 2013, respectively. The stores are located in malls, lifestyle centers, power centers, community centers, outlet centers and street-front locations. Customers may also shop online, where the Company features a similar assortment of product as is carried in its brick-and-mortar stores.

The accompanying unaudited consolidated financial statements include the assets, liabilities, revenues and expenses of the Company. These consolidated financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the U.S. (GAAP) have been omitted from this report as is permitted by SEC rules and regulations.

In the opinion of management, the accompanying unaudited consolidated financial statements contain all normal and recurring adjustments necessary to present fairly the financial condition, results of operations and cash flows of the Company for the interim periods presented. The results of operations for the thirteen and twenty-six weeks ended August 3, 2013 and July 28, 2012 are not necessarily indicative of results to be expected for the full fiscal year. These interim consolidated financial statements should be read in conjunction with the consolidated financial statements and notes included in the Company's Annual Report on Form 10-K for the fiscal year ended February 2, 2013.

***Fiscal Periods***

The Company's fiscal year ends on the Saturday closest to January 31. References to the fiscal quarters ended August 3, 2013 and July 28, 2012 refer to the thirteen-week periods ended as of those dates.

***Initial Public Offering***

On May 3, 2012, the Company completed its initial public offering (IPO) in which it issued and sold 7,600,000 shares of its Class A common stock and certain selling stockholders sold 400,000 shares of Class A common stock. In addition, on May 9, 2012, the underwriters exercised their option to purchase an additional 1,200,000 shares of Class A common stock from the selling stockholders to cover over-allotments. As a result, the total IPO size was

9,200,000 shares of Class A common stock, which consisted of 7,600,000 shares sold by the Company and 1,600,000 shares sold by the selling stockholders. The 9,200,000 shares of Class A common stock sold in the offering were sold at a price of \$15.50 per share. The Company did not receive any proceeds from the sale of shares by the selling stockholders.

As a result of the IPO, the Company received net proceeds of approximately \$107 million, after deducting the underwriting discount of \$8.7 million and related fees and expenses of approximately \$2.5 million. The Company used \$84.0 million of the net proceeds from the IPO to pay in full notes previously issued to the shareholders of WOJT. These notes represented WOJT's undistributed taxable income from the date of its formation through the date of termination of its S Corporation status.

**Table of Contents*****Unaudited Pro Forma Income Information***

The unaudited pro forma income information gives effect to the conversion of the Company to a C Corporation on May 2, 2012. Prior to such conversion, the Company was an S Corporation and generally not subject to income taxes. Therefore, the pro forma net income and per share amounts for the thirteen and twenty-six weeks ended July 28, 2012 includes an adjustment for income tax expense as if the Company had been a C Corporation during those periods at an assumed combined federal, state and local effective tax rate of 40%, which approximates the calculated statutory tax rates for the periods. In addition, the unaudited pro forma diluted weighted average shares outstanding were computed using the assumed 40% effective tax rate. As a result, the pro forma adjustment to diluted weighted average shares outstanding for the twenty-six weeks ended July 28, 2012 was a reduction of approximately 12,000 shares. There was no pro forma adjustment for the thirteen weeks ended July 28, 2012 as the dilutive effect of stock options is applicable only in periods of net income.

**2. Summary of Significant Accounting Policies**

Information regarding significant accounting policies is contained in Note 2, Summary of Significant Accounting Policies, of the consolidated financial statements in the Company's Annual Report on Form 10-K for the fiscal year ended February 2, 2013.

**3. Marketable Securities**

Marketable securities are classified as available-for-sale and, as of August 3, 2013 and February 2, 2013, consisted entirely of commercial paper, all of which was less than one year from maturity.

The following table summarizes the Company's investments in marketable securities at August 3, 2013 and February 2, 2013 (in thousands):

|                  | Cost      | August 3, 2013                          |  | Fair Value |
|------------------|-----------|---|--|------------|
|                  |           | Gross<br>Unrealized<br>Holding<br>Gains | Gross<br>Unrealized<br>Holding<br>Losses |            |
| Commercial paper | \$ 29,918 | \$ 31                                   | \$ 14                                    | \$ 29,935  |

|                  | Cost      | February 2, 2013                        |  | Fair Value |
|------------------|-----------|---|--|------------|
|                  |           | Gross<br>Unrealized<br>Holding<br>Gains | Gross<br>Unrealized<br>Holding<br>Losses |            |
| Commercial paper | \$ 39,839 | \$ 31                                   | \$ 2                                     | \$ 39,868  |

For the thirteen and twenty-six weeks ended August 3, 2013, the Company recognized gains on investments of \$75 thousand and \$119 thousand, respectively, for commercial paper which matured during the periods. Upon recognition of the gains, the Company reclassified these amounts out of accumulated other comprehensive income and into

current period earnings.

**4. Line of Credit**

On May 3, 2012, the Company amended its revolving credit facility agreement with Wells Fargo Bank, N.A. The amended credit facility provides for a line of credit of \$25.0 million and matures on May 3, 2014. Interest charged on borrowings is either at the London Interbank Offered Rate ( LIBOR ) plus 1.75%, or at the bank s

**Table of Contents**

prime rate. The Company has the ability to select between the prime or LIBOR-based rate at the time of a cash advance. Borrowing from the credit facility is secured by substantially all of the Company's assets. A sub-feature of the credit facility allows stand-by and commercial letters of credit up to \$15.0 million. The Company is required to maintain certain financial and nonfinancial covenants in accordance with the revolving credit facility. The financial covenants contain requirements for certain levels of liquidity and profitability, such as: (i) a minimum current asset to current liability ratio of 1.25 to 1.00, (ii) a net profit before tax of at least \$1, determined as of the end of each fiscal quarter on a cumulative rolling four-quarter basis, excluding a non-cash expense of up to a maximum of \$2.0 million for the write-off of impaired fixed assets for that period and (iii) a maximum ratio of 4.00 to 1.00 for funded debt to EBITDAR, where funded debt includes credit facility borrowings, capital lease debt and eight times annual operating lease rent expense, and EBITDAR includes net income before interest, income taxes, depreciation, amortization and rent expense.

As of August 3, 2013, the Company was in compliance with all of its covenants and had no outstanding borrowings under the line of credit.

**5. Commitments and Contingencies*****Legal Proceedings***

From time to time, the Company may become involved in lawsuits and other claims arising from our ordinary course of business. Management is currently unable to predict the ultimate outcome of any litigation or claim, determine whether a liability has been incurred or make an estimate of the reasonably possible liability that could result from an unfavorable outcome because of the uncertainties related to the incurrence, amount and range of loss on any pending litigation or claim. Because of the unpredictable nature of these matters, the Company cannot provide any assurances regarding the outcome of any litigation or claim to which it is a party or that the ultimate outcome of any of the matters threatened or pending against it, including those disclosed below, will not have a material adverse effect on the Company's financial condition, results of operations or cash flows.

*Kristin Christiansen and Shellie Smith, on behalf of themselves and all others similarly situated vs. World of Jeans & Tops, Superior Court of California, County of Sacramento, Case No. 34-2013-00139010.* On January 29, 2013, the plaintiffs in this matter filed a putative class action lawsuit against the Company alleging violations of California Civil Code Section 1747.08, which prohibits requesting or requiring personal identification information from a customer paying for goods with a credit card and recording such information, subject to exceptions. In June 2013, the Court granted the Company's motion to strike portions of the plaintiffs' complaint and granted plaintiffs leave to amend. Plaintiffs amended to add a new named plaintiff, which the Court struck on the Company's motion. The Company has denied the allegations of the complaint and intends to defend this case vigorously.

*Maria Rebolledo, individually and on behalf of all others similarly situated and on behalf of the general public vs. Tilly's, Inc.; World of Jeans & Tops, Superior Court of the State of California, County of Orange, Case No. 30-2012-00616290-CU-OE-CXC.* On December 5, 2012, the plaintiff in this matter filed a putative class action lawsuit against the Company alleging violations of California's wage and hour, meal break and rest break rules and regulations, and unfair competition law, among other things. An amended complaint was filed on February 28, 2013, to include enforcement of California's private attorney general act. The complaint seeks an unspecified amount of damages and penalties. In April 2013, the Company filed a motion to compel arbitration, which was denied in May 2013. The Company has appealed the denial of the motion to compel arbitration. The Company intends to defend this case vigorously.



*Deborah Lyddy v. World of Jeans & Tops and Tilly's, Inc., Superior Court of California, County of San Diego (37-2011-00098812-CU-BT-CTL)*. In October 2011, plaintiff filed a putative class action lawsuit against the Company alleging various causes of action based on its California gift card redemption policies. The state court sustained the original demurrer to the complaint but granted plaintiff leave to amend. The amended complaint survived demurrer and the court has now set a briefing schedule for a hearing on plaintiff's motion for class action treatment of the lawsuit. The Company intends to defend this case vigorously.

**Table of Contents****6. Fair Value Measurements**

Financial Accounting Standards Board Accounting Standards Codification ( ASC ) Topic 820, *Fair Value Measurements and Disclosure*, ( ASC 820 ) defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. Fair value is defined under ASC 820 as the exit price associated with the sale of an asset or transfer of a liability in an orderly transaction between market participants at the measurement date. ASC 820 established the following three-tier fair value hierarchy, which prioritizes the inputs used in measuring fair value:

*Level 1* Quoted prices in active markets for identical assets and liabilities.

*Level 2* Inputs other than Level 1 that are observable, either directly or indirectly, such as quoted prices for similar assets and liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

*Level 3* Unobservable inputs (i.e. projections, estimates, interpretations, etc.) that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

The Company measures certain financial assets at fair value on a recurring basis, including its marketable securities, which are classified as available-for-sale securities, and certain cash equivalents, specifically money market accounts. The money market accounts are valued based on quoted market prices in active markets. The marketable securities are valued based on other observable inputs for those securities (including market corroborated pricing or other models that utilize observable inputs such as interest rates and yield curves) based on information provided by independent third party entities.

During the thirteen and twenty-six weeks ended August 3, 2013 and July 28, 2012, the Company did not make any transfers between Level 1 and Level 2 financial assets. Furthermore, as of August 3, 2013 and February 2, 2013, the Company did not have any Level 3 financial assets. The Company conducts reviews on a quarterly basis to verify pricing, assess liquidity, and determine if significant inputs have changed that would impact the fair value hierarchy disclosure.

From time to time, the Company measures certain assets at fair value on a non-recurring basis, specifically long-lived assets evaluated for impairment. The Company estimates the fair value of its long-lived assets using company-specific assumptions which would fall within Level 3 of the fair value hierarchy.

In accordance with the provisions of ASC 820, the Company categorized its financial assets based on the priority of the inputs to the valuation technique for the instruments as follows (in thousands):

|                         | August 3, 2013 |         |         | February 2, 2013 |         |         |
|-------------------------|----------------|---------|---------|------------------|---------|---------|
|                         | Level 1        | Level 2 | Level 3 | Level 1          | Level 2 | Level 3 |
| Cash equivalents:       |                |         |         |                  |         |         |
| Money market securities | \$ 16,264      | \$      | \$      | \$ 15,224        | \$      | \$      |
| Marketable securities:  |                |         |         |                  |         |         |
| Commercial paper        |                | 29,935  |         |                  | 39,868  |         |

**7. Stock-Based Compensation**

On March 25, 2013, the Company granted stock options to purchase a total of 554,500 shares of Class A common stock under the Tilly's 2012 Equity and Incentive Award Plan (the "2012 Plan"). The exercise price of these awards is \$12.82, which was the closing price of Tilly's Class A common stock on the date of grant. These stock options vest in four equal annual installments beginning on the first anniversary of the date of grant, provided that the respective award recipient continues to be employed by the Company through each of those vesting dates.

**Table of Contents**

The Company also granted options to purchase a total of 50,000 shares of Class A common stock under the 2012 Plan to employees who joined the Company during the second quarter of fiscal year 2013. The exercise prices of these awards range between \$16.18 and \$16.24 per share, and were set equal to the closing price of Tilly's Class A common stock on the date of each grant. These stock option grants vest in four equal annual installments beginning on the first anniversary of the date of grant, provided that the respective award recipient continues to be employed by the Company through each of those vesting dates.

The total grant date fair value of stock options granted during the thirteen and twenty-six weeks ended August 3, 2013 was \$0.4 million and \$3.8 million, respectively, before applying an estimated forfeiture rate. The Company is recognizing the expense relating to these stock options, net of estimated forfeitures, on a straight-line basis over the four year service period of the awards. The grant date fair value of stock options granted during the thirteen and twenty-six weeks ended July 28, 2012 was \$6.1 million, before applying an estimated forfeiture rate.

The stock option awards discussed above were measured at fair value on the grant date using the Black-Scholes option valuation model. Key input assumptions used to estimate the fair value of stock options include the exercise price of the award, the expected option term, expected volatility of the Company's stock over the option's expected term, the risk-free interest rate over the option's expected term and the Company's expected annual dividend yield, if any. The Company's estimate of pre-vesting forfeitures, or forfeiture rate, was based on its internal analysis, which included the award recipients' positions within the Company and the vesting period of the awards. The Company will issue shares of Class A common stock when the options are exercised.

The fair value of stock options granted during the thirteen and twenty-six weeks ended August 3, 2013 and July 28, 2012 were estimated on the grant date using the following assumptions:

|                                | <b>Thirteen<br/>Weeks Ended<br/>August 3, 2013</b> | <b>Thirteen<br/>Weeks Ended<br/>July 28, 2012</b> | <b>Twenty-Six<br/>Weeks Ended<br/>August 3, 2013</b> | <b>Twenty-Six<br/>Weeks Ended<br/>July 28, 2012</b> |
|--------------------------------|--|---|--|---|
| Expected option term(1)        | 5.0 years  | 5.0 years   | 5.0 years  | 5.0 years   |
| Expected volatility factor(2)  | 55.8% - 56.0%                                      | 62.1% - 62.7%                                     | 55.8% - 56.2%  | 62.1% - 62.7%                                       |
| Risk-free interest rate(3)     | 1.0% - 1.2%  | 0.6% - 0.8%                                       | 0.8% - 1.2%  | 0.6% - 0.8%   |
| Expected annual dividend yield | 0%   | 0%  | 0%   | 0%  |

- (1) The Company has limited historical information regarding expected option term. Accordingly, the Company determined the expected option term of the awards using historical data available from comparable public companies and management's expectation of exercise behavior.
- (2) Stock volatility for each grant is measured using the weighted average of historical daily price changes of the Company's competitors' common stock over the most recent period equal to the expected option term of the Company's awards.
- (3) The risk-free interest rate is determined using the rate on treasury securities with the same term as the expected life of the stock option as of the grant date.

**Table of Contents**

The following table summarizes the Company's stock option activity for the twenty-six weeks ended August 3, 2013 (aggregate intrinsic value in thousands):

|   | Stock<br>Options | Grant Date<br>Weighted<br>Average<br>Exercise Price | Weighted<br>Average<br>Remaining<br>Contractual<br>Life (in Years) | Aggregate<br>Intrinsic<br>Value(1) |
|---|------------------|---|--|------------------------------------|
| Outstanding at February 2, 2013               | 2,133,625        | \$ 12.83  |  |                                    |
| Granted year-to-date                          | 604,500          | 13.10   |  |                                    |
| Exercised year-to-date                        | (48,475)         | 8.58  |  |                                    |
| Forfeited year-to-date                        | (10,875)         | 14.27   |  |                                    |
| <b>Outstanding at August 3, 2013</b>          | <b>2,678,775</b> | <b>\$ 12.96</b>                                     | <b>7.5</b>   | <b>\$ 6,162</b>                    |
| Vested and expected to vest at August 3, 2013 | 2,481,734        | \$ 12.82  | 7.4  | \$ 6,017                           |
| <b>Exercisable at August 3, 2013</b>          | <b>1,233,025</b> | <b>\$ 11.06</b>                                     | <b>5.9</b>   | <b>\$ 5,010</b>                    |

(1) Intrinsic value for stock options is defined as the difference between the market price of the Company's Class A common stock on the last business day of the fiscal quarter and the weighted average exercise price of in-the-money stock options outstanding at the end of each fiscal period. The closing price of the Company's Class A common stock on August 2, 2013 was \$14.65 per share.

On June 12, 2013, the Company granted 4,944 restricted shares of Class A common stock to each of its four independent directors under the 2012 Plan. These shares vest in two equal annual installments beginning on June 12, 2014, provided that the respective award recipient continues to serve on the Company's board of directors through each of those vesting dates. The grant date fair value of these awards totaled \$0.3 million. The Company is recognizing the expense related to these awards on a straight-line basis over the two-year service period commencing on the grant date.

There are a total of 2,913,900 shares issuable under the 2012 Plan, of which 1,544,145 shares were still available for issuance as of August 3, 2013. The Company recorded a total of \$0.8 million and \$1.7 million of stock-based compensation expense in the thirteen and twenty-six weeks ended August 3, 2013, respectively. During the thirteen and twenty-six weeks ended July 28, 2012, the Company recorded a total of \$8.2 million of stock-based compensation expense, which included a one-time charge of \$7.6 million for life-to-date stock-based compensation expense recognized upon the consummation of the Company's IPO. At August 3, 2013, there was \$8.0 million of total unrecognized stock-based compensation expense related to unvested stock options and restricted stock grants. This cost has a weighted average remaining recognition period of 2.9 years.

**8. Income Taxes**

Prior to May 2, 2012, WOJT was taxed as an S Corporation for federal income tax purposes under Section 1362 of the Internal Revenue Code, and therefore was not subject to federal and state income taxes (subject to an exception in a limited number of state and local jurisdictions that do not recognize the S Corporation status). On May 2, 2012, as part of the Reorganization, the Company's S Corporation status terminated and the Company became subject to corporate-level federal and state income taxes at prevailing corporate rates.

The Company accounts for income taxes and the related accounts under the liability method in accordance with ASC Topic 740, *Income Taxes*. Deferred tax assets and liabilities are determined based on the difference between the financial statement and tax bases of assets and liabilities using enacted tax rates expected to be in effect during the year in which the basis differences reverse. Because management believes that it is more likely than not that the Company will realize the full amount of the net deferred tax assets, the Company has not recorded any valuation allowance for the deferred tax assets.

The provision for income taxes for interim periods is based on an estimate of the annual effective tax rate adjusted to reflect the impact of discrete items. Significant management judgment is required in projecting ordinary income (loss) to estimate the Company's annual effective tax rate.

**Table of Contents**

The annual effective income tax rate was 40.3% and 33.6% for both the thirteen and twenty-six weeks ended August 3, 2013 and July 28, 2012, respectively. The annual effective rate for the thirteen and twenty-six weeks ended August 3, 2013 is higher than the thirteen and twenty-six weeks ended July 28, 2012 primarily due to the Company's conversion from an S Corporation to a C Corporation on May 2, 2012. Pro forma tax expense for the thirteen and twenty-six weeks ended July 28, 2012 was calculated at an assumed combined federal, state and local effective tax rate of 40%, which approximates the calculated effective tax rate had the Company been a C Corporation during the thirteen and twenty-six weeks ended July 28, 2012.

During the thirteen weeks ended July 28, 2012, the Company recorded a net income tax benefit of \$2.1 million. The net income tax benefit comprised (1) a one-time deferred tax benefit of \$3.0 million recognized upon the conversion to a C Corporation, (2) a provision of \$2.0 million related to the period during fiscal year 2012 in which the Company was an S Corporation (January 29, 2012 through May 1, 2012) computed at the annual effective tax rate of 33.6% rather than the previously recognized 1.1% S Corporation effective tax rate and (3) a tax benefit of \$1.1 million related to the period in which the Company was a C Corporation (May 2, 2012 through July 28, 2012) at an annual effective tax rate of 33.6%.

**9. Earnings (Loss) Per Share**

Earnings (loss) per share is computed under the provisions of ASC Topic 260, *Earnings Per Share*. Basic earnings (loss) per share is computed based on the weighted average number of common shares outstanding during the period. Diluted earnings per share is computed based on the weighted average number of shares of common stock plus the effect of dilutive potential common shares outstanding during the period using the treasury stock method, whereby proceeds from such exercise, unamortized compensation and hypothetical excess tax benefits, if any, on share-based awards are assumed to be used by the Company to purchase the common shares at the average market price during the period. Dilutive potential common shares represent outstanding stock options and restricted stock awards. The dilutive effect of stock options and restricted stock is applicable only in periods of net income. The components of basic and diluted earnings (loss) per share are as follows (in thousands, except per share amounts):

|   | <b>Thirteen Weeks Ended</b> |                          | <b>Twenty-Six Weeks Ended</b> |                          |
|---|-----------------------------|--------------------------|-------------------------------|--------------------------|
|   | <b>August 3,<br/>2013</b>   | <b>July 28,<br/>2012</b> | <b>August 3,<br/>2013</b>     | <b>July 28,<br/>2012</b> |
| Net income (loss)   | \$ 4,267                    | \$ (1,156)               | \$ 6,575                      | \$ 4,757                 |
| Weighted average basic shares outstanding                     | 27,727                      | 27,280                   | 27,710                        | 23,640                   |
| Dilutive effect of stock options and restricted stock         | 353                         |                          | 343                           | 457                      |
| Weighted average shares for diluted earnings (loss) per share | 28,080                      | 27,280                   | 28,053                        | 24,097                   |
| Basic earnings (loss) per share                               | \$ 0.15                     | \$ (0.04)                | \$ 0.24                       | \$ 0.20                  |
| Diluted earnings (loss) per share                             | \$ 0.15                     | \$ (0.04)                | \$ 0.23                       | \$ 0.20                  |

For the thirteen weeks ended August 3, 2013, additional stock options outstanding of 1,856,000 were excluded from the calculation of diluted earnings per share, as their effect would have been anti-dilutive based on the application of the treasury stock method. For the thirteen weeks ended July 28, 2012, the shares used in computing diluted loss per

share do not include 931,500 of dilutive stock options as the effect is anti-dilutive given the Company's net loss. For the twenty-six weeks ended August 3, 2013 and July 28, 2012, additional stock options outstanding of 1,835,750 and 906,750, respectively, were excluded from the calculation of diluted earnings per share, as their effect would have been anti-dilutive based on the application of the treasury stock method.

#### **10. Related Parties**

The Company leases its corporate headquarters and distribution center (10 and 12 Whatney, Irvine, California) from a company that is owned by the co-founders of Tilly's. On June 29, 2012, the Company exercised the first of its three five-year renewal options on this lease, with the renewal commencing on January 1, 2013. The lease now expires on December 31, 2017. The land component of this lease is accounted for as an operating lease and the building component is accounted for as a capital lease. The Company incurred rent expense of \$0.2 million for both of the thirteen weeks ended August 3, 2013 and July 28, 2012 and \$0.4 million for both of the twenty-six weeks



**Table of Contents**

ended August 3, 2013 and July 28, 2012 for the operating component of this lease. The obligation under the capital lease was \$3.6 million and \$4.0 million as of August 3, 2013 and February 2, 2013, respectively. The gross amount of the building under capital lease was \$7.8 million as of both August 3, 2013 and February 2, 2013. Accumulated depreciation of the building under capital lease was \$5.5 million and \$5.3 million as of August 3, 2013 and February 2, 2013, respectively.

The Company leases warehouse space (15 Chrysler, Irvine, California) from a company that is owned by one of the co-founders of Tilly's. The lease expires on October 31, 2014 and is being accounted for as an operating lease. The Company incurred rent expense of \$0.1 million for both of the thirteen weeks ended August 3, 2013 and July 28, 2012, and \$0.1 million for both of the twenty-six weeks ended August 3, 2013 and July 28, 2012. The Company subleases part of the building to an unrelated third party. The sublease terminates on May 31, 2014.

The Company leases office and warehouse space (11 Whatney, Irvine, California) from a company that is owned by one of the co-founders of Tilly's. The lease expires on June 30, 2022 and is being accounted for as an operating lease. The Company occupied the building on June 29, 2012 and incurred rent expense of \$0.1 million and \$33 thousand for the thirteen weeks ended August 3, 2013 and July 28, 2012, respectively, and \$0.2 million and \$33 thousand for the twenty-six weeks ended August 3, 2013 and July 28, 2012, respectively.

The Company leases a building (17 Pasteur, Irvine, California) from a company that is owned by one of the co-founders of Tilly's. The lease terminates on October 31, 2021 and is being accounted for as an operating lease. The Company intends to use this building as its e-commerce distribution center. Pursuant to the lease agreement, the Company requested during fiscal year 2012 that the landlord expand the building. Upon commencement of the building expansion, the Company returned the building to the landlord. As of February 2, 2013, the landlord returned the expanded building to the Company and monthly lease payments re-commenced by the Company in February 2013. The Company incurred rent expense of \$0.3 million and \$0.2 million for the thirteen weeks ended August 3, 2013 and July 28, 2012, respectively, and \$0.5 million and \$0.4 million for the twenty-six weeks ended August 3, 2013 and July 28, 2012, respectively.

Prior to signing each of the related party leases above, the Company received an independent market analysis regarding the property and therefore believes that the terms of each lease are reasonable and are not materially different than terms the Company would have obtained from an unaffiliated third party.

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

*The following discussion and analysis of the financial condition and results of our operations should be read together with the financial statements and related notes of Tilly's, Inc. included in Item 1 of this Quarterly Report on Form 10-Q and with our audited consolidated financial statements and the related notes included in our Annual Report on Form 10-K for the fiscal year ended February 2, 2013. As used in this Quarterly Report on Form 10-Q, except where the context otherwise requires or where otherwise indicated, the terms "company", "World of Jeans & Tops", "we", "our", "us" and "Tilly's" refer to Tilly's, Inc. and its subsidiary.*

**Cautionary Statement Regarding Forward-Looking Statements**

This Quarterly Report on Form 10-Q contains forward-looking statements that involve risks and uncertainties, as well as assumptions that, if they never materialize or prove incorrect, could cause our results to differ materially from those expressed or implied by such forward-looking statements. The statements contained in this Quarterly Report on Form 10-Q that are not purely historical are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended (the "Securities Act"), and Section 21E of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Forward-looking statements are often identified by the use of words such as, but not limited to, "anticipate", "believe", "can", "continue", "could", "estimate", "expect", "intend", "may", "plan", "project", "seek", and similar expressions or variations intended to identify forward-looking statements. These statements are based on the beliefs and assumptions of our management based on information currently available to management. These forward-looking statements are subject to numerous risks and uncertainties, including the risks and uncertainties described under the section titled "Risk Factors" in our Annual Report on Form 10-K for the fiscal year ended February 2, 2013, those identified in this "Management's Discussion and Analysis of Financial Condition and Results of Operations" and elsewhere in this Quarterly Report on Form 10-Q. Moreover, we operate in an evolving environment. New risk factors and uncertainties emerge from time to time and it is not possible for our management to predict all risk factors and uncertainties, nor can we assess the impact of all factors on our business or the extent to which any factor, or combination of factors may cause actual results to differ materially from those contained in any forward-looking statement. We qualify all of our forward-looking statements by these cautionary statements.

**Overview**

Tilly's is a fast-growing, destination specialty retailer of West Coast inspired apparel, footwear and accessories. We believe we bring together an unparalleled selection of the most sought-after brands rooted in action sports, music, art and fashion. Our West Coast heritage dates back to 1982 when Hezy Shaked and Tilly Levine opened our first store in Orange County, California. As of August 3, 2013, we operated 182 stores, averaging 7,800 square feet, in 31 states. We also sell our products through our e-commerce website, [www.tillys.com](http://www.tillys.com) (the information available at our website address is not incorporated by reference into this report).

Our growth and operating results reflect initiatives taken by our management team as well as our customers' increasing awareness of our brand and merchandise assortment as we have expanded our presence in both existing and new markets. We increased net sales 17%, to \$123.0 million for the thirteen weeks ended August 3, 2013 from \$105.1 million for the thirteen weeks ended July 28, 2012. Operating income increased to \$7.2 million for the thirteen weeks ended August 3, 2013 from an operating loss of \$3.3 million for the thirteen weeks ended July 28, 2012, primarily due to a one-time charge recognized during the second quarter of fiscal year 2012 for stock-based compensation expense related to our initial public offering. Our comparable store sales decreased 0.5% for the thirteen weeks ended August 3, 2013, which followed a 2.2% increase for the full fiscal year 2012 and compares to a 5.1% increase in the second quarter of fiscal year 2012.

Since the beginning of fiscal 2008, we more than doubled our store count from 73 stores to 182 stores as of August 3, 2013. As of August 3, 2013, we added 14 net new stores in fiscal year 2013 and plan to add at least 11 additional net stores by the end of the year. We plan to continue opening new stores at an annual rate of approximately 15% for the next several years thereafter. We expect to fund this store expansion through our cash on hand and cash flows from operations.

---

**Table of Contents**

We believe our business strategy will continue to offer significant opportunity, but it also presents risks and challenges. These risks and challenges include, but are not limited to, that we may not be able to effectively identify and respond to changing fashion trends and customer preferences, that we may not be able to find desirable locations for new stores and that we may not be able to effectively manage our future growth. In addition, our financial results can be expected to be directly impacted by trends in the general economy. A decline in consumer spending or a substantial increase in product costs due to commodity cost increases or general inflation could lead to a reduction in our sales as well as greater margin pressure as costs may not be able to be passed on to consumers and the competitive environment could become more highly promotional. See **Risk Factors** in our Annual Report on Form 10-K for the fiscal year ended February 2, 2013 for other important factors that could adversely impact us and our results of operations.

On May 2, 2012, all four shareholders of World of Jeans & Tops contributed all of their equity interests in World of Jeans & Tops to Tilly's, Inc. in exchange for shares of Tilly's, Inc. Class B common stock on a one-for-one basis. In addition, World of Jeans & Tops terminated its S Corporation status and became a C Corporation. These events are collectively referred to as the Reorganization. As a result of the Reorganization, World of Jeans & Tops became a wholly owned subsidiary of Tilly's, Inc.

On May 3, 2012, we completed an initial public offering of common stock, or IPO, in which we issued and sold 7,600,000 shares of Class A common stock at a price of \$15.50 per share, less underwriting discounts and offering expenses payable by us, a portion of which was reimbursed by the underwriters. Certain of our stockholders also sold 1,600,000 shares of Class A common stock in the IPO at a price of \$15.50 per share. We did not receive any of the proceeds from the sale of stock by our stockholders. As a result of the IPO, we raised net proceeds of approximately \$107 million, after deducting the underwriting discount of \$8.7 million and related fees and expenses of approximately \$2.5 million. On May 9, 2012, we used \$84.0 million of the net proceeds from the IPO to pay in full the principal amount of notes representing World of Jeans & Tops undistributed taxable income. These notes were issued to the former shareholders of World of Jeans & Tops in connection with the Reorganization and all payments were made to trusts related to Hezy Shaked, Tilly Levine and their children. We intend to use the remaining net proceeds from the sale of shares by us for working capital and other general corporate purposes. The amounts and timing of any expenditures will vary depending on the amount of cash generated by our operations, competitive and technological developments and the rate of growth of our business.

### **How We Assess the Performance of Our Business**

In assessing the performance of our business, we consider a variety of performance and financial measures. The key indicators of the financial condition and operating performance of our business are net sales, comparable store sales, gross profit, selling, general and administrative expenses and operating income.

#### ***Net Sales***

Net sales reflect revenue from the sale of our merchandise at store locations as well as sales of merchandise through our e-commerce store, which is reflected in sales when the merchandise is received by the customer. Net sales also include shipping and handling fees for e-commerce shipments that have been delivered to the customer. Net sales are net of returns on sales during the period as well as an estimate of returns expected in the future stemming from current period sales. Revenue from the sale of gift cards is deferred and not included in net sales until the gift cards are used to purchase merchandise. However, over time, the redemption of some gift cards becomes remote (referred to as gift card breakage). Revenue from estimated gift card breakage is also included in net sales.

Our business is seasonal and as a result our revenues fluctuate from quarter to quarter. In addition, our revenues in any given quarter can be affected by a number of factors including the timing of holidays and weather patterns. The third and fourth quarters of the fiscal year, which include the back-to-school and holiday sales seasons, have historically produced stronger sales and disproportionately stronger operating results than have the first two quarters of the fiscal year.

**Table of Contents**

***Comparable store sales***

A store is included in comparable store sales when it has been open at least 12 full fiscal months as of the end of the current reporting period. A remodeled or relocated store is included in comparable store sales, both during and after construction, if the square footage of the store was not changed by more than 20% and the store was not closed for more than five days in any fiscal month. Comparable store sales include sales through our e-commerce store, but exclude e-commerce shipping and handling fee revenue. Some of our competitors and other retailers may calculate comparable or same store sales differently than we do. As a result, data regarding our comparable store sales may not be comparable to similar data made available by other retailers.

Measuring the change in year-over-year comparable store sales allows us to evaluate how our store base is performing. Numerous factors affect our comparable store sales, including:

overall economic trends;

our ability to identify and respond effectively to consumer preferences and fashion trends;

competition;

the timing of our releases of new and seasonal styles;

changes in our product mix;

pricing;

the level of customer service that we provide in stores;

our ability to source and distribute products efficiently;

calendar shifts of holiday or seasonal periods;

the number and timing of store openings and the relative proportion of new stores to mature stores; and

the timing and success of promotional and advertising efforts.

Opening new stores is an important part of our growth strategy and we expect a significant percentage of our net sales during this growth period to come from non-comparable store sales. Accordingly, comparable store sales are only one

element we use to assess the success of our business.

***Gross Profit***

Gross profit is equal to our net sales less our cost of goods sold. Cost of goods sold reflects the direct cost of purchased merchandise as well as buying, distribution and occupancy costs. Buying costs include compensation expense for our internal buying organization. Distribution costs include costs for receiving, processing, warehousing and shipping of merchandise to or from our distribution center, to our e-commerce customers and between store locations. Occupancy costs include the rent, common area maintenance, utilities, property taxes, security, and depreciation costs of all store locations. These costs are significant and can be expected to continue to increase as our company grows. The components of our reported cost of goods sold may not be comparable to those of other retail companies.

We regularly analyze the components of gross profit as well as gross profit as a percentage of net sales. Specifically, we look at the initial markup on purchases, markdowns and reserves, shrinkage, buying costs, distribution costs and occupancy costs. Any inability to obtain acceptable levels of initial markups, a significant increase in our use of markdowns or a significant increase in inventory shrinkage or inability to generate sufficient sales leverage on the buying, distribution and occupancy components of cost of goods sold could have an adverse impact on our gross profit and results of operations.

Gross profit is also impacted by shifts in the proportion of sales of proprietary branded products compared to third-party branded products, as well as by sales mix shifts within and between brands and between major product categories such as between guys and juniors apparel, footwear or accessories. A substantial shift in the mix of products could have a material impact on our results of operations. In addition, gross profit and gross profit as a percent of sales have historically been higher in the third and fourth quarters of the fiscal year, as these periods include the back-to-school and winter holiday selling seasons. This reflects that various costs, including occupancy costs, generally do not increase in proportion to the seasonal sales increase.

**Table of Contents**

***Selling, General and Administrative Expenses***

Our selling, general and administrative, or SG&A, expenses comprise store selling expenses and corporate-level general and administrative expenses. Store selling expenses include store and regional support costs, including personnel, advertising and debit and credit card processing costs, e-commerce processing costs and store supplies costs. General and administrative expenses include the payroll and support costs of corporate functions such as executive management, legal, accounting, information systems, human resources and other centralized services. Store selling expenses generally vary proportionately with net sales and store growth. In contrast, general and administrative expenses are generally not directly proportional to net sales and store growth, but will be expected to increase over time to support the needs of our growing company. SG&A expenses as a percentage of net sales are usually higher in lower volume periods and lower in higher volume periods.

The components of our SG&A expenses may not be comparable to those of other retailers. We expect that our SG&A expenses will increase in future periods due to our continuing store growth and in part due to additional legal, accounting, insurance and other expenses we incur as a result of being a public company. Among other things, we expect that compliance with the Sarbanes-Oxley Act of 2002 and related rules and regulations will continue to result in incremental legal, accounting and other overhead costs.

***Operating Income***

Operating income equals gross profit less SG&A expenses. Operating income excludes interest income, interest expense and income taxes. Operating income percentage measures operating income as a percentage of our net sales.

***Income Taxes***

Prior to May 2, 2012, we were taxed as an S Corporation for federal income tax purposes under Section 1362 of the Internal Revenue Code, and therefore were not subject to federal and state income taxes (subject to an exception in a limited number of state and local jurisdictions that do not recognize the S Corporation status). On May 2, 2012, our S Corporation status terminated and we became subject to corporate-level federal and state income taxes at prevailing corporate rates.



**Table of Contents****Results of Operations**

The following tables summarize key components of our unaudited results of operations for the periods indicated, both in dollars and as a percentage of our net sales.

|  | <b>Thirteen Weeks Ended</b> |                          | <b>Twenty-Six Weeks Ended</b> |                          |
|--|-----------------------------|--------------------------|-------------------------------|--------------------------|
|  | <b>August 3,<br/>2013</b>   | <b>July 28,<br/>2012</b> | <b>August 3,<br/>2013</b>     | <b>July 28,<br/>2012</b> |
|  | (in thousands)              |                          |                               |                          |
| <b>Statements of Operations Data:</b>        |                             |                          |                               |                          |
| Net sales                                    | \$ 123,043                  | \$ 105,101               | \$ 232,161                    | \$ 201,625               |
| Cost of goods sold                           | 84,888                      | 73,957                   | 161,808                       | 140,063                  |
| Gross profit                                 | 38,155                      | 31,144                   | 70,353                        | 61,562                   |
| Selling, general and administrative expenses | 30,956                      | 34,462                   | 59,237                        | 58,854                   |
| Operating income (loss)                      | 7,199                       | (3,318)                  | 11,116                        | 2,708                    |
| Interest income (expense), net               | (47)                        | 40                       | (96)                          | (4)                      |
| Income (loss) before income taxes            | 7,152                       | (3,278)                  | 11,020                        | 2,704                    |
| Income tax expense (benefit)                 | 2,885                       | (2,122)                  | 4,445                         | (2,053)                  |
| Net income (loss)                            | \$ 4,267                    | \$ (1,156)               | \$ 6,575                      | \$ 4,757                 |
| <b>Percentage of Net Sales:</b>              |                             |                          |                               |                          |
| Net sales                                    | 100.0%                      | 100.0%                   | 100.0%                        | 100.0%                   |
| Cost of goods sold                           | 69.0%                       | 70.4%                    | 69.7%                         | 69.5%                    |
| Gross profit                                 | 31.0%                       | 29.6%                    | 30.3%                         | 30.5%                    |
| Selling, general and administrative expenses | 25.2%                       | 32.8%                    | 25.5%                         | 29.2%                    |
| Operating income (loss)                      | 5.8%                        | -3.2%                    | 4.8%                          | 1.3%                     |
| Interest income (expense), net               | 0.0%                        | 0.1%                     | -0.1%                         | 0.0%                     |
| Income (loss) before income taxes            | 5.8%                        | -3.1%                    | 4.7%                          | 1.3%                     |
| Income tax expense (benefit)                 | 2.3%                        | -2.0%                    | 1.9%                          | -1.1%                    |
| Net income (loss)                            | 3.5%                        | -1.1%                    | 2.8%                          | 2.4%                     |
| <b>Pro Forma Data (1):</b>                   |                             |                          |                               |                          |
| Income (loss) before income taxes            |                             | \$ (3,278)               |                               | \$ 2,704                 |
| Pro forma income tax expense (benefit)       |                             | (1,311)                  |                               | 1,082                    |
| Pro forma net income (loss)                  |                             | \$ (1,967)               |                               | \$ 1,622                 |

- (1) The pro forma data for both periods presented gives effect to an adjustment for income tax expense as if we had been a C Corporation at an assumed combined federal, state and local effective tax rate of 40%, which approximates our statutory income tax rate.

The following table presents store operating data for the periods indicated:

|  | Thirteen Weeks Ended |                  | Twenty-Six Weeks Ended |                  |
|--|----------------------|------------------|------------------------|------------------|
|  | August 3,<br>2013    | July 28,<br>2012 | August 3,<br>2013      | July 28,<br>2012 |
| <b>Store Operating Data:</b>                   |                      |                  |                        |                  |
| Stores operating at end of period              | 182                  | 155              | 182                    | 155              |
| Comparable store sales change (1)              | -0.5%                | 5.1%             | 0.2%                   | 4.7%             |
| Total square feet at end of period             | 1,423,413            | 1,215,088        | 1,423,413              | 1,215,088        |
| Average net sales per store (in thousands) (2) | \$ 618               | \$ 634           | \$ 1,184               | \$ 1,239         |
| Average net sales per square foot (2)          | \$ 79                | \$ 81            | \$ 151                 | \$ 158           |
| E-commerce revenues (in thousands) (3)         | \$ 12,764            | \$ 9,826         | \$ 25,361              | \$ 20,726        |

- (1) E-commerce sales contributed 2.5% and 1.8% to the comparable store sales change for the thirteen week periods ended August 3, 2013 and July 28, 2012, respectively. E-commerce sales contributed 2.4% and 2.3% to the comparable store sales change for the twenty-six week periods ended August 3, 2013 and July 28, 2012, respectively.
- (2) E-commerce sales, e-commerce shipping fee revenue and gift card breakage are excluded from net sales in deriving average net sales per store and average net sales per square foot.
- (3) E-commerce revenues include e-commerce sales and e-commerce shipping fee revenue.

---

**Table of Contents*****Thirteen Weeks Ended August 3, 2013 Compared to Thirteen Weeks Ended July 28, 2012******Net Sales***

Net sales increased \$17.9 million, or 17%, to \$123.0 million for the thirteen weeks ended August 3, 2013 from \$105.1 million for the thirteen weeks ended July 28, 2012. This increase was due to net sales of \$18.4 million from stores open in the second quarter of fiscal 2013 that were not open during the same period last year, as well as the increase in e-commerce shipping fees, due to the increase in e-commerce sales. This was offset by a comparable store net sales decrease of 0.5%, or \$0.5 million, for the thirteen weeks ended August 3, 2013 compared to the thirteen weeks ended July 28, 2012. This comparable store decrease was due to lower net sales of footwear while apparel and accessories were similar to the prior year. There were 151 comparable brick-and-mortar stores and 31 non-comparable brick-and-mortar stores open as of August 3, 2013.

Net sales from our e-commerce store, including shipping fees, increased \$2.9 million, or 30%, to \$12.8 million for the thirteen weeks ended August 3, 2013 from \$9.8 million for the thirteen weeks ended July 28, 2012 due largely to increased traffic.

***Gross Profit***

Gross profit increased \$7.0 million, or 23%, to \$38.2 million for the thirteen weeks ended August 3, 2013 from \$31.1 million for the thirteen weeks ended July 28, 2012. As a percentage of net sales, gross profit was 31.0% and 29.6% for the thirteen weeks ended August 3, 2013 and July 28, 2012, respectively. A 1.2% decrease in product costs as a result of higher initial margins and lower markdowns and a 0.3% decrease in buying and distribution costs as a percentage of net sales compared to the same period last year was offset by a 0.1% increase in occupancy costs as a percentage of net sales.

***Selling, General and Administrative Expenses***

SG&A expenses decreased \$3.5 million, or 10%, to \$31.0 million for the thirteen weeks ended August 3, 2013 from \$34.5 million for the thirteen weeks ended July 28, 2012. As a percentage of net sales, SG&A expenses were 25.2% and 32.8% for the thirteen weeks ended August 3, 2013 and July 28, 2012, respectively.

Store selling expenses increased \$3.6 million, or 20%, to \$21.2 million for the thirteen weeks ended August 3, 2013 from \$17.6 million for the thirteen weeks ended July 28, 2012. As a percentage of net sales, store selling expenses were 17.2% and 16.7% for the thirteen weeks ended August 3, 2013 and July 28, 2012, respectively.

The following contributed to the increase in store selling expenses as a percentage of net sales:

marketing costs increased \$1.6 million, or 0.9% as a percentage of net sales, primarily resulting from a shift of some catalog mailing costs into the second quarter of fiscal year 2013 compared to being in the third quarter of fiscal 2012, as well as increased distribution of catalog mailings;

supplies and other field support costs increased \$0.1 million, but decreased 0.2% as a percentage of net sales, as these costs increased more slowly than sales; and

store and regional payroll, payroll benefits and related personnel costs increased \$1.9 million, which represents a decrease of 0.2% as a percentage of net sales, as these costs increased more slowly than net sales.

General and administrative expenses decreased \$7.1 million, or 42%, to \$9.8 million for the thirteen weeks ended August 3, 2013 from \$16.9 million for the thirteen weeks ended July 28, 2012. As a percentage of net sales, general and administrative expenses were 7.9% and 16.1% for the thirteen weeks ended August 3, 2013 and July 28, 2012, respectively.

**Table of Contents**

The following contributed to the decrease in general and administrative expenses as a percentage of net sales:

a one-time charge of \$7.6 million, or 7.3% of net sales during the second quarter of fiscal year 2012, to recognize life-to-date compensation expense for stock options that was triggered by the consummation of our IPO, with no such catch-up charge in the second quarter of fiscal year 2013;

payroll, payroll benefits and related costs for corporate office personnel decreased \$0.1 million, or 0.9% as a percentage of net sales, due largely to a decrease in incentive bonus accruals for corporate employees in fiscal year 2013 as compared to fiscal year 2012;

ongoing stock-based compensation expense increased \$0.2 million, but remained constant as a percentage of net sales; and

depreciation, legal and other office expenses increased \$0.4 million, or 0.1% as a percentage of net sales, due to costs related to being a public company and the growth of the company.

*Operating Income (Loss)*

Operating income increased \$10.5 million to \$7.2 million for the thirteen weeks ended August 3, 2013 from a loss of \$3.3 million for the thirteen weeks ended July 28, 2012. As a percentage of net sales, operating income (loss) was 5.8% and (3.2%) for the thirteen weeks ended August 3, 2013 and July 28, 2012, respectively. The increase in operating income was primarily due to the \$7.6 million one-time charge to recognize life-to-date compensation expense for stock options during the second quarter of fiscal year 2012, as discussed above.

*Interest Income (Expense), Net*

Net interest expense was \$47 thousand for the thirteen weeks ended August 3, 2013, compared to net interest income of \$40 thousand for the thirteen weeks ended July 28, 2012. Interest income mainly represents income earned on cash balances and on tenant construction allowances due from landlords. Interest expense reflects interest paid on a capitalized lease of our corporate office and distribution center, as well as costs related to maintaining our unused line of credit bank facility.

*Income Tax Expense (Benefit)*

Income tax expense was \$2.9 million for the thirteen weeks ended August 3, 2013, compared to an income tax benefit of \$2.1 million for the thirteen weeks ended July 28, 2012. This reflects an annual effective tax rate of 40.3% for the thirteen weeks ended August 3, 2013 compared to an annual effective tax rate of 33.6% for the thirteen weeks ended July 28, 2012, when the company was operating as an S Corporation for a portion of fiscal year 2012.

Historically, World of Jeans & Tops recognized income taxes as an S Corporation for federal and state income tax purposes and therefore, with the exception of a limited number of state and local jurisdictions, it was not subject to income taxes. The shareholders of World of Jeans & Tops, and not World of Jeans & Tops itself, were subject to income tax on their distributive share of its earnings. In connection with the Reorganization, World of Jeans & Tops converted to a C Corporation. On a pro forma basis, if World of Jeans & Tops had been taxed as a C Corporation at an

estimated 40% effective tax rate, the income tax benefit would have been \$1.3 million for the thirteen weeks ended July 28, 2012.

For the thirteen weeks ended July 28, 2012, we recorded a net income tax benefit of \$2.1 million. The net benefit comprised (1) a one-time deferred tax benefit of \$3.0 million recognized upon the conversion to a C Corporation, (2) a provision of \$2.0 million related to the period during fiscal year 2012 in which the company was an S Corporation (January 29, 2012 through May 1, 2012) computed at the annual effective tax rate of 33.6% rather than the previously recognized 1.1% S Corporation annual effective tax rate and (3) a tax benefit of \$1.1 million related to the period in which the company was a C Corporation (May 2, 2012 through July 28, 2012) at an annual effective tax rate of 33.6%.

**Table of Contents***Net Income (Loss)*

Net income increased \$5.4 million to \$4.3 million for the thirteen weeks ended August 3, 2013 from a net loss of \$1.2 million for the thirteen weeks ended July 28, 2012, due to the factors discussed above. Applying a pro forma 40% C Corporation effective tax rate to the thirteen weeks ended July 28, 2012, rather than the blended S Corporation and C Corporation tax rates that actually applied to us during that period, the pro forma net loss for the thirteen weeks ended July 28, 2012 was \$2.0 million.

Basic and diluted earnings per share were \$0.15 for the thirteen weeks ended August 3, 2013, compared to a basic and diluted loss per share of \$0.04 for the thirteen weeks ended July 28, 2012. Applying a pro forma 40% C Corporation effective tax rate to the thirteen weeks ended July 28, 2012, rather than the blended S Corporation and C Corporation tax rates that actually applied to us, the pro forma basic and diluted loss per share were \$0.07 for the thirteen weeks ended July 28, 2012. There was no dilution during the thirteen weeks ended July 28, 2012 as the dilutive effect of stock options and restricted stock is only applicable in periods of net income.

***Twenty-Six Weeks Ended August 3, 2013 Compared to Twenty-Six Weeks Ended July 28, 2012****Net Sales*

Net sales increased \$30.5 million, or 15%, to \$232.2 million for the twenty-six weeks ended August 3, 2013 from \$201.6 million for the twenty-six weeks ended July 28, 2012. A portion of this increase was due to net sales of \$30.0 million from stores open in the first half of fiscal 2013 that were not open during the same period last year, as well as the increase in e-commerce shipping fees, due to the increase in e-commerce sales. Net sales also increased due to a comparable store net sales increase of 0.2%, or \$0.5 million, in the twenty-six weeks ended August 3, 2013 compared to the twenty-six weeks ended July 28, 2012. This increase was due to higher net sales of guys and juniors apparel, partially offset by lower net sales of footwear, accessories and kids apparel. There were 151 comparable brick-and-mortar stores and 31 non-comparable brick-and-mortar stores open as of August 3, 2013.

Net sales from our e-commerce store, including shipping fees, increased \$4.6 million, or 22%, to \$25.4 million for the twenty-six weeks ended August 3, 2013 from \$20.7 million for the twenty-six weeks ended July 28, 2012.

*Gross Profit*

Gross profit increased \$8.8 million, or 14%, to \$70.4 million for the twenty-six weeks ended August 3, 2013 from \$61.6 million for the twenty-six weeks ended July 28, 2012. As a percentage of net sales, gross profit was 30.3% and 30.5% for the twenty-six weeks ended August 3, 2013 and July 28, 2012, respectively. A 0.6% increase in occupancy costs as a percentage of net sales was offset by a 0.3% decrease in product, buying and distribution costs as a percentage of net sales.

*Selling, General and Administrative Expenses*

SG&A expenses increased \$0.4 million, or 1%, to \$59.2 million for the twenty-six weeks ended August 3, 2013 from \$58.9 million for the twenty-six weeks ended July 28, 2012. As a percentage of net sales, SG&A expenses were 25.5% and 29.2% for the twenty-six weeks ended August 3, 2013 and July 28, 2012, respectively.

Store selling expenses increased \$6.2 million, or 18%, to \$40.0 million for the twenty-six weeks ended August 3, 2013 from \$33.8 million for the twenty-six weeks ended July 28, 2012. As a percentage of net sales, store selling expenses were 17.2% and 16.8% for the twenty-six weeks ended August 3, 2013 and July 28, 2012, respectively.

The following contributed to the increase in store selling expenses as a percentage of net sales:

store and regional payroll, payroll benefits and related personnel costs increased \$4.2 million, or 0.3% as a percentage of net sales, as these costs increased more quickly than sales to support our store growth;



**Table of Contents**

marketing costs increased \$1.6 million, or 0.3% as a percentage of net sales, primarily resulting from a shift of some catalog mailing costs into the second quarter of fiscal year 2013 compared to being in the third quarter of fiscal year 2012;

credit and debit card processing fees and other field processing costs increased \$0.4 million, but remained constant as a percentage of net sales; and

supplies and other support costs remained constant with the prior year, but decreased 0.1% as a percentage of net sales.

General and administrative expenses decreased \$5.8 million, or 23%, to \$19.2 million for the twenty-six weeks ended August 3, 2013 from \$25.1 million for the twenty-six weeks ended July 28, 2012. As a percentage of net sales, general and administrative expenses were 8.3% and 12.4% for the twenty-six weeks ended August 3, 2013 and July 28, 2012, respectively.

The following contributed to the decrease in general and administrative expenses as a percentage of net sales:

a one-time charge in the second quarter of fiscal year 2012 of \$7.6 million, or 3.8% of net sales, to recognize life-to-date compensation expense for stock options that was triggered by the consummation of our IPO, with no such catch-up charge in the second quarter of fiscal year 2013;

payroll, payroll benefits and related costs for corporate office personnel decreased \$0.3 million, or 1.0% as a percentage of net sales, due to a decrease in incentive bonus accruals for corporate employees in fiscal year 2013 as compared to fiscal year 2012;

ongoing stock-based compensation increased \$1.1 million, or 0.4%, as a result of stock-based compensation expense being recognized throughout the twenty-six weeks ended August 3, 2013, but did not commence in fiscal year 2012 until the completion of the company's IPO; and

depreciation, legal and other office expenses increased \$1.1 million, or 0.2% as a percentage of net sales, due to costs related to being a public company and the growth of the company.

*Operating Income*

Operating income increased \$8.4 million to \$11.1 million for the twenty-six weeks ended August 3, 2013 from \$2.7 million for the twenty-six weeks ended July 28, 2012. As a percentage of net sales, operating income was 4.8% and 1.3% for the twenty-six weeks ended August 3, 2013 and July 28, 2012, respectively. The increase in operating income was primarily due to the \$7.6 million one-time charge to recognize life-to-date compensation expense for stock options during the second quarter of fiscal year 2012, as discussed above.

*Interest Income (Expense), Net*

Net interest expense was \$96 thousand and \$4 thousand for the twenty-six weeks ended August 3, 2013 and July 28, 2012, respectively. Interest income mainly represents income earned on cash balances and on tenant construction allowances due from landlords. Interest expense reflects interest paid on a capitalized lease of our corporate office and distribution center as well as costs related to maintaining our unused line of credit bank facility.

*Income Tax Expense (Benefit)*

Income tax expense was \$4.4 million for the twenty-six weeks ended August 3, 2013, compared to an income tax benefit of \$2.1 million for the twenty-six weeks ended July 28, 2012. This reflects an annual effective tax rate of 40.3% for the twenty-six weeks ended August 3, 2013 compared to an annual effective tax rate of 33.6% for the twenty-six weeks ended July 28, 2012, when the company was operating as an S Corporation for a portion of fiscal year 2012.

---

**Table of Contents**

Historically, World of Jeans & Tops recognized income taxes as an S Corporation for federal and state income tax purposes and therefore, with the exception of a limited number of state and local jurisdictions, it was not subject to income taxes. The shareholders of World of Jeans & Tops, and not World of Jeans & Tops itself, were subject to income tax on their distributive share of its earnings. In connection with the Reorganization, World of Jeans & Tops converted to a C Corporation. On a pro forma basis, if World of Jeans & Tops had been taxed as a C Corporation at an estimated 40% effective tax rate, income tax expense would have been \$1.1 million for the twenty-six weeks ended July 28, 2012.

For the twenty-six weeks ended July 28, 2012, we recorded a net income tax benefit of \$2.1 million. The net benefit comprised (1) a one-time deferred tax benefit of \$3.0 million recognized upon the conversion to a C Corporation, (2) a provision of \$2.0 million related to the period during fiscal year 2012 in which the company was an S Corporation (January 29, 2012 through May 1, 2012) computed at the annual effective tax rate of 33.6% rather than the previously recognized 1.1% S Corporation annual effective tax rate and (3) a tax benefit of \$1.1 million related to the period in which the company was a C Corporation (May 2, 2012 through July 28, 2012) at an annual effective tax rate of 33.6%.

***Net Income***

Net income increased \$1.8 million, or 38%, to \$6.6 million for the twenty-six weeks ended August 3, 2013 from \$4.8 million for the twenty-six weeks ended July 28, 2012, due to the factors discussed above. Applying a pro forma 40% C Corporation effective tax rate to the twenty-six weeks ended July 28, 2012, rather than the blended S Corporation and C Corporation tax rates that actually applied to us during that period, pro forma net income for the twenty-six weeks ended July 28, 2012 was \$1.6 million.

Basic earnings per share increased 20%, to \$0.24 for the twenty-six weeks ended August 3, 2013 from \$0.20 for the twenty-six weeks ended July 28, 2012. Diluted earnings per share increased 15%, to \$0.23 for the twenty-six weeks ended August 3, 2013 from \$0.20 for the twenty-six weeks ended July 28, 2012. Applying a pro forma 40% C Corporation effective tax rate to the twenty-six weeks ended July 28, 2012, rather than the blended S Corporation and C Corporation tax rates that actually applied to us, pro forma basic and diluted earnings per share were \$0.07 for the twenty-six weeks ended July 28, 2012.

**Liquidity and Capital Resources*****General***

Our business relies on cash flows from operating activities as well as cash on hand as our primary sources of liquidity. In addition, we have access to additional liquidity through a \$25 million revolving credit facility with Wells Fargo Bank, NA. We have never drawn funds from or issued letters of credit financing from the revolving credit facility. We do not expect to draw from the revolving credit facility over the next 12 months. We expect to finance company operations and store growth with existing cash on hand.

Historically our primary cash needs have been for merchandise inventories, payroll, store rent, capital expenditures associated with opening new stores, improvements to our distribution facilities, marketing and information technology expenditures and shareholder distributions. In addition to cash and cash equivalents, the most significant components of our working capital are merchandise inventories, accounts payable and other current liabilities. We believe that our current cash balance and cash flows from operating activities and, if needed, the availability of cash under our revolving credit facility will be sufficient to cover working capital requirements and anticipated capital expenditures for the next 12 months. If our current cash balance, cash flows from operations and borrowings under our revolving

credit facility are not sufficient to meet our capital requirements, then we will be required to obtain additional equity or debt financing in the future. There can be no assurance that equity or debt financing will be available to us when we need it or, if available, that the terms will be satisfactory to us and not dilutive to our then-current stockholders.

**Table of Contents****Cash Flow Analysis**

A summary of operating, investing and financing activities is shown in the following table:

|   | <b>Twenty-Six Weeks Ended</b> |                          |
|---|-------------------------------|--------------------------|
|   | <b>August 3,<br/>2013</b>     | <b>July 28,<br/>2012</b> |
|   | <b>(in thousands)</b>         |                          |
| Net cash provided by operating activities | \$ 17,158                     | \$ 15,678                |
| Net cash used in investing activities     | (13,730)                      | (41,717)                 |
| Net cash provided by financing activities | 141                           | 22,443                   |

***Net Cash Provided by Operating Activities***

Operating activities consist primarily of net income adjusted for non-cash items that include depreciation and amortization, stock-based compensation expense, deferred income taxes and gains or losses on disposals of assets, plus the effect on changes during the period in our assets and liabilities.

We generated \$17.2 million of net cash from operating activities for the twenty-six weeks ended August 3, 2013. The significant components of cash flows from operating activities were net income of \$6.6 million, the add-back of non-cash depreciation and amortization expense of \$9.4 million, non-cash stock-based compensation expense recognized during the period of \$1.7 million and the change in deferred income taxes of \$0.6 million. In addition, accounts payable and accrued expenses increased by \$20.9 million due to the timing of payments, and deferred rent increased by \$3.8 million due to the opening of new stores. The above was offset by a decrease in accrued compensation and benefits of \$0.8 million due to reduced bonus accruals, an increase in merchandise inventories of \$16.8 million due to inventory purchases in anticipation of the upcoming back-to-school season and the opening of new stores, an increase in receivables of \$5.0 million due to the timing of payments received from credit card companies and landlord construction allowances, an increase in prepaid expenses and other assets of \$1.8 million mainly due to increases in prepaid rent resulting from the opening of new stores and a decrease in deferred revenue of \$1.3 million due to the redemption of gift cards throughout the period.

We generated \$15.7 million of net cash from operating activities for the twenty-six weeks ended July 28, 2012. The significant components of cash flows from operating activities were net income of \$4.8 million, the add-back of non-cash depreciation and amortization expense of \$8.0 million, the change in deferred income taxes of \$6.1 million and non-cash stock-based compensation expense recognized during the period of \$8.2 million. In addition, accounts payable and accrued expenses increased by \$20.7 million due to the timing of payments and deferred rent increased by \$5.3 million due to the opening of new stores. The above was offset by a decrease in accrued compensation and benefits of \$2.4 million due to the payment of bonuses, an increase in merchandise inventories of \$18.0 million due to inventory purchases in anticipation of the upcoming back-to-school season and the opening of new stores, an increase in prepaid expenses and other assets of \$12.1 million mainly due to increases in prepaid rent resulting from the opening of new stores and the recognition of deferred tax assets resulting from our conversion from an S Corporation to a C Corporation and an increase in receivables of \$3.6 million due to the growth of the business.

***Net Cash Used in Investing Activities***

Investing activities consist primarily of capital expenditures for growth related to new store openings as well as for remodels and changes in fixtures and equipment at existing stores, investments in information technology, distribution

center enhancements, investments in assets at our corporate headquarters and the addition or replacement of company vehicles, net of proceeds from sales and maturities of marketable securities.

Net cash used in investing activities was \$13.7 million for the twenty-six weeks ended August 3, 2013. Capital expenditures totaled \$23.8 million during the period, \$14.1 million of which was for new stores and remodeling or other improvements of existing stores. The remaining capital expenditures were for our investment in a new e-commerce distribution facility, as well as for other distribution and corporate facility enhancements, and investments in information technology systems. In addition, we purchased \$15.0 million of marketable securities and received proceeds of \$25.0 million from the maturities of marketable securities during the period.

## **Table of Contents**

Net cash used in investing activities was \$41.7 million for the twenty-six weeks ended July 28, 2012. Capital expenditures totaled \$16.4 million during the period, \$13.4 million of which was for new stores and remodeling or other improvements of existing stores. The remaining capital expenditures were for our investment in information technology systems and distribution and corporate facility enhancements. In addition, we received \$0.8 million of insurance proceeds related to fixed assets that were destroyed by smoke damage as a result of a fire in 2010 at a mall where one of our stores was located. We purchased \$35.5 million of marketable securities and received proceeds of \$9.5 from the sale of marketable securities during the period.

### ***Net Cash Provided by Financing Activities***

Financing activities consist of payments on our capital lease obligation and proceeds from the exercise of stock options, as well as distributions to the S Corporation shareholders of World of Jeans & Tops prior to the Reorganization.

Net cash provided by financing activities was \$0.1 million for the twenty-six weeks ended August 3, 2013. We received \$0.5 million of proceeds from the exercise of stock options, which was offset by payments on our capital lease obligation totaling \$0.4 million during the period.

Net cash provided by financing activities was \$22.4 million for the twenty-six weeks ended July 28, 2012. This included \$106.8 million in net proceeds from our initial public offering which was consummated during the second quarter and \$84.3 million in distributions to the former shareholders of World of Jeans & Tops. We also received \$0.3 million of proceeds from the exercise of stock options, and paid \$0.3 million for our capital lease obligation during the period.

### **Credit Agreement**

On May 3, 2012, we entered into an amended and restated credit agreement with Wells Fargo Bank, N.A. The revolving credit facility provides for a \$25.0 million revolving credit facility with a maturity date of May 3, 2014. The interest charged is either at the London Interbank Offered Rate, or LIBOR, plus 1.75%, or at the bank's prime rate. We have the ability to select between the prime or LIBOR-based rate at the time of a cash advance. The revolving credit facility is secured by substantially all of the company's assets. As a sub-feature under the revolving credit facility the bank may issue stand-by and commercial letters of credit up to \$15.0 million. We are required to maintain certain financial and nonfinancial covenants in accordance with the revolving credit facility. These covenants include maintaining a minimum current ratio, not exceeding a maximum funded debt to earnings before interest, taxes, depreciation, amortization and annual rent expense ( EBITDAR ) ratio, capital expenditures not exceeding established limits and achieving a minimum pre-tax profit on a rolling four quarter basis.

### **Contractual Obligations**

As of August 3, 2013, there were no material changes to our contractual obligations described in the Management's Discussion and Analysis of Financial Condition and Results of Operations section of our Annual Report on Form 10-K for the fiscal year ended February 2, 2013.

### **Off-Balance Sheet Arrangements**

We are not a party to any off-balance sheet arrangements, except for operating leases, purchase obligations and our revolving credit facility.

**Critical Accounting Policies and Estimates**

The preparation of financial statements in accordance with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets,



## **Table of Contents**

liabilities, revenues and expenses, as well as the related disclosures of contingent assets and liabilities at the date of the financial statements. A summary of the company's significant accounting policies is included in Note 2 to the consolidated financial statements of Tilly's, Inc. in our Annual Report on Form 10-K for the fiscal year ended February 2, 2013.

Certain of our accounting policies and estimates are considered critical, as these policies and estimates are the most important to the depiction of the company's consolidated financial statements and require significant, difficult or complex judgments, often about the effect of matters that are inherently uncertain. Such policies are summarized in the Management's Discussion and Analysis of Financial Condition and Results of Operations section of our Annual Report on Form 10-K for the fiscal year ended February 2, 2013.

### **Item 3. Quantitative and Qualitative Disclosures About Market Risk**

As of August 3, 2013, there were no material changes in the market risks described in the Quantitative and Qualitative Disclosure of Market Risks section of our Annual Report on Form 10-K for the fiscal year ended February 2, 2013.

### **Item 4. Controls and Procedures**

#### **Evaluation of Disclosure Controls and Procedures**

Our management, with the participation of our Disclosure Committee, including our Chief Executive Officer and our Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures as of August 3, 2013. The term disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act, means controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the company's management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure. Based on the evaluation of our disclosure controls and procedures as of August 3, 2013, our Chief Executive Officer and Chief Financial Officer concluded that, as of such date, our disclosure controls and procedures were effective at the reasonable assurance level.

#### **Changes in Internal Control Over Financial Reporting**

There was no change in our internal control over financial reporting identified in connection with the evaluation required by Rule 13a-15(d) and 15d-15(d) of the Exchange Act that occurred during the period covered by this Quarterly Report on Form 10-Q that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

#### **Inherent Limitations on Effectiveness of Controls**

Our management, including our Chief Executive Officer and Chief Financial Officer, believes that our disclosure controls and procedures and internal control over financial reporting are designed to provide reasonable assurance of achieving their objectives and are effective at the reasonable assurance level. However, our management does not expect that our disclosure controls and procedures or our internal control over financial reporting will prevent all

errors and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, have been detected. These inherent limitations include the realities that judgments in decision making can be faulty, and that breakdowns can occur because of a simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people or by management override of the controls. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can

**Table of Contents**

be no assurance that any design will succeed in achieving its stated goals under all potential future conditions; over time, controls may become inadequate because of changes in conditions, or the degree of compliance with policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

**Part II. Other Information****Item 1. Legal Proceedings**

From time to time, we may become involved in lawsuits and other claims arising from our ordinary course of business. Management is currently unable to predict the ultimate outcome of any litigation or claim, determine whether a liability has been incurred or make an estimate of the reasonably possible liability that could result from an unfavorable outcome because of the uncertainties related to the incurrence, amount and range of loss on any pending litigation or claim. Because of the unpredictable nature of these matters, we cannot provide any assurances regarding the outcome of any litigation or claim to which it is a party or that the ultimate outcome of any of the matters threatened or pending against it, including those disclosed below, will not have a material adverse effect on our financial condition, results of operations or cash flows.

*Kristin Christiansen and Shellie Smith, on behalf of themselves and all others similarly situated vs. World of Jeans & Tops, Superior Court of California, County of Sacramento, Case No. 34-2013-00139010.* On January 29, 2013, the plaintiffs in this matter filed a putative class action lawsuit against us alleging violations of California Civil Code Section 1747.08, which prohibits requesting or requiring personal identification information from a customer paying for goods with a credit card and recording such information, subject to exceptions. In June 2013, the Court granted our motion to strike portions of the plaintiffs' complaint and granted plaintiffs leave to amend. Plaintiffs amended to add a new named plaintiff, which the Court struck on our motion. We have denied the allegations of the complaint and intend to defend this case vigorously.

*Maria Rebolledo, individually and on behalf of all others similarly situated and on behalf of the general public vs. Tilly's, Inc.; World of Jeans & Tops, Superior Court of the State of California, County of Orange, Case No. 30-2012-00616290-CU-OE-CXC.* On December 5, 2012, the plaintiff in this matter filed a putative class action lawsuit against us alleging violations of California's wage and hour, meal break and rest break rules and regulations, and unfair competition law, among other things. An amended complaint was filed on February 28, 2013, to include enforcement of California's private attorney general act. The complaint seeks an unspecified amount of damages and penalties. In April 2013, we filed a motion to compel arbitration, which was denied in May 2013. We have appealed the denial of the motion to compel arbitration. We intend to defend this case vigorously.

*Deborah Lyddy v. World of Jeans & Tops and Tilly's, Inc., Superior Court of California, County of San Diego (37-2011-00098812-CU-BT-CTL).* In October 2011, plaintiff filed a putative class action lawsuit against us alleging various causes of action based on its California gift card redemption policies. The state court sustained the original demurrer to the complaint but granted plaintiff leave to amend. The amended complaint survived demurrer and the court has now set a briefing schedule for a hearing on plaintiff's motion for class action treatment of the lawsuit. We intend to defend this case vigorously.

**Item 1A. Risk Factors**

We operate in a rapidly changing environment that involves a number of risks that could materially and adversely affect our business, financial condition, prospects, operating results or cash flows. For a detailed discussion of the risks that affect our business, please refer to the section entitled Risk Factors in our Annual Report on Form 10-K for the fiscal year ended February 2, 2013. There have been no material changes to our risk factors as previously disclosed in our Annual Report on Form 10-K.

**Table of Contents**

**Item 6. Exhibits**

| <b>Exhibit No.</b> | <b>Description of Exhibit</b>  |
|--------------------|--|
| 31.1               | Certification of Chief Executive Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended.  |
| 31.2               | Certification of Chief Financial Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended.  |
| 32.1*              | 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.   |
| 101**              | Interactive data files from Tilly's, Inc.'s Quarterly Report on Form 10-Q for the quarter ended August 3, 2013, formatted in XBRL (eXtensible Business Reporting Language): (i) the Consolidated Balance Sheets; (ii) the Consolidated Statements of Income; (iii) the Consolidated Statements of Comprehensive Income; (iv) the Consolidated Statement of Stockholders' Equity; (v) the Consolidated Statements of Cash Flows and (vi) Notes to Consolidated Financial Statements. ** |
| *                  | Furnished herewith and not filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended.  |
| **                 | 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, and are deemed not filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.   |

Table of Contents

**SIGNATURES**

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

Date: September 11, 2013

Tilly's, Inc.

/s/ Daniel Griesemer  
Daniel Griesemer  
*President, Chief Executive Officer and Director*

*(Principal Executive Officer)*

Date: September 11, 2013

/s/ William Langsdorf  
William Langsdorf  
*Senior Vice President and  
Chief Financial Officer*  
(Principal Financial Officer)