

Citi Trends Inc  
Form 10-Q  
November 28, 2006

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**Form 10-Q**

(Mark One)

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

For the quarterly period ended October 28, 2006

OR

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

Commission File Number 000-51315

**CITI TRENDS, INC.**

(Exact name of registrant as specified in its charter)

**DELAWARE**

(State or other jurisdiction of  
incorporation or organization)

**102 Fahm Street  
Savannah, Georgia**

**52-2150697**

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

**31401**

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(Address of principal executive offices)

(Zip Code)

Registrant's telephone number, including area code **912-236-1561**

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 is a large accelerated filer, an accelerated filer or a non-accelerated filer. See definition of accelerated filer and large accelerated filer as defined in Rule 12b-2 of the Exchange Act.

(Check one): Large Accelerated Filer  Accelerated Filer  Non-Accelerated Filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

| Class                         | Outstanding at November 27, 2006 |
|-------------------------------|----------------------------------|
| Common Stock, \$.01 par value | 13,663,462 shares                |

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**Item 1. Financial Statements.****Citi Trends, Inc.****Condensed Balance Sheets  
October 28, 2006 and January 28, 2006  
(Unaudited)**

|  | October 28,<br>2006 | January 28,<br>2006 |
|--|---------------------|---------------------|
| <b>Assets</b>  |                     |                     |
| Current assets:  |                     |                     |
| Cash and cash equivalents  | \$ 5,666,790        | \$ 9,079,388        |
| Marketable securities, available for sale  | 49,904,249          | 54,458,146          |
| Inventory  | 74,499,328          | 54,020,879          |
| Prepaid and other current assets   | 4,293,600           | 3,099,919           |
| Income tax receivable  | 2,624,960           |                     |
| Deferred tax asset   | 1,710,331           | 1,620,400           |
| Total current assets   | 138,699,258         | 122,278,732         |
| Property and equipment, net  | 30,334,914          | 23,425,601          |
| Goodwill   | 1,371,404           | 1,371,404           |
| Other assets   | 269,687             | 213,800             |
| Total assets   | \$ 170,675,263      | \$ 147,289,537      |
| <b>Liabilities and Stockholders Equity</b>   |                     |                     |
| Current liabilities:   |                     |                     |
| Borrowings under revolving lines of credit   | \$                  | \$                  |
| Accounts payable   | 43,444,218          | 45,789,220          |
| Accrued expenses   | 6,895,966           | 6,896,442           |
| Accrued compensation   | 5,628,229           | 4,980,434           |
| Current portion of long-term debt  | 107,334             |                     |
| Current portion of capital lease obligations   | 941,266             | 662,196             |
| Income taxes payable   |                     | 1,047,968           |
| Layaway deposits   | 1,907,044           | 317,647             |
| Total current liabilities  | 58,924,057          | 59,693,907          |
| Long-term debt, less current portion   |                     | 108,936             |
| Capital lease obligations, less current portion  | 2,456,759           | 422,128             |
| Other long-term liabilities  | 4,698,951           | 3,315,265           |
| Total liabilities  | 66,079,767          | 63,540,236          |
| Commitments and contingencies (note 7 and 8)   |                     |                     |
| Stockholders equity:   |                     |                     |
| Common stock, \$0.01 par value. Authorized 32,000,000; 13,802,423 shares issued at October 28, 2006 and 13,179,765 shares issued at January 28, 2006; 13,636,673 shares outstanding at October 28, 2006 and 13,014,015 outstanding at January 28, 2006 | 138,024             | 131,798             |
| Additional paid-in-capital   | 59,614,719          | 49,753,909          |
| Retained earnings  | 45,007,303          | 34,028,144          |
| Treasury stock, at cost; 165,750 shares  | (164,550)           | (164,550)           |
| Total stockholders equity  | 104,595,496         | 83,749,301          |
| Total liabilities and stockholders equity  | \$ 170,675,263      | \$ 147,289,537      |

See accompanying notes to the condensed financial statements (unaudited).



**Citi Trends, Inc.****Condensed Statements of Operations**  
**Thirty-nine Weeks Ended October 28, 2006 and October 29, 2005**  
**(Unaudited)**

|   | <b>Oct. 28,<br/>2006</b> | <b>Oct. 29,<br/>2005</b> |
|---|--------------------------|--------------------------|
| Net sales   | \$ 255,129,560           | \$ 192,960,784           |
| Cost of sales   | 157,639,477              | 119,038,450              |
| Gross profit  | 97,490,083               | 73,922,334               |
| Selling, general and administrative expenses                            | 82,124,564               | 64,281,322               |
| Income from operations  | 15,365,519               | 9,641,012                |
| Interest income   | 1,429,239                | 499,403                  |
| Interest expense, including redeemable preferred stock dividend in 2005 | (168,599                 | ) (302,335               |
| Income before provision for income taxes                                | 16,626,159               | 9,838,080                |
| Provision for income taxes  | 5,647,000                | 3,560,000                |
| Net income  | \$ 10,979,159            | \$ 6,278,080             |
| Basic income per common share   | \$ 0.81                  | \$ 0.55                  |
| Diluted income per common share   | \$ 0.78                  | \$ 0.49                  |
| Average number of shares outstanding                                    |                          |                          |
| Basic   | 13,515,645               | 11,348,502               |
| Diluted   | 14,031,733               | 12,847,419               |

See accompanying notes to the condensed financial statements (unaudited).

**Citi Trends, Inc.****Condensed Statements of Operations**  
**Thirteen Weeks Ended October 28, 2006 and October 29, 2005**  
**(Unaudited)**

|  | <b>Oct. 28,<br/>2006</b> | <b>Oct 29,<br/>2005</b> |
|--|--------------------------|-------------------------|
| Net sales                                    | \$ 87,118,399            | \$ 69,894,855           |
| Cost of sales                                | 54,155,525               | 42,872,559              |
| Gross profit                                 | 32,962,874               | 27,022,296              |
| Selling, general and administrative expenses | 29,202,316               | 23,252,521              |
| Income from operations                       | 3,760,558                | 3,769,775               |
| Interest income                              | 475,735                  | 314,089                 |
| Interest expense                             | (89,994                  | ) (61,635               |
| Income before provision for income taxes     | 4,146,299                | 4,022,229               |
| Provision for income taxes                   | 1,337,000                | 1,390,000               |
| Net income                                   | \$ 2,809,299             | \$ 2,632,229            |
| Basic income per common share                | \$ 0.21                  | \$ 0.21                 |
| Diluted income per common share              | \$ 0.20                  | \$ 0.18                 |
| Average number of shares outstanding         |                          |                         |
| Basic  | 13,583,263               | 12,825,199              |
| Diluted                                      | 14,082,634               | 14,379,974              |

See accompanying notes to the condensed financial statements (unaudited).



## Citi Trends, Inc.

**Condensed Statements of Cash Flows**  
**Thirty-Nine Weeks Ended October 28, 2006 and October 29, 2005**  
(Unaudited)

|  | Oct. 28,<br>2006 | Oct 29,<br>2005 |
|--|------------------|-----------------|
| <b>Operating activities:</b>   |                  |                 |
| Net income   | \$ 10,979,159    | \$ 6,278,080    |
| Adjustment to reconcile net income to net cash (used in) provided by operating activities: |                  |                 |
| Depreciation and amortization  | 5,962,636        | 4,369,232       |
| Gain on disposal of property and equipment   | (283,476 )       | 161,506         |
| Deferred income taxes  | (89,931 )        | (23,412 )       |
| Stock option expense   | 661,828          | 75,531          |
| Dividends on preferred shares subject to mandatory redemption                              |                  | 100,308         |
| Tax benefit on stock option exercise   |                  | 1,316,621       |
| Changes in assets and liabilities:   |                  |                 |
| Inventory  | (20,478,449 )    | (17,805,643 )   |
| Prepaid and other current assets   | (1,193,681 )     | (576,850 )      |
| Other assets   | (69,222 )        | (73,388 )       |
| Accounts payable   | (2,345,002 )     | 6,666,006       |
| Accrued expenses and other long-term liabilities   | 1,383,210        | 2,601,051       |
| Accrued compensation   | 647,795          | 2,476,603       |
| Income tax receivable  | (3,672,928 )     | (3,740,299 )    |
| Layaway deposits   | 1,589,397        | 1,241,962       |
| Net cash (used in) provided by operating activities  | (6,908,664 )     | 3,067,308       |
| <b>Investing activities:</b>   |                  |                 |
| Investments in marketable securities   | (20,133,918 )    | (40,215,652 )   |
| Sales of marketable securities   | 24,687,815       | 7,634,586       |
| Insurance proceeds received for property and equipment                                     | 268,744          |                 |
| Purchase of property and equipment   | (10,023,458 )    | (8,431,852 )    |
| Net cash used in investing activities  | (5,200,817 )     | (41,012,918 )   |
| <b>Financing activities:</b>   |                  |                 |
| Repayments on long-term debt and capital lease obligations                                 | (508,325 )       | (2,237,296 )    |
| Proceeds from payment of shareholder note receivable                                       |                  | 23,691          |
| Repayment of preferred shares subject to mandatory redemption                              |                  | (3,605,000 )    |
| Excess tax benefits realized from the exercise of stock options                            | 8,418,608        |                 |
| Proceeds from the sale of stock  |                  | 41,074,909      |
| Proceeds from the exercise of stock options  | 786,600          | 258,996         |
| Net cash provided by financing activities  | 8,696,883        | 35,515,300      |
| Net decrease in cash and cash equivalents  | (3,412,598 )     | (2,430,310 )    |
| <b>Cash and cash equivalents:</b>  |                  |                 |
| Beginning of period  | 9,079,388        | 11,801,442      |
| End of period  | \$ 5,666,790     | \$ 9,371,132    |
| <b>Supplemental disclosure of cash flow information:</b>                                   |                  |                 |
| Cash paid for interest   | \$ 138,807       | \$ 664,750      |
| Cash paid for income taxes   | \$ 991,250       | \$ 6,007,090    |
| Purchases of property and equipment financed by entering into capital leases               | \$ 2,820,426     | \$ 514,191      |

See accompanying notes to the condensed financial statements(unaudited).



Citi Trends, Inc

Notes to the Condensed Financial Statements (unaudited)

October 28, 2006

1. Basis of Presentation

The condensed balance sheet as of October 28, 2006, the condensed statements of operations for the thirty-nine and thirteen-week periods ended October 28, 2006 and October 29, 2005, and the condensed statements of cash flows for the thirty-nine week periods ended October 28, 2006 and October 29, 2005 have been prepared by Citi Trends, Inc. (the Company), without audit. The condensed balance sheet as of January 28, 2006 has been derived from the audited financials statements as of that date, but does not include all required year end disclosures. In the opinion of management, such statements include all adjustments considered necessary to present fairly the Company's financial position as of October 28, 2006 and January 28, 2006, and its results of operations and cash flows at October 28, 2006 and October 29, 2005 and for all periods presented.

Certain information and disclosures normally included in the notes to the annual financial statements prepared in accordance with U.S. generally accepted accounting principles have been omitted from these condensed financial statements. The Company suggests that you read its condensed financial statements in conjunction with the financial statements and notes thereto included in our Annual Report on Form 10-K for the fiscal year ended January 28, 2006.

The results of operations for the thirty-nine and thirteen weeks ended October 28, 2006 are not necessarily indicative of the operating results that may be expected for the year ending February 3, 2007.

The following contains references to years 2006 and 2005, which represent fiscal years ending or ended on February 3, 2007 (fiscal 2006) and January 28, 2006 (fiscal 2005), respectively. Fiscal 2006 has a 53-week accounting period and fiscal 2005 has a 52-week accounting period.

2. Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

3. Stock-Based Compensation

In 1999, the Company established the 1999 Citi Trends, Inc. Stock Option Plan (the 1999 Plan). The 1999 Plan provided for the grant of incentive and nonqualified options to key employees and directors. The Board of Directors determined the exercise price of the option grants. The option grants generally vested in equal installments over four years from the date of grant and are generally exercisable up to ten years from the date of grant, which is the contractual life of the options. The Company authorized up to 1,950,000 shares of common stock for issuance under the 1999 Plan.

On March 8, 2005 the Company adopted the 2005 Citi Trends, Inc. Long Term Incentive Plan, (the Incentive Plan), which became effective upon the consummation of the Company's initial public offering in May, 2005. The Incentive Plan superseded and replaced the 1999 Plan. The Incentive Plan provides for the grant of incentive and nonqualified options to key employees and directors. The Board of Directors determines the exercise prices of the option grants which are generally equal to the closing market price of the Company's stock on the date of grant. Option grants generally vest in equal installments over four years from the date of grant and are generally exercisable up to ten years from the date of grant. Under the Incentive Plan, the Company may issue up to 1,300,000 shares of common stock that may be issued upon the exercise of stock options and other equity incentive awards.

For fiscal years prior to 2006, the Company applied the intrinsic-value-based method of accounting prescribed by the Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations including Financial Accounting Standards Board (FASB) interpretation (FIN) No. 44, *Accounting for Certain Transactions Involving Stock Compensation, an interpretation of APB Opinion No. 25* to account for its fixed-plan stock options. Under this method, compensation expense was recorded on the date of grant only if the then-current fair value of the underlying stock exceeded the exercise price. The Company recognized the fair value of stock rights granted to non-employees in the financial statements. Statement of Financial Accounting Standards (SFAS) No. 123, *Accounting for Stock-Based*

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*Compensation, and SFAS No. 148, Accounting for Stock-Based Compensation-Transition and Disclosure, an amendment of FASB statement No. 123, established accounting and disclosure requirements using a fair-value-based method of accounting for stock-based employee compensation plans. As permitted by the accounting standards, the Company continued to apply the intrinsic-value based method of accounting as described previously and adopted only the disclosure requirements of SFAS No. 123, as amended.*

Effective January 29, 2006, the Company began recording compensation expense associated with all stock options and other forms of equity compensation in accordance with SFAS No. 123R, *Share-Based Payment*, as interpreted by SEC Staff Accounting Bulletin

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No. 107. The Company has selected the Modified Prospective transition approach for adoption of SFAS No. 123R. Under the Modified Prospective approach, prior periods are not restated. Compensation expense for the unvested portions of grants awarded prior to January 29, 2006, will be recognized over the grants remaining service periods using the compensation cost calculated previously for pro-forma disclosure under APB Opinion No. 25, *Accounting for Stock Issued to Employees*. For awards granted after January 28, 2006, the Company is recognizing compensation expense based on the grant-date fair value calculated in accordance with SFAS No. 123R. Such expense will be recognized on a straight line basis over the service period of the option recipients which is generally equal to four years.

Under SFAS No. 123R, the fair value of each option award is estimated on the date of grant using the Black-Scholes-Merton option pricing model, which uses the assumptions noted in the following table. Expected volatility is based on estimated future volatility of the Company's common stock price. Having completed its initial public offering in May 2005, the Company has limited historical data regarding the price of its publicly traded shares. To estimate future volatility of the Company's stock price, the stock price volatility of similar entities for which shares have been publicly traded for a period of seven years or more was measured. The Company uses a volatility measure which is approximately equal to the average volatility of such similar entities as measured over a period of the most recent seven years. The Company uses historical data to estimate forfeitures used in the model. The expected term of options granted is based on guidance provided by the SEC Staff Accounting Bulletin 107 (simplified method for plain vanilla options.). The simplified method (available for entities which do not have sufficient historical exercise data available for making a refined estimate of expected term) assumes a 10 year contractual term with vesting at a rate of 25% per year. Accordingly, expected term = ((vesting term + original contractual term)/2). The risk-free interest rate for the periods which corresponds with the contractual life of the option is based on the U.S. Treasury yield curve in effect at the time of grant.

The following is a summary of the Company's assumptions as of October 28, 2006 under SFAS No. 123R.

|   | Thirty-nine Weeks Ended |        |                  |       | Thirteen Weeks Ended |     |                  |      |
|---|-------------------------|--------|------------------|-------|----------------------|-----|------------------|------|
|   | October 28, 2006        |        | October 29, 2005 |       | October 28, 2006     |     | October 29, 2005 |      |
| Expected dividend yield                   | 0.00                    | %      | 0.00             | %     | 0.00                 | %   | 0.00             | %    |
| Expected volatility                       | 50.00                   | %      | 50.00            | %     | 50.00                | %   | 50.00            | %    |
| Risk-free interest rate                   | 4.63%                   | - 5.26 | %                | 3.61% | - 3.97               | %   | 4.74             | %    |
| Weighted-average expected lives, in years | 6.18 years              |        | 6.23 years       |       | 6.25 years           |     | 6.25 years       |      |
| Forfeiture rate                           | 0%                      | - 5.0  | %                | 10.0  | %                    | 5.0 | %                | 10.0 |

A summary of the status of stock options under our plans and changes during the thirty-nine weeks ended October 28, 2006 is presented in the table below:

|                                    | Shares    | Weighted-Average Exercise Price | Weighted-Average Remaining Contractual Term (Years) | Aggregate Intrinsic Value |
|------------------------------------|-----------|---------------------------------|---|---------------------------|
| Outstanding at beginning of period | 1,572,833 | \$ 2.60                         |   |                           |
| Granted                            | 89,750    | 40.46                           |   |                           |
| Exercised                          | (623,437) | 1.30                            |   | \$ 21,010,269             |
| Forfeited                          | (20,650)  | 14.47                           |   |                           |
| Outstanding end of period          | 1,018,496 | \$ 6.49                         | 5.5   | \$ 32,904,027             |
| Options exercisable end of period  | 750,321   | \$ 1.36                         | 4.3   | \$ 27,934,790             |

The weighted average grant-date fair value of options granted during the thirty-nine and thirteen weeks ended October 28, 2006 was \$21.96 and \$16.65 per share, respectively or approximately \$1,970,000 and \$54,100, respectively for all options granted. The weighted average grant-date fair value of options granted during the thirty-nine and thirteen weeks ended October 29, 2005 was \$7.59 and \$13.89 per share, respectively or approximately \$1,305,000 and \$55,600, respectively for all options granted. Cash received from options exercised totaled approximately \$810,000 and \$263,000 for the thirty-nine weeks ended October 28, 2006 and October 29, 2005, respectively and approximately \$71,000 and \$113,000 for the thirteen weeks ended October 28, 2006, and October 29, 2005, respectively.



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Prior to the adoption of SFAS No. 123R, the Company presented all tax benefits resulting from the exercise of stock options as operating cash flows in the Condensed Statements of Cash Flows. SFAS No. 123R requires that cash flows resulting from tax deductions in excess of the cumulative compensation cost recognized for options exercised ( excess tax benefits ) be classified as financing cash flows. For the thirty-nine and thirteen weeks ended October 28, 2006, excess tax benefits realized from the exercise of stock options was approximately \$8,419,000 and \$1,058,000, respectively.

During the thirty-nine weeks and thirteen weeks ended October 28, 2006, the Company recognized approximately \$662,000 (\$434,000 after tax) and \$246,000 (\$161,000 after tax), respectively, in share-based compensation expense with a resulting increase in its deferred tax assets of approximately \$228,000 and \$85,000 respectively, for the thirty-nine weeks and thirteen weeks ended October 28, 2006. No compensation cost was recognized prior to January 29, 2006, except for option grants made in 2001 and 2004 that were issued below fair market value. Had compensation cost for our share-based compensation plans been determined consistent with SFAS No. 123R, the Company's net income and earnings per share for the thirty-nine weeks and thirteen weeks ended October 29, 2005 would have been reduced to the following pro forma amounts:

|   | <b>Thirty-nine<br/>Weeks Ended<br/>October 29,<br/>2005</b> | <b>Thirteen<br/>Weeks Ended<br/>October 29,<br/>2005</b> |
|---|---|--|
| Net income, as reported   | \$ 6,278,080  | \$ 2,632,229   |
| Add stock-based employee compensation expense included in reported net income, net of tax of \$27,336 for the thirty-nine weeks and \$9,115 in the thirteen weeks                                   | 48,195  | 16,065   |
| Deduct total stock-based employee compensation expense determined under fair-value-based method for all awards, net of tax of \$98,350 for the thirty-nine weeks and \$44,248 in the thirteen weeks | (173,335)   | (77,985)   |
| Pro forma net income  | \$ 6,152,940  | \$ 2,570,309   |
| As reported basic income per common share   | \$ 0.55   | \$ 0.21  |
| Pro forma basic income per common share   | \$ 0.54   | \$ 0.20  |
| As reported diluted income per common share   | \$ 0.49   | \$ 0.18  |
| Pro forma diluted income per common share   | \$ 0.48   | \$ 0.18  |

As of October 28, 2006, the total compensation cost related to non-vested awards that will be incurred in future periods amounts to approximately \$2,384,000. The weighted-average period over which this amount is expected to be recognized is 35.7 months. The Company's stock option plans allows the Company to issue new shares from shares authorized for issuance or repurchase shares on the open market to complete employee stock option exercises. The Company does not currently plan to repurchase shares.

#### 4. Earnings per Share

Earnings per share is based on the weighted average number of common shares outstanding and diluted earnings per share is based on the weighted average number of common shares outstanding plus the incremental shares that would have been outstanding upon the assumed exercise of all dilutive stock options.

The following table is a reconciliation of the number of average common shares outstanding used to calculate basic earnings per share to the number of common shares and common share equivalents outstanding used in calculating diluted earnings per share for the thirty-nine weeks ended October 28, 2006 and October 29, 2005:

|  | <b>Thirty-nine Weeks Ended<br/>October 28, 2006</b> | <b>October 29, 2005</b> |
|--|---|-------------------------|
| Average number of common shares outstanding                              | 13,515,645  | 11,348,502              |
| Incremental shares from assumed exercises of stock options               | 516,088   | 1,498,917               |
| Average number of common shares and common stock equivalents outstanding | 14,031,733  | 12,874,419              |

According to SFAS No. 128, *Earnings per Share*, the dilutive effect of stock-based compensation arrangement is determined using the treasury stock method. This method assumes that the proceeds the Company receives from the exercise of stock options are used to repurchase common shares in the market. The adoption of SFAS No. 123R, *Share-Based Payment* requires the Company to include as assumed proceeds the amount of compensation cost attributed to future services and not yet recognized, and the amount of tax benefits (both deferred and current), if any, that

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would be credited to additional paid-in capital assuming exercise of the options. For the thirty-nine weeks ended October 28, 2006 the recognition of these assumed proceeds using the Treasury Stock method reduces the recognized dilution due to the Company's stock options outstanding. For the thirty-nine weeks ended October 28, 2006 and the thirty-nine weeks ended October 29, 2005 there were 75,750 and 4,000 options outstanding respectively, to purchase shares of common stock excluded from the calculation of diluted earnings per share because of antidilution.

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For the thirty-nine weeks ended October 29, 2005, had the amount of incremental shares from assumed exercises of stock options been calculated consistently with the treasury stock method as modified due to the Company's implementation of SFAS No. 123R on January 29, 2006, incremental shares assumed issued, the average number of common shares and common stock equivalents, and the resulting diluted earnings per share would have been as follows:

|  | <b>Thirty-nine Weeks ended<br/>October 29, 2005</b> |                  |
|--|---|------------------|
|  | <b>As Reported</b>                                  | <b>Pro Forma</b> |
| Average number of common shares outstanding  | 11,348,502  | 11,348,502       |
| Incremental shares from assumed exercises of stock options                           | 1,498,917   | 979,745          |
| Average number of common shares outstanding and common stock equivalents outstanding | 12,847,419  | 12,328,247       |
| Net income as reported   | \$ 6,278,080  | \$ 6,278,080     |
| Basic earnings per share   | \$ 0.55   | \$ 0.55          |
| Diluted earnings per share   | \$ 0.49   | \$ 0.51          |

The following table is a reconciliation of the number of average common shares outstanding used to calculate basic earnings per share to the number of common shares and common share equivalents outstanding used in calculating diluted earnings per share for the thirteen weeks ended October 28, 2006 and October 29, 2005:

|  | <b>Thirteen Weeks Ended</b> |                         |
|--|-----------------------------|-------------------------|
|  | <b>October 28, 2006</b>     | <b>October 29, 2005</b> |
| Average number of common shares outstanding                              | 13,583,263                  | 12,825,199              |
| Incremental shares from assumed exercises of stock options               | 499,371                     | 1,554,775               |
| Average number of common shares and common stock equivalents outstanding | 14,082,634                  | 14,379,974              |

For the thirteen weeks ended October 28, 2006 and the thirteen weeks ended October 29, 2005 there were 85,950 options and 4,000 options outstanding respectively, to purchase shares of common stock excluded from the calculation of diluted earnings per share because of antidilution.

For the thirteen weeks ended October 29, 2005, had the amount of incremental shares from assumed exercises of stock options been calculated consistently with the treasury stock method as modified due to the Company's implementation of SFAS No. 123R on January 29, 2006, incremental shares assumed issued, the average number of common shares and common stock equivalents, and the resulting diluted earnings per share would have been as follows:

|  | <b>Thirteen Weeks ended<br/>October 29, 2005</b> |                  |
|--|--|------------------|
|  | <b>As Reported</b>                               | <b>Pro Forma</b> |
| Average number of common shares outstanding  | 12,825,199                                       | 12,825,199       |
| Incremental shares from assumed exercises of stock options                           | 1,554,775  | 1,015,330        |
| Average number of common shares outstanding and common stock equivalents outstanding | 14,379,974                                       | 13,840,529       |
| Net income as reported   | \$ 2,632,229                                     | \$ 2,632,229     |
| Basic earnings per share   | \$ 0.21  | \$ 0.21          |
| Diluted earnings per share   | \$ 0.18  | \$ 0.19          |

### 5. Marketable Securities

Marketable securities consist of highly liquid, auction rate municipal securities of at least grade AA by Standard and Poor's or Aa by Moody's. While the underlying security has a long-term nominal maturity, the interest rate is periodically reset through Dutch Auctions typically every seven through forty-nine days. As of October 28, 2006, all auction rate securities held by the Company were purchased with reset periods of 35 days. The Company has the opportunity to sell its investment during such periodic auctions subject to the availability of buyers. Since these auction rate securities are priced and subsequently trade at short-term intervals, they are classified as current assets.

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The Company classifies all investments as available-for-sale. Available-for-sale securities are carried at estimated fair value, based on available market information, with unrealized gains and losses, if any, reported as a component of stockholders' equity. As a result of the resetting variable rates, the carrying value of available-for-sale securities approximates fair market value due to their short maturities. For these reasons, the Company has no cumulative gross unrealized or realized gains or losses from these investments. All income generated from these investments is recorded as interest income. The Company has no investments considered to be trading securities.

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6. Revolving Lines of Credit

The Company has a revolving line of credit with Wachovia Capital Finance that is secured by substantially all of the Company's assets and pursuant to which the Company pays customary fees. This secured line of credit expires in April 2007. At October 28, 2006, the line of credit provided for aggregate cash borrowings and the issuance of letters of credit up to the lesser of \$25,000,000 or the Company's borrowing base (approximately \$25,000,000 at October 28, 2006), as defined in the credit agreement. Borrowings under this secured line of credit bear interest at either the prime rate or the Eurodollar rate plus 2.25%, at the Company's election, based on conditions in the credit agreement. Additionally, there is a letter of credit fee of 1.25% per annum on the outstanding balance of letters of credit. On May 18, 2006, the Company entered into an amendment (the "Fifth Amendment") to its Loan and Security Agreement dated April 2, 1999, as amended (the "Loan Agreement"), with Wachovia Capital Finance. The Fifth Amendment provides, subject to certain conditions, that the reduction by Hampshire Equity Partners, L.P., the Company's largest stockholder, of its investment in the Company is not an event of default under the Loan Agreement. At October 28, 2006, there were no outstanding borrowings on the revolving line of credit, nor were there any outstanding letters of credit. Under the terms of the credit agreement, the Company is required to maintain a minimum tangible net worth. The Company was in compliance with this requirement at October 28, 2006.

On June 16, 2006, the Company entered into a renewal of its unsecured revolving line of credit with Bank of America. The renewal extends the expiration date on the line of credit to June 30, 2007. At October 28, 2006, the line of credit provided for aggregate cash borrowings up to \$3,000,000. Borrowings under the credit agreement bear interest at the London Interbank Offered Rate (LIBOR) plus 2.00%. At October 28, 2006, there were no outstanding borrowings on this unsecured revolving line of credit.

7. Long-term Debt and Capital Lease Obligations

*Capital Leases.* The Company has capital lease obligations that finance the purchase of its computer equipment. The Company entered into a capital lease in August of 2006 to finance equipment for its stores and to buy out several older leases. These obligations have maturity dates ranging from November 2006 to January 2010. The interest rates on these obligations range from 7.2% to 17.5%. All of these obligations are secured by the computer equipment under the lease.

As of October 28, 2006 and January 28, 2006, long-term debt and capital lease obligations consist of the following:

|  | October 28,<br>2006 | January 28,<br>2006 |
|--|---------------------|---------------------|
| Non-negotiable three year junior subordinated note payable on September 30, 2007 issued in exchange for 600 shares of common stock   | 107,334             | 108,936             |
| Capital lease obligations issued to finance purchase of computer equipment; payable in monthly installments averaging approximately \$117,147, \$117,147 \$108,806 and \$106,026 in 2006, 2007, 2008 and 2009, with maturity dates ranging from November 2006 to January 2010; interest at rates ranging from 7.2% to 17.5%; secured by computer equipment | 3,398,025           | 1,084,324           |
| <b>Total Long Term Debt and Capital Lease Obligations</b>  | <b>3,505,359</b>    | <b>1,193,260</b>    |
| Less current portion of long-term debt and capital lease obligations   | 1,048,600           | 662,196             |
| <b>Total Long Term Debt and Capital Lease Obligations, less current portion</b>  | <b>\$ 2,456,759</b> | <b>\$ 531,064</b>   |

As of October 28, 2006, annual long-term debt and capital lease obligation maturities are as follows:

| Fiscal Year   | Long-term<br>Debt | Capital Lease<br>Obligations |
|---|-------------------|------------------------------|
| 4th quarter 2006  | \$                | \$ 351,440                   |
| 2007  | 107,334           | 1,405,761                    |
| 2008  |                   | 1,305,672                    |
| 2009  |                   | 1,272,309                    |
|   | 107,334           | 4,335,183                    |
| Less portion attributable to future interest payments (at rates ranging from 7.2% to 17.5%) |                   | (937,157)                    |
| <b>Total Long Term Debt and Capital Lease Obligations</b>                                   | <b>\$ 107,334</b> | <b>\$ 3,398,025</b>          |

8. Contingencies

The Company from time to time is involved in various legal proceedings incidental to the conduct of its business, including claims by customers, employees or former employees. While litigation is subject to uncertainties and the outcome of any litigated matter is not predictable, the Company is not aware of any legal proceedings pending or threatened against it that it expects to have a material adverse effect on its financial condition or results of operations.

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9. Related Party Transactions - Management Consulting Agreement

The Company was a party to an Amended and Restated Management Consulting Agreement (the "Consulting Agreement"), effective as of February 1, 2004 with Hampshire Management Company LLC (the "Consultant"), an affiliate of the Company's largest shareholder, pursuant to which the Consultant provided the Company with certain consulting services related to, but not limited to, financial affairs, relationships with lenders, stockholders and other third-party associates or affiliates, and the expansion of the Company's business. In connection with the Company's initial public offering in May 2005, the parties terminated the Consulting Agreement, and the Company paid the Consultant a one time termination fee of \$1.2 million in the second quarter of 2005.

Included in operating expenses for the thirty-nine weeks ended October 28, 2006 were management fees of \$0 compared to management fees of \$72,857 for the thirty-nine weeks ended October 29, 2005 and the termination fee of \$1.2 million for the thirty-nine weeks ended October 29, 2005.

10. Secondary Offering

On January 31, 2006, the Company completed a secondary offering of shares of its common stock by certain shareholders of the Company. The shares sold were priced at \$42.25 per share. The offering consisted of 1,926,250 shares of common stock, including 251,250 shares that were subject to the underwriters' over-allotment option. All of the shares were sold by the Company's shareholders and, as a result, the Company did not receive any of the proceeds from the offering. The Company incurred expenses in fiscal 2005 in connection with the secondary offering of approximately \$525,000.

11. Recent Accounting Pronouncements

In July 2006, the FASB issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, (FIN 48), an interpretation of SFAS No. 109, *Accounting for Income Taxes*, (SFAS No. 109). FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken in a tax return. The Company must determine whether it is more-likely-than-not that a tax position will be sustained upon examination, including resolution of any related appeals or litigation processes, based on the technical merits of the position. Once it is determined that a position meets the more-likely-than-not recognition threshold, the position is measured to determine the amount of benefit to recognize in the financial statements. FIN 48 applies to all tax positions related to income taxes subject to SFAS 109. Additionally, FIN 48 provides guidance on de-recognition, income statement classification of interest and penalties, accounting in interim periods, disclosure, and transition. This interpretation is effective for fiscal years beginning after December 15, 2006. The Company is currently assessing the impact of FIN 48 on its financial statements.

In October 2005, the FASB issued FASB Staff Position (FSP) No. FAS 13-1, *Accounting for Rental Costs Incurred during a Construction Period*, which mandates that rental costs associated with ground or building operating leases incurred during construction shall be recognized as rental expense. The guidance is effective as of the first reporting period beginning after December 15, 2005. The adoption of FSP No. FAS 13-1 did not have a material effect on the Company's financial position, results of operations or cash flows.

In September 2006, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 108 (SAB 108). SAB 108 addresses the process and diversity in practice of quantifying financial statement misstatements resulting in the potential build up of improper amounts on the balance sheet. The Company will be required to adopt the provisions of SAB 108 in fiscal 2007. The Company does not believe that the adoption of SAB 108 will have a material impact on its consolidated financial statements.

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

### **Forward-Looking Statements**

Except for specific historical information, many of the matters discussed in this Form 10-Q may express or imply projections of revenues or expenditures, statements of plans and objectives for future operations, growth or initiatives, statements of future economic performance, or statements regarding the outcome or impact of pending or threatened litigation. These, and similar statements, are forward-looking statements concerning matters that involve risks, uncertainties and other factors that may cause the actual performance of the Company to differ materially from those expressed or implied by these statements. All forward-looking information should be evaluated in the context of these risks, uncertainties and other factors. The words believe, anticipate, project, plan, expect, estimate, objective, forecast, goal, intend, or will continue and similar words and expressions generally identify forward-looking statements. The Company believes the assumptions underlying these forward-looking statements are reasonable; however, any of the assumptions could be inaccurate, and therefore, actual results may differ materially from those projected in the forward-looking statements.

The factors that may result in actual results differing from such forward-looking information include, but are not limited to: transportation and distribution delays or interruptions; changes in freight rates; the Company's ability to negotiate effectively the cost and purchase of merchandise; inventory risks due to shifts in market demand; the Company's ability to gauge fashion trends and changing consumer preferences; changes in consumer spending on apparel; changes in product mix; interruptions in suppliers' businesses; interest rate fluctuations; a continued rise in insurance costs; a deterioration in general economic conditions caused by acts of war or terrorism; temporary changes in demand due to weather patterns; seasonality of the Company's business; delays associated with building, opening and operating new stores; delays associated with building, opening, expanding or converting new or existing distribution centers; and other factors.

Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date of this Form 10-Q. Except as may be required by law, the Company undertakes no obligation to update or revise publicly any forward-looking statements contained herein to reflect events or circumstances occurring after the date of this Form 10-Q or to reflect the occurrence of unanticipated events. Readers are advised, however, to read any further disclosures the Company may make on related subjects in its public disclosures or documents filed with the SEC.

### **Overview**

The Company is a rapidly growing, value-priced retailer of urban fashion apparel and accessories for the entire family. The Company's merchandise offerings are designed to appeal to the preferences of fashion conscious consumers, particularly African-Americans. Stores are located in the Southeast, the Mid-Atlantic region, Texas and the Midwest. As of October 28, 2006, there were 266 stores in operation in both urban and rural markets in sixteen states.

The Company measures its performance using key operating statistics. One of the main performance measures is comparable store sales growth. A comparable store is defined as a store that has been open for an entire fiscal year. Therefore, a store will not be considered a comparable store until its 13<sup>th</sup> month of operation at the earliest or its 24<sup>th</sup> month at the latest. As an example, stores opened in fiscal 2004 and fiscal 2005 were not considered comparable stores in fiscal 2005. Relocated and expanded stores are included in the comparable store sales results. Other operating statistics, most notably average sales per store, are utilized in managing the Company. The Company typically occupies existing space in established shopping centers rather than sites built specifically for its stores, and, therefore, store square footage (and sales per square foot) varies by store. The Company focuses on the overall store sales volume as the critical driver of profitability. Average sales per store have increased from approximately \$0.8 million in fiscal 2000 to approximately \$1.3 million in fiscal 2005. The Company also measures gross margin percentage and store operating expenses, with a particular focus on labor as a percentage of sales. These results translate into store level contribution, which is used to evaluate overall performance of each individual store. Corporate expenses are monitored against budgeted amounts.

The Company's cash requirements are primarily for working capital, construction of new stores, remodeling of existing stores and improvements to its information systems. Historically, these cash requirements have been met from cash flow from operations, short-term trade credit and borrowings under the revolving lines of credit, long-term debt, capital leases and the proceeds from the initial public offering.

### **Accounting Periods**

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The following discussion contains references to years 2006 and 2005, which represent fiscal years ending or ended on February 3, 2007 (fiscal 2006) and January 28, 2006 (fiscal 2005), respectively. Fiscal 2006 has a 53-week accounting period and fiscal 2005 had a 52-week accounting period. This discussion and analysis should be read with the condensed financial statements and the notes thereto.

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## Results of Operations

The following discussion of the Company's financial performance is based on the condensed financial statements set forth herein. The nature of the Company's business is seasonal. Historically, sales in the first and fourth quarters have been higher than sales achieved in the second and third quarters of the fiscal year. Expenses, and to a greater extent operating income, vary by quarter. Results of a period shorter than a full year may not be indicative of results expected for the entire year. Furthermore, the seasonal nature of the Company's business may affect comparisons between periods.

### Thirty-nine Weeks Ended October 28, 2006 and October 29, 2005

*Net Sales.* Net sales increased \$62.2 million, or 32.2%, to \$255.1 million for the thirty-nine weeks ended October 28, 2006 from \$193.0 million in the thirty-nine weeks ended October 29, 2005. The increase in net sales was primarily due to 41 new stores opened since October 29, 2005 and a comparable store sales increase of 11.6% for the thirty-nine weeks ended October 28, 2006 compared to the thirty-nine weeks ended October 29, 2005. The 41 stores opened since October 29, 2005 accounted for \$31.2 million of the total increase in sales, the 26 stores opened between January 30, 2005 and October 29, 2005 accounted for \$11.8 million and the 199 comparable stores contributed \$20.2 million of the increase in sales. These sales increases were partially offset by one store that was closed in fiscal 2005. Three stores have been expanded and/or relocated since October 29, 2005, all of which occurred in the thirty-nine weeks ended October 28, 2006. The increase in same store sales was due primarily to increased store traffic and a higher average item price, which we believe, resulted from the increasing popularity of branded goods.

*Gross Profit.* Gross profit increased \$23.6 million, or 31.9%, to \$97.5 million in the thirty-nine weeks ended October 28, 2006 from \$73.9 million in the thirty-nine weeks ended October 29, 2005. The increase in gross profit is primarily a result of the increase in sales for the same period. As a percentage of net sales, gross profit decreased to 38.2% in the thirty-nine weeks ended October 28, 2006 from 38.3% in the thirty-nine weeks ended October 29, 2005. This decrease, as a percentage of net sales, was primarily due to higher markdown rates as a percent of sales in the thirty-nine weeks ended October 28, 2006 compared to the thirty-nine weeks ended October 29, 2005 that were partially offset by a higher initial mark up on merchandise.

*Selling, General and Administrative Expense.* Selling, general and administrative expenses increased \$17.8 million, or 27.8%, to \$82.1 million in the thirty-nine weeks ended October 28, 2006 from \$64.3 million in the thirty-nine weeks ended October 29, 2005. The increase in these expenses was due primarily to additional store level, distribution and corporate costs arising from the opening of 41 new stores since October 29, 2005. Selling, general and administrative expense as a percentage of net sales decreased to 32.2% in the thirty-nine weeks ended October 28, 2006 from 33.3% in the thirty-nine weeks ended October 29, 2005. The decrease as a percentage of net sales was primarily due in part to the payment in the thirty-nine weeks ending October 29, 2005 of a \$1.2 million fee to terminate the consulting agreement with Hampshire Equity Partners and to leveraging corporate costs against new store and comparable store sales growth. Partially offsetting these favorable items were additional costs incurred by the Company for compliance with section 404 of the Sarbanes-Oxley Act, other legal and professional fees and increased insurance costs for medical claims in the thirty-nine weeks ended October 28, 2006, all of which totaled approximately \$2.0 million.

*Interest Income.* Interest income increased to \$1.4 million in the thirty-nine weeks ended October 28, 2006 from approximately \$499,000 in the thirty-nine weeks ended October 29, 2005. The increase in interest income was due primarily to interest income earned on proceeds received from the Company's initial public offering in the second quarter of 2005. These proceeds are invested in marketable securities.

*Interest Expense.* Interest expense decreased 44.2% to approximately \$169,000 in the thirty-nine weeks ended October 28, 2006 from approximately \$302,000 in the thirty-nine weeks ended October 29, 2005. The decrease in interest expense was due primarily to the Company's redemption in the second quarter of 2005 of the preferred shares subject



to mandatory redemption and the Company repaying in full the mortgage on its Fahm Street Distribution Center in the second quarter of 2005.

*Provision for Income Taxes.* The provision for income taxes increased 58.6% to \$5.6 million in the thirty-nine weeks ended October 28, 2006 from \$3.6 million in the thirty-nine weeks ended October 29, 2005. The income tax rate for the thirty-nine weeks ended October 28, 2006 was 34.0% compared to 36.2% for the thirty-nine weeks ended October 29, 2005. The decrease in the effective tax rate was due to the Company's increased investment in tax exempt securities and the Company's increased realization of various tax credits in the thirty-nine weeks ended October 28, 2006 compared to the thirty nine weeks ended October 29, 2005 and the absence of any non-deductible interest expense in fiscal year 2006.

*Net Income.* Net income increased 74.9% to \$11.0 million in the thirty-nine weeks ended October 28, 2006 from \$6.3 million in the thirty-nine weeks ended October 29, 2005. The increase in net income was due to the factors discussed above.

**Thirteen Weeks Ended October 28, 2006 and October 29, 2005**

*Net Sales.* Net sales increased \$17.2 million, or 24.6%, to \$87.1 million for the thirteen weeks ended October 28, 2006 from \$69.9 million in the thirteen weeks ended October 29, 2005. The increase in net sales was primarily due to 41 new stores opened since October 29, 2005 and a comparable store sales increase of 6.2% for the thirteen weeks ended October 28, 2006 compared to a comparable store sales increase of 25.0% for the thirteen weeks ended October 29, 2005. The 41 stores opened since October 29, 2005 accounted for \$12.9 million of the total increase in sales, the 26 stores opened between January 30, 2005 and October 29, 2005 accounted for approximately \$588,000 and the 199 comparable stores contributed \$3.8 million of the increase in sales. These sales

increases were partially offset by one store that was closed in fiscal 2005. Three stores have been expanded and/or relocated since October 29, 2005, none of which occurred in the thirteen weeks ended October 28, 2006. The increase in same store sales was due primarily to an increase in the average price of items sold, which occurred primarily due to branded goods increasing as percentage of the Company's assortment of goods sold.

*Gross Profit.* Gross profit increased \$5.9 million, or 22.0%, to \$33.0 million in the thirteen weeks ended October 28, 2006 from \$27.0 million in the thirteen weeks ended October 29, 2005. The increase in gross profit is primarily a result of the increase in sales for the same period. As a percentage of net sales, gross profit decreased to 37.8% in the thirteen weeks ended October 28, 2006 from 38.7% in the thirteen weeks ended October 29, 2005. This decrease, as a percentage of net sales, was primarily due to higher markdowns rates as of percent of sales and an increase in shrink expense as a percent of sales in the thirteen weeks ended October 28, 2006 compared to the thirteen weeks ended October 29, 2005, that were partially offset by a higher initial mark up on merchandise and lower freight costs. The Company's markdown rates increased in the thirteen weeks ended October 28, 2006 compared to the thirteen weeks ended October 29, 2005 as the Company markdown experience returned to historical norms one year after the post-hurricane sales.

*Selling, General and Administrative Expense.* Selling, general and administrative expenses increased \$5.9 million, or 25.6%, to \$29.2 million in the thirteen weeks ended October 28, 2006 from \$23.3 million in the thirteen weeks ended October 29, 2005. The increase in these expenses was due primarily to additional store level, distribution and corporate costs arising from the opening of 41 new stores since October 29, 2005. Selling, general and administrative expense as a percentage of net sales increased to 33.5% in the thirteen weeks ended October 28, 2006 from 33.3% in the thirteen weeks ended October 29, 2005. Expenses related to auditing and SOX Compliance were approximately \$543,000 and approximately \$168,000, respectively for the thirteen weeks ended October 28, 2006 and the thirteen weeks ended October 29, 2005. The increase as a percentage of net sales was primarily due to the deleveraging of occupancy costs and store payroll compared to the third quarter last year. This deleveraging was partially offset by property losses in the thirteen weeks ended October 29, 2005 from Hurricanes Katrina, Rita and Wilma which totaled approximately \$700,000.

*Interest Income.* Interest income increased to approximately \$476,000 in the thirteen weeks ended October 28, 2006 from approximately \$314,000 in the thirteen weeks ended October 29, 2005. The increase in interest income was due primarily to more cash invested in short term marketable securities and higher interest rates realized on cash invested in the thirteen weeks ended October 28, 2006 compared to the thirteen weeks ended October 29, 2005.

*Interest Expense.* Interest expense increased 46.0% to approximately \$90,000 in the thirteen weeks ended October 28, 2006 from approximately \$62,000 in the thirteen weeks ended October 29, 2005. The increase in interest expense was due primarily to the Company's entering into a new \$3.3 million equipment lease in the third quarter of 2006.

*Provision for Income Taxes.* The provision for income taxes decreased 3.8% to \$1.3 million in the thirteen weeks ended October 28, 2006 from \$1.4 million in the thirteen weeks ended October 29, 2005. The income tax rate for the thirteen weeks ended October 28, 2006 was 32.2% compared to 34.6% for the thirteen weeks ended October 29, 2005. The decrease in the effective tax rate was due to the Company's increased investment in tax exempt securities and the Company's increased realization of various tax credits in the thirteen weeks ended October 28, 2006 compared to the thirteen weeks ended October 29, 2005.

*Net Income.* Net income increased 6.7% to \$2.8 million in the thirteen weeks ended October 28, 2006 from \$2.6 million in the thirteen weeks ended October 29, 2005. The increase in net income was due to the factors discussed above.

#### **Liquidity and Capital Resources**

*Current Financial Condition.* At October 28, 2006, the Company had total cash and marketable securities of \$55.6 million compared with total cash and marketable securities of \$63.5 million at January 28, 2006. The most significant factors in the change in the Company's net liquidity position during the first thirty-nine weeks of 2006 were the purchase of additional inventory, capital expenditures related to new store openings, and the build out of our new distribution center in Darlington, South Carolina and an increase in prepaid assets and other current assets which was partially offset by net income from operations adjusted for depreciation and other non-cash charges, cash retained due to the excess tax benefit of stock options exercised that would otherwise been paid for income taxes and cash deposits received for goods placed on layaway.

Inventory represented approximately 44% of the Company's total assets as of October 28, 2006. Management's ability to manage its inventory can have a significant impact on the Company's cash flows from operations during a given interim period or fiscal year. In addition, inventory purchases can be somewhat seasonal in nature, such as the purchase of warm-weather or Christmas-related merchandise.

*Cash Flows (Used in) Provided by Operating Activities.* Net cash (used in) provided by operating activities was (\$6.9) million in the thirty-nine weeks ended October 28, 2006 compared to \$3.1 million in the thirty-nine weeks ended October 29, 2005. Uses of cash consisted of the increase in net inventory of \$22.8 million, a \$3.7 million increase in the net income tax receivable/payable and a \$1.2 million increase in prepaid assets and other current assets. The main sources of cash provided during the thirty-nine weeks ended October 28, 2006 was net income adjusted for depreciation and other non-cash charges of \$17.2 million, increases in accrued expenses and compensation of \$2.0 million and deposits taken on layaway transactions of \$1.6 million.

*Cash Flows Used in Investing Activities.* Cash used in investing activities was \$5.2 million in the thirty-nine weeks ended October 28, 2006 and \$41.0 million in the thirty-nine weeks ended October 29, 2005. Investment activities in marketable securities consisted of net redemptions of \$4.6 million of cash in municipal auction rate securities. Capital expenditure activities consisted of \$10.0 million used for the purchase of property and equipment for the build out of 31 new stores, three relocations and remodels, the build out of the distribution center in Darlington, South Carolina and other general corporate purposes. \$2.0 million of the Company's capital expenditures on new stores in the thirty-nine weeks ended October 28, 2006 will be reimbursed to the Company in the form of cash or free rent by the landlords of the leased properties. These tenant improvement dollars will be amortized over the life of the individual store's lease as a reduction to occupancy expense. Capital expenditures during fiscal 2006, are projected to be approximately \$12 million to \$13 million. The Company anticipates funding its fiscal 2006 and longer term capital requirements with cash flows from operations, and cash obtained from its initial public offering in May 2005, if necessary.

*Cash Flows Provided by Financing Activities.* Cash provided by financing activities was \$8.7 million in the thirty-nine weeks ended October 28, 2006 and approximately \$35.5 million in the thirty-nine weeks ended October 29, 2005. Financing activities in the thirty-nine weeks ended October 28, 2006 included the tax benefit from stock option exercises of \$8.4 million, the receipt of approximately \$787,000 from options exercised during our secondary offering and employee stock option exercises that occurred in the thirty-nine weeks ended October 28, 2006 and repayments of approximately \$508,000 on outstanding capital leases.

#### **Cash Requirements**

The Company's cash requirements are primarily for working capital, construction of new stores, remodeling of existing stores, improvements to its distribution infrastructure and improvements to its information systems. Historically, the Company has met these cash requirements from cash flow from operations, short-term trade credit and borrowings under the revolving lines of credit, long-term debt, capital leases and cash proceeds from the initial public offering in May 2005. The Company expects to be able to meet its cash requirements for at least the next twelve months using cash flow from operations and the cash generated from the sale of its marketable securities.

#### **Critical Accounting Policies**

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. The Company believes the following critical accounting policies describe the more significant judgments and estimates used in the preparation of its financial statements:

##### *Revenue Recognition*

While the recognition of revenue is predominantly derived from routine retail transactions and does not involve significant judgment, revenue recognition represents an important accounting policy of the Company. The Company recognizes retail sales at the time the customer takes possession of the merchandise and purchases are paid for less an allowance for returns. The Company allows for returns up to 10 days after the date of sales and the estimate for returns is based on actual observed return activity 10 days after the period ends. Revenue from layaway sales is recognized when the customer has paid for and received the merchandise. However, revenue from the \$2.00 service charge for participating in the layaway program and from the \$5.00 re-stocking fee, if charged as part of the program, is recognized at the time of payment. All sales are from cash, check or major credit card company transactions.

##### *Inventory*

Inventory is stated at the lower of cost (first-in, first-out basis) or market as determined by the retail inventory method less a provision for estimated inventory shrinkage. Under the retail inventory method, the cost value of inventory and gross margins are determined by calculating a cost-to-retail ratio and applying it to the retail value of inventory. Inherent in the retail inventory calculation are certain significant management judgments and estimates including, among others, merchandise markups, markdowns and shrinkage, which impact the ending inventory valuation at cost as well as resulting gross margins. The Company estimates a shrinkage reserve for the period between the last physical count and the balance sheet date. The estimate for the shrinkage reserve can be affected by changes in actual shrinkage trends. The Company believes

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the first-in first-out retail inventory method results in an inventory valuation that is fairly stated. Many retailers have arrangements with vendors that provide for rebates and allowances under certain conditions, which ultimately affect the value of the inventory. The Company has not entered into any such material arrangements with its vendors.

### *Property and Equipment, net*

The Company has a significant investment in property and equipment. Property and equipment are stated at cost less accumulated depreciation. Equipment under capital leases is stated at the present value of minimum lease payments. Depreciation and amortization are computed using the straight-line method over the lesser of the estimated useful lives (primarily three to five years for computer equipment and furniture, fixtures and equipment, five years for leasehold improvements, and 15 years for buildings) of the related assets or the relevant lease term, whichever is shorter. Any reduction in these estimated useful lives would result in a higher annual depreciation expense for the related assets.

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*Impairment of Long-Lived Assets*

The Company continually evaluates whether events and changes in circumstances warrant revised estimates of the useful lives or recognition of an impairment loss for intangible assets. Future adverse changes in market and legal conditions or poor operating results of underlying assets could result in losses or an inability to recover the carrying value of the intangible asset, thereby possibly requiring an impairment charge in the future. If facts and circumstances indicate that a long-lived asset, including property and equipment, may be impaired, the carrying value is reviewed. If this review indicates that the carrying value of the asset will not be recovered as determined based on projected undiscounted cash flows related to the asset over its remaining life, the carrying value of the asset is reduced to its estimated fair value. Impairment losses in the future are dependent on a number of factors such as site selection and general economic trends, and thus could be significantly different from historical results. To the extent the Company's estimates for net sales, gross profit and store expenses are not realized, future assessments of recoverability could result in impairment charges.

*Stock-Based Compensation*

The Company adopted SFAS No. 123R during the first quarter of fiscal 2006. SFAS No. 123R requires the measurement and recognition of compensation expense for all stock-based awards made to employees based on estimated fair value. The determination of the fair value of the Company's stock options on the date of grant using an option-price model is affected by the Company's stock price as well as assumptions regarding a number of complex and subjective variables. These variables include, but are not limited to, the expected stock price volatility over the term of the awards, and actual and projected employee stock option exercise behaviors. The fair values of options and shares issued pursuant to the Company's stock based compensation plans at each grant date were estimated using the Black-Scholes Merton option pricing model. If factors change and the Company employs different assumptions in the application of SFAS No. 123R in future periods, the compensation expense recorded under SFAS No. 123R may differ significantly from the amount recorded in the current period. (See Note 3 to the Company's Condensed Financial Statements.)

*Operating Leases*

The Company leases substantially all of its store properties and accounts for the leases as operating leases in accordance with SFAS No. 13, *Accounting for Leases*. Many lease agreements contain tenant improvement allowances, rent holidays, rent escalation clauses and/or contingent rent provisions. For purposes of recognizing incentives and minimum rental expenses on a straight-line basis over the terms of the leases, the Company uses the date of initial possession to begin amortization, which is generally when the Company enters the space and begins to make improvements in preparation of intended use.

For scheduled rent escalation clauses during the lease terms or for rental payments commencing rent holidays at a date other than the date of initial occupancy, the Company records minimum rental expenses on a straight-line basis over the terms of the leases. For tenant improvement allowances the Company records a deferred rent liability on the balance sheets and amortizes the deferred rent over the terms of the leases.

Certain leases provide for contingent rents that are not measurable at inception. These contingent rents are primarily based on a percentage of sales that are in excess of a predetermined level. These amounts are excluded from minimum rent and are included in the determination of total rent expense when it is probable that the expense has been incurred and the amount is reasonably estimable.

*Accounting for Income Taxes*

The Company accounts for income taxes in accordance with SFAS No. 109, *Accounting for Income Taxes*. The computation of income taxes is subject to estimation due to the judgment required and the uncertainty related to the recoverability of deferred tax assets or the outcome of tax audits. The Company adjusts its income tax provision in the period it is determined that actual results will differ from its estimates. Tax law and rate changes are reflected in the income tax provision in which such changes are enacted.

The above listing is not intended to be a comprehensive list of all the Company's accounting policies. In many cases the accounting treatment of a particular transaction is specifically dictated by U.S. generally accepted accounting principles, with no need for management's judgment in their application. There are also areas in which management's judgment in selecting any available alternative would not produce a materially different result.

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

The market risk of the Company's financial instruments as of October 28, 2006 has not significantly changed since January 28, 2006. The Company's risk profile as of January 28, 2006 is disclosed in Quantitative and Qualitative Disclosures About Market Risk included in our Annual Report on Form 10-K for the fiscal year ended January 28, 2006.

**Item 4. Controls and Procedures.**

The Company has carried out an evaluation, under the supervision and with the participation of the Company's management, including the Company's Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures as of October 28, 2006 pursuant to Rule 13a-15 and 15d-15 of the Securities Exchange Act of 1934, as amended (the Exchange Act). Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer each concluded that the Company's disclosure controls and procedures are effective in ensuring that all information required to be disclosed in the reports that the Company files or submits, under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms. There were no changes in internal controls over financial reporting during the fiscal quarter ended October 28, 2006 identified in connection with the Chief Executive Officer's and Chief Financial Officer's evaluation that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

At the end of fiscal 2006, Section 404 of the Sarbanes-Oxley Act will require the Company's management to provide an assessment of the effectiveness of the Company's internal control over financial reporting, and the Company's independent registered public accountants will be required to audit management's assessment. The Company is in the process of performing the system and process documentation, evaluation and testing required and has engaged a third party professional firm to assist management to make this assessment and for its independent registered public accountants to provide their attestation report. The Company has not completed this process or its assessment, and this process will require significant amounts of management time and resources. In the course of evaluation and testing, management may identify deficiencies that will need to be addressed and remediated.

## PART II OTHER INFORMATION

### Item 1. Legal Proceedings.

The Company from time to time is involved in various legal proceedings incidental to the conduct of its business, including claims by customers, employees or former employees. While litigation is subject to uncertainties and the outcome of any litigated matter is not predictable, the Company is not aware of any legal proceedings pending or threatened against it that it expects to have a material adverse effect on its financial condition or results of operations.

### Item 1A. Risk Factors.

There are no material changes to the Risk Factors described under the title ITEM 1A. RISK FACTORS in our Annual Report on Form 10-K for the fiscal year ended January 28, 2006.

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

Not applicable.

### Item 3. Defaults Upon Senior Securities.

Not applicable.

### Item 4. Submission of Matter to a Vote of Security Holders.

Not applicable.

### Item 5. Other Information.

As previously disclosed in the Company's Current Report on Form 8-K filed with the Securities and Exchange Commission on November 13, 2006, Tom Stoltz resigned as Chief Financial Officer and Senior Vice President of Finance of the Company, effective November 30, 2006, to accept a position with another company. The Company has initiated a search for his replacement. Mr. Stoltz will assist in the transition of his duties. In the interim, Christopher Bergen, Director of Financial Reporting, will serve in the role of Principal Financial and Accounting Officer and will report directly to Ed Anderson, Chairman and Chief Executive Officer.

Christopher Bergen is 34 and has served as the Director of Financial Reporting for the Company since March 2004. From September 2002 to March 2004, Mr. Bergen served as Assistant Controller for the Company. From August 1999 to August 2002, Mr. Bergen served as the Financial Statement Coordinator for Swifty Serve Corporation, which was a convenience store chain located in Durham, North Carolina. Mr. Bergen is a certified public accountant licensed in North Carolina.

### Item 6. Exhibits.

Exhibits

- 10.1 Amendment to the 1999 Allied Fashion Inc. Stock Option Plan (as previously amended and restated effective as of June 17, 2004) \*
- 10.2 Amendment to the Citi Trends, Inc. 2005 Long-Term Incentive Plan \*
- 31.1 Certification of Chief Executive Officer Pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.\*
- 31.2 Certification of Chief Financial Officer Pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.\*
- 32.1 Certification Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.\*



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\* Filed herewith.

Pursuant to Securities and Exchange Commission Release No. 33-8238, this certification will be treated as accompanying this Quarterly Report on Form 10-Q and not filed as part of such report for purposes of Section 18 of the Securities Exchange Act of 1934, or otherwise subject to the liability of Section 18 of the Securities Exchange Act of 1934 and this certification will not be deemed to be incorporated by reference into any filing under the Securities Act of 1933 or the Securities Exchange Act 1934, except to the extent that the registrant specifically incorporates it by reference.

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**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, and the undersigned also has signed this report in his capacity as the Registrant's Secretary and Chief Financial Officer (Principal Financial Officer).

CITI TRENDS, INC.

Date: November 28, 2006

|        |                                       |
|--------|---------------------------------------|
| By:    | /s/ Thomas W. Stoltz                  |
| Name:  | Thomas W. Stoltz                      |
| Title: | Secretary and Chief Financial Officer |

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