TILLY'S, INC.
Form 10-Q
September 09, 2015
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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 1, 2015

OR

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

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 x 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 x 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	x
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 x

As of September 4, 2015, the registrant had the following shares of common stock outstanding:

Class A common stock $0.001 par value	12,297,234
Class B common stock $0.001 par value	16,169,097

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Part I. Financial Information

Item 1. Financial Statements (Unaudited)
TILLY'S, INC.
CONSOLIDATED BALANCE SHEETS
(In thousands, except share data)
(Unaudited)

	August 1, 2015	January 31, 2015
ASSETS		
Current assets:		
Cash and cash equivalents	$51,725	$49,789
Marketable securities	24,991	34,957
Receivables	11,384	4,682
Merchandise inventories	79,923	51,507
Prepaid expenses and other current assets	13,222	12,349
Total current assets	181,245	153,284
Property and equipment, net	101,214	101,335
Other assets	3,088	2,932
Total assets	$285,547	$257,551
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$39,076	$23,109
Accrued expenses	18,527	12,325
Deferred revenue	5,306	7,075
Accrued compensation and benefits	6,322	5,911
Current portion of deferred rent	5,477	6,070
Current portion of capital lease obligation	832	806
Total current liabilities	75,540	55,296
Long-term portion of deferred rent	42,821	41,875
Long-term portion of capital lease obligation	1,271	1,694
Total long-term liabilities	44,092	43,569
Total liabilities	119,632	98,865
Commitments and contingencies (Note 5)		
Stockholders' equity:		
Common stock (Class A), $0.001 par value; August 1, 2015 - 100,000 shares authorized, 12,297 shares issued and outstanding; January 31, 2015 - 100,000 shares authorized, 11,546 shares issued and outstanding	12	11
Common stock (Class B), $0.001 par value; August 1, 2015 - 35,000 shares authorized, 16,169 shares issued and outstanding; January 31, 2015 - 35,000 shares authorized, 16,544 shares issued and outstanding	16	17
Preferred stock, $0.001 par value; August 1, 2015 and January 31, 2015 - 10,000 shares authorized, no shares issued or outstanding	—	—
Additional paid-in capital	131,960	126,565
Retained earnings	33,914	32,072
Accumulated other comprehensive income	13	21
Total stockholders' equity	165,915	158,686
Total liabilities and stockholders' equity	$285,547	$257,551

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

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TILLY’S, INC.
CONSOLIDATED STATEMENTS OF INCOME
(In thousands, except per share data)
(Unaudited)

	Thirteen Weeks Ended		Twenty-Six Weeks Ended	
	August 1, 2015	August 2, 2014	August 1, 2015	August 2, 2014
Net sales	$130,023	$123,060	$250,213	$234,194
Cost of goods sold (includes buying, distribution, and occupancy costs)	93,427	88,405	177,565	168,212
Gross profit	36,596	34,655	72,648	65,982
Selling, general and administrative expenses	35,492	32,326	69,415	62,576
Operating income	1,104	2,329	3,233	3,406
Other income, net	10	4	18	3
Income before income taxes	1,114	2,333	3,251	3,409
Income tax expense	554	1,067	1,409	1,552
Net income	$560	$1,266	$1,842	$1,857
Basic earnings per share of Class A and Class B common stock	$0.02	$0.05	$0.07	$0.07
Diluted earnings per share of Class A and Class B common stock	$0.02	$0.05	$0.06	$0.07
Weighted average basic shares outstanding	28,333	28,014	28,253	27,999
Weighted average diluted shares outstanding	28,426	28,049	28,403	28,100

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

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TILLY’S, INC.
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(In thousands)
(Unaudited)

	Thirteen Weeks Ended		Twenty-Six Weeks Ended	
	August 1, 2015	August 2, 2014	August 1, 2015	August 2, 2014
Net income	$560	$1,266	$1,842	$1,857
Other comprehensive income:				
Net change in unrealized gain on available-for-sale securities, net of tax	(7)	(12)	(8)	(12)
Other comprehensive income	(7)	(12)	(8)	(12)
Comprehensive income	$553	$1,254	$1,834	$1,845

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

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TILLY’S, INC.
CONSOLIDATED STATEMENT OF STOCKHOLDERS’ EQUITY
(In thousands)
(Unaudited)

	Number of Shares						
	Common Stock (Class A)	Common Stock (Class B)	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income	Total Stockholders’ Equity
Balance at January 31, 2015	11,546	16,544	$28	$126,565	$32,072	$21	$158,686
Net income	—	—	—	—	1,842	—	1,842
Restricted Stock	40	—	—	—	—	—	—
Shares converted by founders	375	(375)	—	—	—	—	—
Stock-based compensation expense	—	—	—	2,301	—	—	2,301
Exercise of stock options	336	—	—	3,094	—	—	3,094
Change in unrealized gain/loss on available-for-sale securities	—	—	—	—	—	(8)	(8)
Balance at August 1, 2015	12,297	16,169	$28	$131,960	$33,914	$13	$165,915

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

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TILLY’S, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)
(Unaudited)

	Twenty-Six Weeks Ended	
	August 1, 2015	August 2, 2014
Cash flows from operating activities		
Net income	$1,842	$1,857
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	11,260	10,182
Stock-based compensation expense	2,301	1,903
Loss on disposal of assets	67	39
Impairment of assets	367	—
Gain on sales and maturities of marketable securities	(65)	(77)
Deferred income taxes	147	334
Excess tax benefit from stock-based compensation	(95)	—
Changes in operating assets and liabilities:		
Receivables	(6,702)	(1,750)
Merchandise inventories	(28,416)	(24,121)
Prepaid expenses and other assets	(1,171)	(1,268)
Accounts payable	15,928	18,397
Accrued expenses	6,149	6,906
Accrued compensation and benefits	411	782
Deferred rent	353	(4)
Deferred revenue	(1,769)	(1,437)
Net cash provided by operating activities	607	11,743
Cash flows from investing activities		
Purchase of property and equipment	(11,481)	(14,587)
Proceeds from sale of property and equipment	—	9
Purchases of marketable securities	(19,982)	(24,961)
Maturities of marketable securities	30,000	35,000
Net cash used in investing activities	(1,463)	(4,539)
Cash flows from financing activities		
Proceeds from exercise of stock options	3,094	165
Payment of capital lease obligation	(397)	(373)
Excess tax benefit from stock-based compensation	95	—
Net cash provided by (used in) financing activities	2,792	(208)
Change in cash and cash equivalents	1,936	6,996
Cash and cash equivalents, beginning of period	49,789	25,412
Cash and cash equivalents, end of period	$51,725	$32,408
Supplemental disclosures of cash flow information		
Interest paid	$73	$97
Income taxes paid	$3,716	$63
Supplemental disclosure of non-cash activities		
Unpaid purchases of property and equipment	$1,605	$2,992

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

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TILLY’S, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

Note 1: Description of the Company and Basis of Presentation

Tilly’s, Inc. is a leading chain of specialty retail stores featuring casual clothing, footwear and accessories for teens and young adults. We operated 216 stores in 33 states as of August 1, 2015. The stores are located in malls, lifestyle centers, ‘power’ centers, community centers, outlet centers and street-front locations. Customers may also shop on-line, where we feature a similar assortment of products as is carried in our brick-and-mortar stores.

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 the Company, Tilly’s, we, or us, refers to WOJT before the Reorganization and to Tilly’s, Inc. and its subsidiary, WOJT, after the Reorganization.

We have prepared the accompanying unaudited consolidated financial statements in accordance with accounting principles generally accepted in the United States of America ("GAAP"), for interim financial reporting. These consolidated financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission, or the SEC. Certain information and footnote disclosures normally included in financial statements prepared in accordance with 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 for the interim periods presented. The results of operations for the thirteen and twenty-six weeks ended August 1, 2015 and August 2, 2014 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 our Annual Report on Form 10-K for the fiscal year ended January 31, 2015.

Fiscal Periods

Our fiscal year ends on the Saturday closest to January 31. References to the fiscal quarters ended August 1, 2015 and August 2, 2014 refer to the thirteen weeks ended as of those dates.

Note 2: Summary of Significant Accounting Policies and New Accounting Standard

Information regarding significant accounting policies is contained in Note 2, “Summary of Significant Accounting Policies”, of the consolidated financial statements in our Annual Report on Form 10-K for the fiscal year ended January 31, 2015.

Income Taxes

We account for income taxes and the related accounts under the liability method in accordance with ASC Topic 740. 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 we believe that it is more likely than not that we will realize the full amount of the net deferred tax assets, we have 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 our annual effective tax rate.

Our effective income tax rate for the thirteen and twenty-six weeks ended August 1, 2015 was 50% and 43%, respectively. The effective income tax rate for the thirteen and twenty-six weeks ended August 1, 2015 reflect the write-off of deferred tax assets related to a tax settlement related to a prior tax year and the forfeiture of vested stock options and stock option exercises in the first and second quarters of fiscal 2015, which represent discrete items. Our effective income tax rate for the thirteen and twenty-six weeks ended August 2, 2014 was 46%.

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In the third quarter of fiscal year 2014, the Internal Revenue Service initiated an examination of our federal income tax returns for the C-Corporation short period year ended February 2, 2013. The examination was settled in the second quarter of fiscal 2015 without a material impact to the Company.
We were notified during the first quarter of fiscal 2015 that the S-Corporation tax period ending May 1, 2012 was also selected for examination by the Internal Revenue Service. There are not any known liabilities and we do not expect that the results of the examinations will have a material impact on our financial condition or statement of operations in fiscal 2015.

New Accounting Standard

In May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2014-09 Revenue from Contracts with Customers (“ASU 2014-09”), which amends the existing accounting standards for revenue recognition. ASU 2014-09 outlines principles that govern revenue recognition at an amount an entity expects to be entitled when products are transferred to customers. In August 2015, FASB issued ASU 2015-14, which extends the effective date of ASU 2014-09 and will be effective for us in the first fiscal quarter of 2018. ASU 2014-09 may be applied retrospectively for each period presented or retrospectively with the cumulative effect recognized in the opening retained earnings balance in fiscal year 2018. We are in the process of evaluating the impact of adopting the new standard on our consolidated financial statements.

Note 3: Marketable Securities

Marketable securities are classified as available-for-sale and, as of August 1, 2015 and January 31, 2015, consisted entirely of commercial paper, all of which was less than one year from maturity.
The following table summarizes our investments in marketable securities at August 1, 2015 and January 31, 2015 (in thousands):

	August 1, 2015			
	Cost	Gross Unrealized Holding Gains	Gross Unrealized Holding Losses	Fair Value
Commercial paper	$24,969	$22	$—	$24,991
	January 31, 2015			
	Cost	Gross Unrealized Holding Gains	Gross Unrealized Holding Losses	Fair Value
Commercial paper	$34,922	$35	$—	$34,957

For the thirteen and twenty-six weeks ended August 1, 2015, we recognized gains on investments of $34 thousand and $65 thousand, respectively, for commercial paper which matured during the period, as compared to $40 thousand and $77 thousand for the thirteen and twenty-six weeks ended August 2, 2014, respectively. Upon recognition of the gains, we reclassified these amounts out of accumulated other comprehensive income and into “Other income, net” on the Consolidated Statements of Income.

Note 4: Line of Credit

On May 3, 2012, we entered into an amended and restated credit agreement with Wells Fargo Bank, N.A. ("Bank"), which we amended on March 17, 2014 to extend the maturity date, reduce the borrowing rate, eliminate a fee of 0.10% on the average daily unused amount on the line of credit, eliminate certain financial covenants related to current liabilities, funded debt and net profits, and add certain new covenants relating to total net losses and maximum balance sheet leverage. The amended credit facility, which was effective as of February 3, 2014, continues to provide for a $25.0 million revolving line of credit, with a maturity date of May 31, 2017. The interest charged on borrowings is either at the London Interbank Offered Rate ("LIBOR"), plus 1.00%, or at the Bank’s prime rate. We have the ability to select between the prime rate or LIBOR-based rate at the time of a cash advance. The revolving credit facility is secured by substantially all of our 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.

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We are required to maintain certain financial and non-financial covenants in accordance with the revolving credit facility. The financial covenants require certain levels of leverage and profitability, such as (i) an aggregate maximum net loss after taxes not to exceed $5 million (measured at the end of each fiscal quarter), with no more than one annual net loss after taxes for any fiscal year (in either case, excluding all charges for impairment of goodwill, other intangibles and store assets impairment on the balance sheet of WOJT, in an aggregate amount of up to $2.0 million for the relevant period), and (ii) a maximum ratio of 2.00 to 1.00 for “balance sheet leverage”, defined as total liabilities divided by total tangible net worth.

On June 10, 2015, we received a consent to guarantee payments under a settlement agreement with one of our vendors and provide a payment advance on their behalf in exchange for a promissory note. Refer to Note 5 Commitments and Contingencies below for further discussion.

On July 9, 2015, we further amended the line of credit to modify the event of default with respect to a change in the composition of a majority of our Board of Directors in a period of 12 consecutive months, to no longer exclude from the determination any individual whose nomination for an assumption of office as a member of our Board of Directors occurred as a result of a solicitation of proxies or consents that was not made by or on behalf of our Board of Directors.

As of August 1, 2015, we were in compliance with all of our covenants and had no outstanding borrowings under the revolving credit facility.

Note 5: Commitments and Contingencies

From time to time, we may become involved in lawsuits and other claims arising from our ordinary course of business. We have established loss provisions of approximately $0.5 million for matters in which losses are probable and can be reasonably estimated. For some of the matters, we are currently unable to predict the ultimate outcome, 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 we are a party or that the ultimate outcome of any of the matters threatened or pending against us, including those disclosed below, will not have a material adverse effect on our financial condition, results of operations or cash flows. See Item 1A “Risk Factors—Litigation costs and the outcome of litigation could have a material adverse effect on our business” included in this report.

Kirstin Christiansen, Shellie Smith and Paul Haug, on behalf of themselves and all others similarly situated vs. World of Jeans & Tops, Superior Court of California, County of Sacramento, Case No. 34-2013-139010. 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 have amended the complaint. The parties have completed class certification discovery and briefing, and a hearing was held on August 13, 2015. The complaint seeks certification of a class, unspecified damages, injunctive relief and attorneys’ fees. We 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 22, 2013, to add a claim for penalties under the California Private Attorneys General Act. In March 2013, we filed a motion to compel arbitration, which was denied in June 2013 and later affirmed on appeal. In October 2014, we filed an answer to the amended complaint. The parties recently attended a mediation proceeding and are working on a potential resolution. If this matter does not settle, we intend to defend this case vigorously.

Karina Whitten, on behalf of herself and all others similarly situated, v. Tilly’s Inc., Superior Court of California, County of Los Angeles, Case No. BC 548252. On June 10, 2014, plaintiff filed a putative class action and representative Private Attorney General Act 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. The complaint seeks class certification, penalties, restitution, injunctive relief and attorneys' fees and costs. Plaintiff filed a first amended complaint on December 3, 2014, removing the expense reimbursement claim. We answered the complaint on January 8, 2015. We intend to defend this case vigorously.

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Herbert Ortiz and Audra Haynes, individually, and on behalf of the generally public, v. Tilly's Inc., United States District Court for the Eastern District of California, Case No. 1:15-CV-108-MJS. On November 6, 2014, plaintiff filed a putative class action and representative Private Attorney General Act lawsuit against the Company in the Superior Court of California, County of Fresno, alleging violations of California's wage and hour, meal break and rest break rules and regulations, and unfair competition law, among other things. The complaint seeks class certification, penalties, restitution, injunctive relief and attorneys' fees and costs. On January 21, 2015, we answered the complaint and removed the action to the United States District Court for the Eastern District of California. In June 2015, the parties settled the action and the case was dismissed on July 10, 2015.

On June 10, 2015, we and one of our vendors entered into a settlement arrangement with a plaintiff who filed a copyright infringement lawsuit against us and the vendor related to certain vendor products we sell. The settlement requires that the vendor pay $2.0 million to the plaintiff over three years and we have agreed to guarantee such payments. In the event of the vendor's default, the current estimated range of a reasonably possible loss is zero to $1.8 million. If required to perform under this settlement, we would utilize all available rights of offset to reduce our potential loss, including application of amounts owed by us to the vendor from our ongoing purchases of the vendor's merchandise and/or the enforcement of a security interest we have in the vendor's intellectual property.

Note 6: Fair Value Measurements

We determine fair value based on the three level valuation hierarchy established under GAAP, which provides a framework for measuring fair value and expands disclosures about fair value measurements. Fair value is defined under GAAP 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. The three level hierarchy of inputs is as follows:

•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.

We measure certain financial assets at fair value on a recurring basis, including our 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 1, 2015 and August 2, 2014, we did not make any transfers between Level 1 and Level 2 financial assets. We conduct 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, we measure certain assets at fair value on a non-recurring basis, specifically long-lived assets evaluated for impairment. We estimate the fair value of our long-lived assets using company-specific assumptions which would fall within Level 3 of the fair value hierarchy.

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Financial Assets

In accordance with GAAP, we categorized our financial assets based on the priority of the inputs to the valuation technique for the instruments as follows (in thousands):

	August 1, 2015			January 31, 2015		
	Level 1	Level 2	Level 3	Level 1	Level 2	Level 3
Cash equivalents:						
Money market securities	$39,467	$—	$—	$34,433	$—	$—
Marketable securities:						
Commercial paper	—	24,991	—	—	34,957	—

Long-Lived Assets

We assess long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying value of such assets may not be recoverable. Based on Level 3 inputs of historical operating performance, including sales trends, gross margin rates, current cash flows from operations and the projected outlook for each of our stores, we determined that certain stores would not be able to generate sufficient cash flows over the remaining term of the related leases to recover our investment in the respective stores. As a result, we recorded non-cash impairment charges of approximately $0.4 million during the second quarter of fiscal 2015 to write-down the carrying value of certain long-lived store assets to their estimated fair values. We did not record any impairment charges in the first half of fiscal 2014.

	August 1, 2015
	($ in thousands)
Carrying value of assets tested for impairment	$6,226
Carrying value of assets with impairment	$645
Fair value of assets impaired	$278
Number of stores tested for impairment	12
Number of stores with impairment	1

Note 7: Stock-Based Compensation

In April 2012, the Compensation Committee of our Board of Directors adopted the Tilly’s 2012 Equity and Incentive Award Plan, which authorized the issuance of options, shares or rights to acquire up to 2,913,900 shares of our Class A common stock. In June 2014, our stockholders approved the Amended and Restated Tilly’s 2012 Equity and Incentive Award Plan (the "2012 Plan"), which increased the aggregate number of shares reserved for issuance thereunder by 1,500,000 shares, from 2,913,900 shares to a total of 4,413,900 shares; and added operating income and comparable store sales growth as additional performance goals that may be used in connection with performance-based awards granted under the 2012 Plan. As of August 1, 2015, there were 2,232,294 shares still available for future issuance under the 2012 Plan.

Options

The Compensation Committee has granted stock options to certain existing and new employees to acquire our Class A common stock under the 2012 Plan. The exercise price of options granted is equal to the closing price per share of our stock at the date of grant. The nonqualified options vest ratably at a rate of 25% on each of the first four anniversaries of the grant date provided that the award recipient continues to be employed by us through each of those vesting dates, and expire ten years from the date of grant.

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The following table summarizes the stock option activity for the twenty-six weeks ended August 1, 2015 (aggregate intrinsic value in thousands):

	Stock Options	Grant Date Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (in Years)	Aggregate Intrinsic Value (1)
Outstanding at January 31, 2015	2,880,040	$13.03		
Granted	62,500	$13.54		
Exercised	(336,140)	$9.21		
Forfeited	(125,625)	$13.29		
Expired	(21,625)	$14.40		
Outstanding at August 1, 2015	2,459,150	$13.54	6.6	$148
Vested and expected to vest at August 1, 2015	2,392,686	$13.56	6.6	$146
Exercisable at August 1, 2015	1,510,900	$13.90	5.6	$130

(1) Intrinsic value for stock options is defined as the difference between the market price of our 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 market value per share was $9.05 at August 1, 2015.

The stock option awards 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 our stock over the option's expected term, the risk-free interest rate over the option's expected term and our expected annual dividend yield, if any. Our estimate of pre-vesting forfeitures, or forfeiture rate, was based on our internal analysis, which included the award recipients' positions and the vesting period of the awards. We 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 1, 2015 and August 2, 2014 was estimated on the grant date using the following assumptions:

	Thirteen Weeks Ended		Twenty-Six Weeks Ended	
	August 1, 2015	August 2, 2014	August 1, 2015	August 2, 2014
Expected option term (1)	5.0 years	5.0 years	5.0 years	5.0 years
Expected volatility factor (2)	45.2%	45.2% - 45.3%	45.16% - 47.78%	45.2% - 46.9%
Risk-free interest rate (3)	1.6%	1.8%	1.5%	1.8%
Expected annual dividend yield	—%	—%	—%	—%

(1) We have limited historical information regarding the expected option term. Accordingly, we 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 our competitors' common stock over the most recent period equal to the expected option term of the 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.

Restricted stock

We grant restricted stock awards (RSAs) and restricted stock units (collectively with the RSAs "restricted stock") under the 2012 Plan to the independent directors on our Board of Directors and certain of our employees. The RSAs granted to the independent directors on our Board of Directors vest ratably at a rate of 50% on each of the first two anniversaries of the grant date provided that the respective award recipient continues to serve on the our Board of Directors through each of those vesting dates. The restricted stock units granted to certain employees vest ratably at a rate of 25% on each of the first four anniversaries of the grant date provided that the respective recipient continues to be employed by us through each of those vesting dates. Restricted stock units represent shares issuable in the future upon vesting whereas RSAs represent restricted shares issued upon the date of grant in which the recipient's rights in the stock are restricted until the shares are vested. We determine the fair value of restricted stock based upon the closing price of our Class A common stock on the date of grant.

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A summary of the status of non-vested restricted stock changes during the twenty-six weeks ended August 1, 2015 are presented below:

	Restricted Stock	Weighted Average Grant-Date Fair Value
Nonvested at January 31, 2015	48,584	$9.88
Granted	330,240	$15.13
Vested	(29,236)	$10.95
Forfeited	(34,500)	$16.07
Nonvested at August 1, 2015	315,088	$14.61

Stock-based compensation expense associated with stock options and restricted stock is recognized on a straight-line basis over the vesting period. The following table summarizes stock-based compensation recorded in the Consolidated Statements of Income:

	Thirteen Weeks Ended		Twenty-Six Weeks Ended	
	August 1, 2015	August 2, 2014	August 1, 2015	August 2, 2014
Cost of goods sold	$284	$286	$523	$458
Selling, general and administrative expenses	748	779	1,778	1,445
Stock-based compensation	$1,032	$1,065	$2,301	$1,903

At August 1, 2015, there was $9.1 million of total unrecognized stock-based compensation expense related to unvested stock options and restricted stock. This cost has a weighted average remaining recognition of 2.8 years.

Note 8: Earnings Per Share

Net income per share is computed under the provisions of ASC Topic 260, Earnings Per Share. Basic net income per share is computed based on the weighted average number of common shares outstanding during the period. Diluted net income 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 us 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 components of basic and diluted net income per share are as follows (in thousands, except per share amounts):

	Thirteen Weeks Ended		Twenty-Six Weeks Ended	
	August 1, 2015	August 2, 2014	August 1, 2015	August 2, 2014
Net income	$560	$1,266	$1,842	$1,857
Weighted average basic shares outstanding	28,333	28,014	28,253	27,999
Dilutive effect of stock options and restricted stock	93	35	150	101
Weighted average shares for diluted earnings per share	28,426	28,049	28,403	28,100
Basic earnings per share	$0.02	$0.05	$0.07	$0.07
Diluted earnings per share	$0.02	$0.05	$0.06	$0.07

Total stock options and restricted stock of 2,439,275 and 2,463,500 as of August 1, 2015 and August 2, 2014, respectively, have been excluded from the calculation of diluted earnings per share as the effect of including these stock options would have been anti-dilutive.

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Note 9: Related Party Transactions

Tilly’s Life Center

Tilly’s Life Center (TLC) is a charitable organization that was founded and is run by Ms. Levine. In July 2015, our Board of Directors approved annual support for TLC of up to $50,000. We incurred costs of approximately $38,000 related to printing of TLC’s program’s materials during the first half of fiscal 2015. We also provide support for marketing and website services for TLC.

There have been no material changes to other related party transactions as previously disclosed in our Annual Report on Form 10-K. For a detailed discussion of related party transactions, please refer to "Note 16: Related Party Transactions" of the Notes to the Consolidated Financial Statements in Item 8. Part II in our Annual Report on Form 10-K for the fiscal year ended January 31, 2015.

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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 January 31, 2015. 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, and Section 21E of the Securities Exchange Act of 1934, as amended, or 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”, “should”, “target”, “will”, “would 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 January 31, 2015, 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, and in other filings we may make with the Securities and Exchange Commission from time to time. 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 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 1, 2015, we operated 216 stores, averaging 7,660 square feet, in 33 states. We also sell our products through our e-commerce website, www.tillys.com (the information available at our website is not incorporated by reference into this report).

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.

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Comparable Store Sales

Comparable store sales is a measure that indicates the change in year-over-year comparable store sales which 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.

Comparable store sales are sales from our e-commerce platform and stores open at least 12 full fiscal months as of the end of the current reporting period. A remodeled, relocated or refreshed 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 20.0% and the store was not closed for more than five days in any fiscal month. We include sales from our e-commerce platform as part of comparable store sales as we manage and analyze our business on a single omni-channel and have substantially integrated our investments and operations for our stores and e-commerce platform to give our customers seamless access and increased ease of shopping. Comparable store sales exclude gift card breakage income and 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 in this report regarding our comparable store sales may not be comparable to similar data made available by other retailers.

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 and benefit expense for our internal buying organization. Distribution costs include costs for receiving, processing and warehousing our store merchandise, shipping of merchandise to or from our distribution and e-commerce fulfillment centers and 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 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.

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Selling, General and Administrative Expenses

Our selling, general and administrative, or SG&A, expenses are composed of 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 receiving and 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 ongoing compliance with the Sarbanes-Oxley Act of 2002 and related rules and regulations could result in significant 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.

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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.

	Thirteen Weeks Ended		Twenty-Six Weeks Ended	
	August 1, 2015	August 2, 2014	August 1, 2015	August 2, 2014
	(in thousands)		(in thousands)	
Statements of Income Data:				
Net sales	$130,023	$123,060	$250,213	$234,194
Cost of goods sold	93,427	88,405	177,565	168,212
Gross profit	36,596	34,655	72,648	65,982
Selling, general and administrative expenses	35,492	32,326	69,415	62,576
Operating income	1,104	2,329	3,233	3,406
Other income, net	10	4	18	3
Income before income taxes	1,114	2,333	3,251	3,409
Income tax expense	554	1,067	1,409	1,552
Net income	$560	$1,266	$1,842	$1,857
Percentage of Net Sales:				
Net sales	100.0 %	100.0 %	100.0 %	100.0 %
Cost of goods sold	71.9 %	71.8 %	71.0 %	71.8 %
Gross profit	28.1 %	28.2 %	29.0 %	28.2 %
Selling, general and administrative expenses	27.3 %	26.3 %	27.7 %	26.7 %
Operating income	0.8 %	1.9 %	1.3 %	1.5 %
Interest income, net	0.1 %	0.0 %	0.0 %	0.0 %
Income before income taxes	0.9 %	1.9 %	1.3 %	1.5 %
Income tax expense	0.5 %	0.9 %	0.6 %	0.7 %
Net income	0.4 %	1.0 %	0.7 %	0.8 %

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

	Thirteen Weeks Ended		Twenty-Six Weeks Ended	
	August 1, 2015	August 2, 2014	August 1, 2015	August 2, 2014
Store Operating Data:				
Stores operating at end of period	216	203	216	203
Comparable store sales change (1)	0.5 %	(7.1)%	1.2 %	(6.9)%
Total square feet at end of period	1,654,570	1,563,409	1,654,570	1,563,409
Average net sales per brick-and-mortar store (in $000's) (2)	$540	$552	$1,043	$1,051
Average net sales per square foot (2)	$71	$71	$136	$136

(1) Comparable store sales include sales through our e-commerce store, but excludes gift card breakage income and e-commerce shipping and handling fee revenue.

(2) E-commerce sales, e-commerce shipping fee revenue and gift card breakage are excluded from net sales in deriving average net sales per brick-and-mortar store and average net sales per square foot.

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Thirteen Weeks Ended August 1, 2015 Compared to Thirteen Weeks Ended August 2, 2014

Net Sales

Net sales were $130.0 million in the second quarter of fiscal 2015 compared to $123.1 million in the second quarter of fiscal 2014, an increase of $6.9 million, or 5.6%. The components of our net sales increase were as follows:

$ millions	Attributable to
$6.3	Increase in non-comparable store sales due to opening 13 net new stores in the prior twelve months
0.6	Increase in comparable store sales of 0.5%
$6.9	Total

Comparable store sales were driven by stronger conversion rates offset by lower traffic compared to the second quarter of fiscal 2014. Net sales were driven by relative strength in women's and kids', with other categories slightly below our overall comparable sales result.

Gross Profit

Gross profit was $36.6 million in the second quarter of fiscal 2015 compared to $34.7 million in the second quarter of fiscal 2014, an increase of $1.9 million, or 5.5%, primarily due to the increase in net sales. Gross margin, or gross profit as a percentage of net sales, was 28.1% and 28.2% during the second quarter of fiscal 2015 and fiscal 2014, respectively. The components of the 0.1% decrease in gross margin were as follows:

%	Attributable to
(0.4)	Decrease in product margins due to increased markdowns on seasonal summer inventory
0.3	Decrease in buying, distribution and occupancy costs as a percentage of net sales primarily due to improved labor and other operational efficiencies in our distribution center and e-commerce fulfillment center, partially offset by an increase in occupancy costs
(0.1)	Total

Selling, General and Administrative Expenses

SG&A expenses were $35.5 million in the second quarter of fiscal 2015 compared to $32.3 million in the second quarter of fiscal 2014, an increase of $3.2 million, or 9.9%. As a percentage of net sales, SG&A expenses were 27.3% and 26.3% during the second quarter of fiscal 2015 and fiscal 2014, respectively. The components of the 1.0% increase in SG&A expenses as a percentage of net sales were as follows:

%	Attributable to
0.6	Increase of $0.9 million due to a combination of legal expenses associated with a loss contingency and a non-cash retail store impairment
0.5	Increase of $0.8 million in print and digital marketing expenses
0.3	Increase of $0.6 million in corporate payroll and benefits primarily due to merit awards and minimal headcount additions
(0.4)	Decrease of $0.4 million in e-commerce fulfillment labor expenses associated with our dedicated e-commerce fulfillment center
—	Increase of $1.3 million in all other SG&A expenses
1.0	Total

Operating Income

Operating income was $1.1 million in the second quarter of fiscal 2015 compared to $2.3 million for the second quarter of fiscal 2014, a decrease of $1.2 million, or 52.2%. As a percentage of net sales, operating income was 0.8% and 1.9% for the second quarter of fiscal 2015 and fiscal 2014, respectively. The decrease in operating income was primarily attributable to the increase in SG&A, partially offset by increased gross profit as discussed above.

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Income Tax Expense

Income taxes were $0.6 million and $1.1 million for the second quarter of fiscal 2015 and fiscal 2014, respectively. Our effective tax rates were 50% and 46% for the second quarter of fiscal 2015 and fiscal 2014, respectively. The increase in our effective tax rate for the second quarter of fiscal 2015 was due to a tax settlement related to a prior tax year.

Net Income and Earnings Per Share

Net income was $0.6 million for the second quarter of fiscal 2015 compared to $1.3 million for the second quarter of fiscal 2014, a decrease of $0.7 million, or 53.8%. Diluted earnings per share was $0.02 for the second quarter of fiscal 2015 compared to $0.05 for the second quarter of fiscal 2014.

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Twenty-Six Weeks Ended August 1, 2015 Compared to Twenty-Six Weeks Ended August 2, 2014

Net Sales

Net sales were $250.2 million in the first half of fiscal 2015 as compared to $234.2 million in the first half of fiscal 2014, an increase of $16.0 million, or 6.8%. The components of our net sales increase were as follows:

$ millions	Attributable to
$13.3	Increase in non-comparable store sales due to opening 13 net new stores in the prior twelve months
2.7	Increase in comparable store sales of 1.2%
$16.0	Total

Comparable store sales were driven by stronger conversion rates offset by lower traffic compared to the first half of fiscal 2014. Sales were driven by relative strength in women's and kids, with other categories slightly below our overall comparable store sales result.

Gross Profit

Gross profit was $72.6 million in the first half of fiscal 2015 compared to $66.0 million in first half of fiscal 2014, an increase of $6.6 million, or 10.0%, primarily due to the net sales increase. Gross margin, or gross profit as a percentage of net sales, was 29.0% and 28.2% during the first half of fiscal 2015 and fiscal 2014, respectively. The components of the 0.8% increase in gross margin were as follows:

%	Attributable to
0.6	Decrease in buying, distribution and occupancy costs as a percentage of net sales, primarily due to improved labor and other operational efficiencies in our distribution center and e-commerce fulfillment center
0.2	Increase in product margins
0.8	Total

Selling, General and Administrative Expenses

SG&A expenses were $69.4 million in the first half of fiscal 2015 from $62.6 million in the first half of fiscal 2014, an increase of $6.8 million, or 10.9%. As a percentage of net sales, SG&A expenses were 27.7% and 26.7% during the first half of fiscal 2015 and fiscal 2014, respectively. The components of the 1.0% increase in store selling expenses as a percentage of net sales were as follows:

%	Attributable to
0.5	Increase of $1.2 million in corporate payroll and benefits primarily due to merit awards and minimal headcount additions
0.4	Increase of $1.1 million due to a combination of legal expenses associated with a loss contingency, a non-cash retail store impairment and various other general corporate costs
0.4	Increase of $1.5 million in print and digital marketing expenses
0.2	Increase of $2.0 million in store payroll expenses primarily due to 13 net new store openings in the prior twelve months
(0.5)	Decrease of $1.0 million in e-commerce fulfillment labor expenses associated with our dedicated e-commerce fulfillment center
—	Increase of $2.0 million in all other SG&A expenses
1.0	Total

Operating Income

Operating income was $3.2 million for the first half of fiscal 2015 compared to $3.4 million for the first half of fiscal 2014, a decrease of $0.2 million, or 5.9%. As a percentage of net sales, operating income was 1.3% and 1.5% for the first half of fiscal 2015 and fiscal 2014, respectively. The decrease in operating income was primarily attributable to the increase in SG&A, partially offset by increased gross profit as discussed above.

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Income Tax Expense

Income taxes were $1.4 million and $1.6 million for the first half of fiscal 2015 and fiscal 2014, respectively. Our effective tax rates were 43% and 46% for the first half of fiscal 2015 and fiscal 2014, respectively. The increase in our effective tax rate in the first half of fiscal 2015 was due to a tax settlement related to a prior tax year.

Net Income and Earnings Per Share

Net income decreased slightly to $1.8 million for the first half of fiscal 2015 from $1.9 million for the first half of fiscal 2014, due to the factors discussed above. Diluted earnings per share was $0.06 for the first half of fiscal 2015 compared to $0.07 for the first half of fiscal 2014.

Liquidity and Capital Resources

Our primary cash needs are for merchandise inventories, payroll, store rent and capital expenditures. We have historically provided for these needs from internally generated cash flows. In addition, we have access to additional liquidity through a $25.0 million revolving credit facility with Wells Fargo Bank, NA. We expect to continue to finance our operations from cash and marketable securities on hand as well as cash flows from operations without borrowing under our revolving credit facility over the next twelve months.

Working capital at August 1, 2015, was $105.7 million compared to $98.0 million at January 31, 2015, an increase of $7.7 million. The changes in our working capital during fiscal 2015 were as follows:

$ millions	Description
$98.0	Working capital at January 31, 2015
11.8	Increase in merchandise inventories, net of accounts payable
6.7	Increase in receivables
1.9	Increase in cash and cash equivalents
(10.0)	Decrease in marketable securities
(2.7)	Decrease in other changes in working capital
$105.7	Working capital at August 1, 2015

Cash Flow Analysis

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

	Twenty-Six Weeks Ended	
	August 1, 2015	August 2, 2014
	(in thousands)	
Net cash provided by operating activities	$607	$11,743
Net cash used in investing activities	(1,463)	(4,539)
Net cash provided by/(used in) financing activities	2,792	(208)
Net increase in cash and cash equivalents	$1,936	$6,996

Net Cash Provided by Operating Activities

Cash flows from operating activities consist of: 1) net income; 2) adjustments to net income for non-cash items that include depreciation and amortization, stock-based compensation expense, deferred income taxes, impairment of assets and gains or losses on disposals of assets; and 3) changes in our assets and liabilities.

Net cash flows provided by operating activities were $0.6 million during the first half of fiscal 2015 compared to $11.7 million in the first half of fiscal 2014. The primary factors contributing to this $11.1 million decrease in cash provided by operating activities were: 1) a $5.5 million decrease in cash flows resulting from the timing of inventory purchases, net of merchandise

payables, due to operating 13 net additional stores and the timing of back-to-school merchandise flows year over year; and 2) a $5.0 million decrease in cash flows due to the growth of receivables associated with income taxes and landlord allowances.

Net Cash Used in Investing Activities

Cash flows from investing activities consist primarily of capital expenditures and maturities and purchases of marketable securities.

Net cash used in investing activities was $1.5 million during the first half of fiscal 2015 compared to $4.5 million during the first half of fiscal 2014. Investing activities in fiscal 2015 consisted of capital expenditures of $11.5 million, partially offset by net proceeds from marketable securities of $10.0 million. We currently expect total capital expenditures for fiscal 2015 to be in the range of approximately $27 million to $29 million. Capital expenditures totaled $14.6 million in the first half of fiscal 2014.

Net Cash Provided by/(Used in) Financing Activities

Cash flows from financing activities consist primarily of payments on our capital lease obligation and proceeds from employee exercises of stock options.

Net cash provided by financing activities was $2.8 million during the first half of fiscal 2015 compared to net cash used of $0.2 million during the first half of fiscal 2014. Financing activities in the first half of fiscal 2015 consisted of cash proceeds from employee exercises of stock options and excess tax benefits of stock-based compensation of $3.2 million, partially offset by payments on our capital lease obligation of $0.4 million. Proceeds from employee exercises of stock options were $0.2 million in the first half of fiscal 2014.

Line of Credit

We maintain a credit facility with Wells Fargo Bank, N.A. that provides for a $25.0 million revolving line of credit with a maturity date of May 31, 2017. The interest charged on borrowings is either at LIBOR plus 1.00%, or at the bank’s prime rate. We have the ability to select between the prime rate or LIBOR-based rate at the time of a cash advance. The credit facility is secured by substantially all of our 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 non-financial covenants in accordance with the revolving credit facility. The financial covenants require certain levels of leverage and profitability, such as (i) an aggregate maximum net loss after taxes not to exceed $5 million (measured at the end of each fiscal quarter), with no more than one annual net loss after taxes for any fiscal year (in either case, excluding all charges for impairment of goodwill, other intangibles and store assets impairment on the balance sheet of World of Jeans & Tops, in an aggregate amount of up to $2.0 million for the relevant period), and (ii) a maximum ratio of 2.00 to 1.00 for “balance sheet leverage”, defined as total liabilities divided by total tangible net worth.

On June 10, 2015, we received a consent to guarantee payments under a settlement agreement with one of our vendors and provide a payment advance on their behalf in exchange for a promissory note. See “Note 5: Commitments and Contingencies” in the notes to our consolidated financial statements for further discussion.

On July 9, 2015, we further amended the line of credit to modify the event of default with respect to a change in the composition of a majority of our Board of Directors in a period of 12 consecutive months, to no longer exclude from the determination any individual whose nomination for an assumption of office as a member of our Board of Directors occurred as a result of a solicitation of proxies or consents that was not made by or on behalf of our Board of Directors.

As of August 1, 2015, we were in compliance with all of our covenants and had no outstanding borrowings under the revolving credit facility.

Contractual Obligations

As of August 1, 2015, there were no material changes to our contractual obligations as 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 January 31, 2015.

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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 U.S. requires the appropriate application of certain accounting policies, some of which require us to make estimates and assumptions about future events and their impact on amounts reported in our consolidated financial statements. Since future events and their impact cannot be determined with absolute certainty, the actual results will inevitably differ from our estimates. A summary of our significant accounting policies is included in Note 2 to the consolidated financial statements in our Annual Report on Form 10-K for the fiscal year ended January 31, 2015.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

As of August 1, 2015, 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 January 31, 2015.

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 1, 2015. 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 our 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 1, 2015, 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 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.

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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. We have established loss provisions of approximately $0.5 million for matters in which losses are probable and can be reasonably estimated. For some of the matters, we are currently unable to predict the ultimate outcome, 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 we are a party or that the ultimate outcome of any of the matters threatened or pending against us, including those disclosed below, will not have a material adverse effect on our financial condition, results of operations or cash flows. See Item 1A "Risk Factors—Litigation costs and the outcome of litigation could have a material adverse effect on our business" included in this report.

Kirstin Christiansen, Shellie Smith and Paul Haug, on behalf of themselves and all others similarly situated vs. World of Jeans & Tops, Superior Court of California, County of Sacramento, Case No. 34-2013-139010. 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 have amended the complaint. The parties have completed class certification discovery and briefing, and a hearing was held on August 13, 2015. The complaint seeks certification of a class, unspecified damages, injunctive relief and attorneys' fees. We 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 22, 2013, to add a claim for penalties under the California Private Attorneys General Act. In March 2013, we filed a motion to compel arbitration, which was denied in June 2013 and later affirmed on appeal. In October 2014, we filed an answer to the amended complaint. The parties recently attended a mediation proceeding and are working on a potential resolution. If this matter does not settle, we intend to defend this case vigorously.

Karina Whitten, on behalf of herself and all others similarly situated, v. Tilly's Inc., Superior Court of California, County of Los Angeles, Case No. BC 548252. On June 10, 2014, plaintiff filed a putative class action and representative Private Attorney General Act 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. The complaint seeks class certification, penalties, restitution, injunctive relief and attorneys' fees and costs. Plaintiff filed a first amended complaint on December 3, 2014, removing the expense reimbursement claim. We answered the complaint on January 8, 2015. We intend to defend this case vigorously.

Herbert Ortiz and Audra Haynes, individually, and on behalf of the generally public, v. Tilly's Inc., United States District Court for the Eastern District of California, Case No. 1:15-CV-108-MJS. On November 6, 2014, plaintiff filed a putative class action and representative Private Attorney General Act lawsuit against the Company in the Superior Court of California, County of Fresno, alleging violations of California's wage and hour, meal break and rest break rules and regulations, and unfair competition law, among other things. The complaint seeks class certification, penalties, restitution, injunctive relief and attorneys' fees and costs. On January 21, 2015, we answered the complaint and removed the action to the United States District Court for the Eastern District of California. In June 2015, the parties settled the action and the case was dismissed on July 10, 2015.

On June 10, 2015, we and one of our vendors entered into a settlement arrangement with a plaintiff who filed a copyright infringement lawsuit against us and the vendor related to certain vendor products we sell.

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Item 1A. Risk Factors

Our business faces significant risks and uncertainties. Certain important factors may have a material adverse effect on our business, prospects, financial condition and results of operations, any of which could subsequently have an adverse effect on the trading price of our Class A common stock, and you should carefully consider them. Accordingly, in evaluating our business, we encourage you to consider the following discussion of risk factors, in its entirety, in addition to other information contained in this Quarterly Report or our Annual Report on Form 10-K for the fiscal year ended January 31, 2015 and our other public filings with the SEC. Additional risks not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and results of operations in future periods.

Risks Related to Our Business

Our business depends upon identifying and responding to changing customer fashion preferences and fashion-related trends. If we cannot identify trends in advance or we select the wrong fashion trends, our sales could be adversely affected.

Fashion trends in the West Coast and action sports inspired apparel, footwear and accessories market can change rapidly. We need to anticipate, identify and respond quickly to changing trends and consumer demands in order to provide the merchandise our customers seek and maintain our brand image. If we cannot identify changing trends in advance, fail to react to changing trends or misjudge the market for a trend, our sales could be adversely affected and we may be faced with a substantial amount of unsold inventory or missed opportunities. As a result, we may be forced to mark down our merchandise in order to dispose of slow moving inventory, which may result in lower profit margins, negatively impacting our financial condition and results of operations.

We face intense competition in our industry and we may not be able to compete effectively.

The retail industry is highly competitive. We currently compete with other retailers such as, but not limited to, Abercrombie & Fitch Co., Aeropostale, Inc., American Eagle Outfitters, Inc., The Buckle, Inc., Forever 21, Inc., Hot Topic, Inc., Pacific Sunwear of California, Inc., Urban Outfitters, Inc. and Zumiez, Inc. In addition, we compete with independent specialty shops, department stores and direct marketers that sell similar lines of merchandise and target customers through catalogs and e-commerce. Moreover, the internet and other new technologies facilitate competitive entry and comparison shopping in our retail segment. While we offer a multichannel shopping experience and use social media as a way to interact with our customers and enhance their shopping experiences, multichannel retailing is rapidly evolving and we must keep pace with changing customer expectations and new developments by our competitors. Competition with some or all of these retailers noted above could require us to lower our prices or risk losing customers. In addition, significant or unusual promotional activities by our competitors may cause us to respond in-kind and adversely impact our operating cash flow. Because of these factors, current and future competition could have a material adverse effect on our financial condition and results of operations.

Furthermore, many of our competitors have greater financial, marketing and other resources than we currently do, and therefore may be able to devote greater resources to the marketing and sale of their products, generate national brand recognition or adopt more aggressive pricing policies than we can, which would put us at a competitive disadvantage. Moreover, we do not possess exclusive rights to many of the elements that comprise our in-store experience and product offerings. Our competitors may seek to emulate facets of our business strategy and in-store experience, which could result in a reduction of any competitive advantage or special appeal that we might possess. In addition, most of our products are sold to us on a non-exclusive basis. As a result, our current and future competitors may be able to duplicate or improve on some or all of our in-store experience or product offerings that we believe are important in differentiating our stores and our customers’ shopping experience. If our competitors were to duplicate or improve on some or all of our in-store experience or product offerings, our competitive position and our business could suffer.

Our sales could be severely impacted by declines in consumer confidence and decreases in consumer spending.

We depend upon consumers feeling confident to spend discretionary income on our product offering to drive our sales. Consumer spending may be adversely impacted by economic conditions such as consumer confidence in future economic conditions, interest and tax rates, employment levels, salary and wage levels, general business conditions, the availability of consumer credit and the level of housing, energy and food costs. These risks may be exacerbated for retailers like us who focus on specialty apparel and accessories. Our financial performance is particularly susceptible

to economic and other conditions in regions or states where we have a significant number of stores, such as the southwestern and northeastern United States and Florida. If periods of decreased consumer spending persist, our sales could decrease and our financial condition and results of operations could be adversely affected.
Our continued growth depends upon our ability to successfully open a significant number of new stores.
We have grown our store count rapidly in recent years and that has contributed to our growth in revenue. However, we must continue to open and operate new stores to help maintain this revenue growth. However, there can be no assurance that we will open the planned number of new stores in the second half of fiscal year 2015 or thereafter. Our ability to successfully open and operate new stores is subject to a variety of risks and uncertainties, such as:

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- identifying suitable store locations, the availability of which is beyond our control;
- obtaining acceptable lease terms;
- sourcing sufficient levels of inventory;
- selecting the appropriate merchandise that appeals to our customers;
- hiring and retaining store employees;
- assimilating new store employees into our corporate culture;
- effectively marketing the new stores' locations;
- avoiding construction delays and cost overruns in connection with the build-out of new stores;
- managing and expanding our infrastructure to accommodate growth; and
- integrating the new stores with our existing buying, distribution and other support operations.

Our failure to successfully address these challenges could have a material adverse effect on our financial condition and results of operations.

Expanding into new geographic markets may present challenges that are different from those we currently encounter. Failure to effectively adapt to these new challenges could adversely affect our ability to profitably operate those stores and maintain our brand image.

We operate stores in a variety of different geographic markets in the United States and do not significantly differentiate between our stores by visual display or by the product offering. We also currently do not significantly differentiate our general store business plan from store to store. As we expand store locations, we may face challenges that are different from those we currently encounter. Our expansion into new geographic markets could result in competitive, merchandising, distribution and other challenges. In addition, as the number of our stores increases, we may face risks associated with market saturation of our product offerings and locations. Our vendors may also restrict their sales to us in new markets to the extent they are already saturating that market with their products through other retailers or their own stores. There can be no assurance that any newly opened stores will be received as well as, or achieve net sales or profitability levels comparable to those of, our existing stores in the time periods estimated by us, or at all. If our stores fail to achieve, or are unable to sustain, acceptable net sales and profitability levels, our business may be materially harmed and we may incur significant costs associated with closing those stores and our brand image may be negatively impacted.

Our business largely depends on a strong brand image, and if we are not able to maintain and enhance our brand, particularly in new markets where we have limited brand recognition, we may be unable to increase or maintain our level of sales.

We believe that our brand image and brand awareness has contributed significantly to the success of our business. We also believe that maintaining and enhancing our brand image, particularly in new markets where we have limited brand recognition, is important to maintaining and expanding our customer base. As we execute our growth strategy, our ability to successfully integrate new stores into their surrounding communities, to expand into new markets or to maintain the strength and distinctiveness of our brand image in our existing markets will be adversely impacted if we fail to connect with our target customer. Maintaining and enhancing our brand image may require us to make substantial investments in areas such as merchandising, marketing, store operations, community relations, store graphics, catalog distribution and employee training, which could adversely affect our cash flow and which may not ultimately be successful. Failure to successfully market our brand in new and existing markets could harm our business, results of operations and financial condition.

Our sales can significantly fluctuate based upon shopping seasons, which may cause our operating results to fluctuate disproportionately on a quarterly basis.

Because of a traditionally higher level of sales during the back-to-school and winter holiday shopping seasons, our sales are typically higher in the third and fourth fiscal quarters than they are in the first and second fiscal quarters. Accordingly, the results of a single fiscal quarter, particularly the third and fourth fiscal quarters, should not be relied on as an indication of our annual results or future performance. In addition, any factors that harm our third and fourth fiscal quarter operating results could have a disproportionate effect on our results of operations for the entire fiscal year.

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We depend on cash generated from our operations to support our growth, which could strain our cash flow.

We primarily rely on cash flow generated from existing stores to fund our current operations and our growth plans. It takes several months and a significant amount of cash to open a new store. If we continue to open a large number of stores relatively close in time, the cost of these store openings and the cost of continuing operations could reduce our cash position. An increase in our net cash outflow for new stores could adversely affect our operations by reducing the amount of cash available to address other aspects of our business.

In addition, as we expand our business, we will need significant amounts of cash from operations to pay our existing and future lease obligations, build out new store space, purchase inventory, pay personnel, pay for the increased costs associated with operating as a public company, and, if necessary, further invest in our infrastructure and facilities. If our business does not generate sufficient cash flow from operations to fund these activities and sufficient funds are not otherwise available from our existing revolving credit facility or future credit facilities, we may need additional equity or debt financing. If such financing is not available to us on satisfactory terms, our ability to operate and expand our business or to respond to competitive pressures would be limited and we could be required to delay, curtail or eliminate planned store openings. Moreover, if we raise additional capital by issuing equity securities or securities convertible into equity securities, your ownership may be diluted. Any debt financing we may incur may impose on us covenants that restrict our operations, and will require interest payments that would create additional cash demands and financial risk for us.

Our ability to attract customers to our stores depends significantly on the success of the retail centers where the stores are located.

We depend on the location of our stores to generate a large amount of our customer traffic. We try to select well-known and popular malls, power centers, neighborhood and lifestyle centers, outlet centers and street-front locations, usually near prominent retailers, to generate customer traffic for our stores. Customer traffic at these retail centers, and consequently our stores, could be adversely affected by economic downturns nationally or regionally, competition from Internet retailers, changes in consumer demographics, the closing or decrease in popularity of other retailers in the retail centers in which our stores are located, our inability to obtain or maintain prominent store locations within retail centers or the selection by prominent retailers and businesses of other locations. A reduction in customer traffic would likely lead to a decrease in our sales, and, if similar reductions in traffic occur at a number of our stores, this could have a material adverse effect on our financial condition and results of operations.

Some of our new stores may open in locations close enough to our existing stores that sales at those existing stores may be negatively impacted.

As we continue to open additional locations within existing markets, some of our new stores may open in locations close enough to our existing stores that a segment of customers will stop shopping at our existing locations and prefer to shop at the new locations, and therefore sales and profitability at those existing stores may decline. If this were to occur with a number of our stores, this could have a material adverse effect on our results of operations.

We purchase merchandise in advance of the season in which it will be sold and if we purchase too much inventory we may need to reduce prices in order to sell it, which may adversely affect our overall profitability.

We must actively manage our purchase of inventory. Generally, we order merchandise months in advance of it being received and offered for sale. If there is a significant decrease in demand for our products or if we fail to accurately predict fashion trends or consumer demands, we may be forced to rely on markdowns or promotional sales to dispose of excess inventory. In addition, seasonal fluctuations also affect our inventory levels, as we usually order and carry a significant amount of inventory before the back-to-school and winter holiday shopping seasons. If we are not successful in selling our inventory during these periods, we may be forced to rely on markdowns or promotional sales to dispose of the inventory, or we may not be able to sell the inventory at all, which could have an adverse effect on our margins and operating income.

We buy and stock merchandise based upon seasonal weather patterns and therefore unseasonable weather could negatively impact our sales.

We buy select merchandise for sale based upon expected weather patterns during the seasons of winter, spring, summer and fall. If we encounter untimely aberrations in weather conditions, such as warmer winters or cooler summers than would be considered typical, these weather variations could cause some of our merchandise to be inconsistent with what consumers wish to purchase, causing our sales to decline. Furthermore, extended unseasonable weather conditions in regions such as in the southwestern United States, particularly in California, Arizona and Nevada, Florida and northeastern United States will likely have a greater impact on our sales because of our store concentration in those regions.

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If we fail to maintain good relationships with our suppliers or if our suppliers are unable or unwilling to provide us with sufficient quantities of merchandise at acceptable prices, our business and operations may be adversely affected.

Our business is largely dependent on continued good relations with our suppliers, including vendors for our third-party branded products and manufacturers for our proprietary branded products. We operate on a purchase order basis for our proprietary branded and third-party branded merchandise and do not have long-term contractual relationships with our suppliers. Accordingly, our suppliers can refuse to sell us merchandise, limit the type or quantity of merchandise they sell us or raise prices at any time, which can have an adverse impact on our business. Deterioration in our relationships with our suppliers could have a material adverse impact on our business, and there can be no assurance that we will be able to acquire desired merchandise in sufficient quantities on terms acceptable to us in the future. Also, some of our vendors are vertically integrated, selling products directly from their own retail stores, and therefore are in direct competition with us. These vendors may decide at some point in the future to discontinue supplying their merchandise to us, supply us less desirable merchandise or raise prices on the products they do sell us. If we lose key vendors or are unable to find alternative vendors to supply us with substitute merchandise for lost products, our business may be adversely affected.

A rise in the cost of raw materials, labor and transportation could increase our cost of sales and cause our results of operations and margins to decline.

Fluctuations in the price, availability and quality of fabrics or other raw materials used to manufacture our products, as well as the price for labor and transportation, could have adverse impacts on our cost of sales and our ability to meet our customers' demands. In particular, because a key component of our clothing is cotton, increases in the cost of cotton may significantly affect the cost of our products and could have an adverse impact on our cost of sales. We may not be able to pass all or a portion of these higher costs on to our customers, which could have a material adverse effect on our profitability.

Any inability to balance merchandise bearing our proprietary brands with the third-party branded merchandise we sell may have an adverse effect on our sales and gross margin.

Our proprietary branded merchandise represented a significant portion of our net sales during the first half of fiscal 2015. Our proprietary branded merchandise generally has a higher gross margin than the third-party branded merchandise we offer. As a result, we may determine that it is best for us to continue to hold or increase the penetration of our proprietary brands in the future. However, carrying our proprietary brands limits the amount of third-party branded merchandise we can carry and, therefore, there is a risk that the customers' perception that we offer many major brands will decline. By maintaining or increasing the amount of our proprietary branded merchandise, we are also exposed to greater fashion risk, as we may fail to anticipate fashion trends correctly. These risks, if they occur, could have a material adverse effect on sales and profitability.

Most of our merchandise is produced in foreign countries, making the price and availability of our merchandise susceptible to international trade and other international conditions.

Although we purchase our merchandise from domestic suppliers, these suppliers have a majority of their merchandise made in foreign countries. Some foreign countries can be, and have been, affected by political and economic instability and natural disasters, negatively impacting trade. The countries in which our merchandise currently is manufactured or may be manufactured in the future could become subject to new trade restrictions imposed by the United States or other foreign governments. Trade restrictions, including increased tariffs or quotas, embargoes and customs restrictions, against apparel items, as well as United States or foreign labor strikes, work stoppages or boycotts, could increase the cost or reduce the supply of apparel available to us and have a material adverse effect on our business, financial condition and results of operations. In addition, our merchandise supply could be impacted if our suppliers' imports become subject to existing or future duties and quotas, or if our suppliers face increased competition from other companies for production facilities, import quota capacity and shipping capacity. Any increase in the cost of our merchandise or limitation on the amount of merchandise we are able to purchase could have a material adverse effect on our financial condition and results of operations.

If our vendors and manufacturing sources fail to use acceptable labor or other practices our reputation may be harmed, which could negatively impact our business.

We purchase merchandise from independent third-party vendors and manufacturers. If any of these suppliers have practices that are not legal or accepted in the United States, consumers may develop a negative view of us, our brand image could be damaged and we could become the subject of boycotts by our customers and/or interest groups. Further, if the suppliers violate labor or other laws of their own country, these violations could cause disruptions or delays in their shipments of merchandise. For example, much of our merchandise is manufactured in China and Mexico, which have different labor practices than the United States. We do not independently investigate whether our suppliers are operating in compliance with all applicable laws and therefore we rely upon the suppliers' representations set forth in our purchase orders and vendor agreements concerning the suppliers' compliance with such laws. If our goods are manufactured using illegal or unacceptable labor practices in these countries, or other countries from which our suppliers source the product we purchase, our ability to supply merchandise for our stores without interruption, our brand image and, consequently, our sales may be adversely affected.

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If we lose key management personnel our operations could be negatively impacted.

Our business and growth depends upon the leadership and experience of our key executive management team, including our co-founder, Hezy Shaked, who currently serves as our Chief Strategy Officer and Executive Chairman of our board of directors, and Daniel Griesemer, our President and Chief Executive Officer, and we may be unable to retain their services. We also may be unable to retain other existing management personnel that are critical to our success, which could result in harm to our vendor and employee relationships, loss of key information, expertise or know-how and unanticipated recruitment and training costs. The loss of services of any of our key personnel could have a material adverse effect on our business and prospects, and could be viewed in a negative light by investors and analysts, which could cause our Class A common stock price to decline. None of our employees, except for Mr. Griesemer, has an employment agreement and we do not intend to purchase key person life insurance covering any employee. If we lose the services of any of our key personnel or we are not able to attract additional qualified personnel, we may not be able to successfully manage our business.

If we cannot retain or find qualified employees to meet our staffing needs in our stores, our distribution and e-commerce fulfillment centers, or our corporate offices, our business could be adversely affected.

Our success depends upon the quality of the employees we hire. We seek employees who are motivated, represent our corporate culture and brand image and, for many positions, have knowledge of our merchandise and the skill necessary to excel in a customer service environment. The turnover rate in the retail industry is high and finding qualified candidates to fill positions may be difficult. If we cannot attract and retain corporate employees, district managers, store managers and store associates with the qualifications we deem necessary, our ability to effectively operate and expand may be adversely affected. In addition, we rely on temporary personnel to staff our distribution and fulfillment centers, as well as seasonal part-time employees to provide incremental staffing to our stores in busy selling seasons such as the back-to-school and winter holiday seasons. We cannot guarantee that we will be able to find adequate temporary or seasonal personnel to staff our operations when needed, which may strain our existing personnel and negatively impact our operations.

Our corporate headquarters, distribution and e-commerce fulfillment centers and management information systems are in two locations in southern California, and if their operations are disrupted, we may not be able to operate our store support functions or ship merchandise to our stores, which would adversely affect our business.

Our corporate headquarters, distribution center and management information systems are in two locations in Irvine, California. If we encounter any disruptions to our operations within these buildings or if they were to shut down for any reason, including by fire or other natural disaster, then we may be prevented from effectively operating our stores, shipping and processing our merchandise and operating our e-commerce platform. Furthermore, the risk of disruption or shut down at these buildings are greater than it might be if they were located in another region, as southern California is prone to natural disasters such as earthquakes and wildfires. Any disruption or shut down at these locations could significantly impact our operations and have a material adverse effect on our financial condition and results of operations.

Our stores are mostly located in the southwestern and northeastern United States and in Florida, with a significant number of stores located in California, putting us at risk to region-specific disruptions.

Sales in these states could be more susceptible than the country generally to disruptions, such as from economic and weather conditions, demographic and population changes and changes in fashion tastes, and consequently, we may be more susceptible to these factors than more geographically diversified competitors. For example, because of the negative economic impact caused by the downturn in the housing market that began several years ago, sales in these states may have slowed more than sales would have in other regions or the country as a whole. Compared to the country as a whole, stores in California are exposed to a relatively high risk of damage from a major earthquake or wildfires, while stores in Florida are exposed to a relatively high risk from hurricane damage. Any negative impact upon or disruption to the operations of stores in these states could have a material adverse effect on our financial condition and results of operations.

We are required to make significant lease payments for our store leases, corporate offices, warehouses and distribution and e-commerce fulfillment centers, which may strain our cash flow.

We lease all of our retail store locations as well as our corporate headquarters, warehouses, distribution and e-commerce fulfillment centers. We do not own any real estate. Leases for our stores are typically for terms of ten years and many can be extended in five-year increments. Many of our leases have early cancelation clauses which permit us to terminate the lease if certain sales thresholds are not met in certain periods of time. Our costs under these leases are a significant amount of our expenses and are growing rapidly as we expand the number of locations and existing locations experience expense increases. We are required to pay additional rent under many of our lease agreements based upon achieving certain sales plateaus for each store location. In addition, we must make significant payments for common area maintenance and real estate taxes. Many of our lease agreements also contain provisions which increase the rent payments on a set time schedule, causing the cash rent paid for a location to escalate over the term of the lease. In addition, rent costs could escalate when multi-year leases are renewed at the expiration of their lease term. These costs are significant, recurring and increasing, which places a consistent strain on our cash flow.

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We depend on cash flows from operations to pay our lease expenses and to fulfill our other cash needs. If our business does not generate sufficient cash flows from operating activities, and sufficient funds are not otherwise available to us from borrowings under our available revolving credit facility or from other sources, we may not be able to service our operating lease expenses, grow our business, respond to competitive challenges or to fund our other liquidity and capital needs, which would harm our business.

Additional sites that we lease are likely to be subject to similar long-term leases. If an existing or future store is not profitable, and we decide to close it, we may nonetheless be committed to perform our obligations under the applicable lease including, among other things, paying the base rent for the balance of the lease term. In addition, as our leases expire, we may fail to negotiate renewals, either on commercially acceptable terms or at all, which could cause us to close stores in desirable locations. If we are unable to enter into new leases or renew existing leases on terms acceptable to us or be released from our obligations under leases for stores that we close, our business, profitability and results of operations may be harmed.

We rely on third parties to deliver merchandise to our stores located outside of southern California and therefore our business could be negatively impacted by disruptions in the operations of these third-party providers.

We rely on third parties to ship our merchandise from our distribution center in Irvine, California to our stores located across the United States, as well as to ship e-commerce sales packages directly to our customers. Relying on these third-party delivery services puts us at risk from disruptions in their operations, such as employee strikes, inclement weather and their ability to meet our shipping demands. If we are forced to use other delivery services, our costs could increase and we may not be able to meet shipment deadlines. Moreover, we may not be able to obtain delivery terms as favorable as those received from the transportation providers we currently use, which would further increase our costs. These circumstances may negatively impact our financial condition and results of operations.

We use print and online marketing services.

We use the U.S. Postal Service to mail printed marketing materials several times each year to inform our customers about our products, acquire new customers, drive customers into our stores, and promote our website and stores. As a result, postal rate increases and paper and printing costs affect the cost of our mailings. We also use third-party online services to market our website and stores and to distribute promotions to attract new customers and encourage existing customers to purchase from us. Any significant or unanticipated increase in postage, reduction in postal service, or slow-down in postal delivery, increases in paper and printing costs, increases in the cost of our online marketing services or any service interruption or failure on the part of such service providers could impair our ability to deliver printed marketing materials or our online marketing in a timely or economically efficient manner. This could also adversely impact our sales and earnings if we are unable to pass such increases on to our customers or are unable to implement more efficient printing, mailing, delivery and order fulfillment systems or, in the case of our online marketing, to find alternative providers in a timely manner and on terms that are not significantly more costly to us.

We may continue to experience comparable store sales or sales per square foot declines, which may cause our results of operations to decline.

The investing public may use comparable store sales or net store sales per square foot projections or results, over a certain period of time, such as on a quarterly or yearly basis, as an indicator of our profitability growth. Our comparable store sales have declined in recent periods and can vary significantly from period to period for a variety of reasons, such as the age of stores, changing economic factors, unseasonable weather, changing fashion trends, pricing, the timing of the release of new merchandise and promotional events and increased competition. These factors could cause comparable store sales or net store sales per square foot to decline period to period or fail to grow at expected rates, which could adversely affect our results of operations during such periods.

If our management information systems fail to operate or are unable to support our growth, our operations could be disrupted.

We rely upon our management information systems in almost every aspect of our daily business operations. For example, our management information systems serve an integral part in enabling us to order merchandise, process merchandise at our distribution center and retail stores, perform and track sales transactions, manage personnel, pay vendors and employees, operate our e-commerce platform and report financial and accounting information to management. In addition, we rely on our management information systems to enable us to leverage our costs as we grow. If our management information systems fail to operate or are unable to support our growth, our store operations and e-commerce platform could be severely disrupted, and we could be required to make significant additional expenditures to remediate any such failure.

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Our internal operations, management information systems and databases containing the personal information of our customers could be disrupted by system security failures or breached by intentional attacks. These disruptions or attacks could negatively impact our sales, increase our expenses, and harm our reputation.

Database privacy, network security and identify theft are matters of growing public concern. Hackers, computer programmers and internal users may be able to penetrate our network security and create system disruptions, cause shutdowns and misappropriate our confidential information or that of third parties, including our customers. Therefore, we could incur significant expenses addressing problems created by security breaches to our network. This risk is heightened because we collect and store customer information for marketing purposes, as well as credit card information. We must, and do, take precautions to secure customer information and prevent unauthorized access to our database of confidential information. However, if unauthorized parties, including external hackers or computer programmers, gain access to our database, they may be able to steal this confidential information. Our failure to secure this information could result in costly litigation, adverse publicity or regulatory action that could have a material adverse effect on our financial condition and results of operations. In addition, sophisticated hardware and operating system software and applications that we procure from third parties may contain defects in design or manufacture that could unexpectedly interfere with our operations. The cost to alleviate security risks, defects in software and hardware and address any problems that occur could negatively impact our sales, distribution and other critical functions, as well as our financial results.

If we are unable to protect our intellectual property rights, our financial results may be negatively impacted.

Our success depends in large part on our brand image. Our company's name, logo, domain name and our proprietary brands and our registered and unregistered trademarks and copyrights are valuable assets that serve to differentiate us from our competitors. We currently rely on a combination of copyright, trademark, trade dress and unfair competition laws to establish and protect our intellectual property rights. We cannot assure you that the steps taken by us to protect our proprietary rights will be adequate to prevent infringement of our trademarks and proprietary rights by others, including imitation and misappropriation of our brand. We cannot assure you that obstacles will not arise as we expand our product lines and geographic scope. The unauthorized use or misappropriation of our intellectual property could damage our brand identity and the goodwill we created for our company, which could cause our sales to decline. Moreover, litigation may be necessary to protect or enforce these intellectual property rights, which could result in substantial costs and diversion of our resources, causing a material adverse effect on our business, financial condition, results of operations or cash flows. If we cannot protect our intellectual property rights, our brand identity and the goodwill we created for our company may diminish, causing our sales to decline.

Most of our intellectual property has not been registered outside of the United States and we cannot prohibit other companies from using our unregistered trademarks in foreign countries. Use of our trademarks in foreign countries could negatively impact our identity in the United States and cause our sales to decline.

We may be subject to liability if we, or our vendors, infringe upon the intellectual property rights of third parties.

We may be subject to liability if we infringe upon the intellectual property rights of third parties. If we were to be found liable for any such infringement, we could be required to pay substantial damages and could be subject to injunctions preventing further infringement. Such infringement claims could harm our brand image. In addition, any payments we are required to make and any injunction with which we are required to comply as a result of such infringement actions could adversely affect our financial results.

We purchase merchandise from vendors that may utilize design copyrights, or design patents, or that may otherwise incorporate protected intellectual property. We are not involved in the manufacture of any of the merchandise we purchase from our vendors for sale to our customers, and we do not independently investigate whether these vendors legally hold intellectual property rights to merchandise that they are manufacturing or distributing. As a result, we rely upon vendors' representations set forth in our purchase orders and vendor agreements concerning their right to sell us the products that we purchase from them. If a third-party claims to have licensing rights with respect to merchandise we purchased from a vendor, or we acquire unlicensed merchandise, we could be obligated to remove such merchandise from our stores, incur costs associated with destruction of such merchandise if the distributor or vendor is unwilling or unable to reimburse us and be subject to liability under various civil and criminal causes of action, including actions to recover unpaid royalties and other damages and injunctions. Although our purchase orders and vendor agreement with each vendor require the vendor to indemnify us against such claims, a vendor may not have the financial resources to defend itself or us against such claims, in which case we may have to pay the costs and expenses associated with defending such claim. Any of these results could harm our brand image and have a material adverse effect on our business and growth.

Our founders control a majority of the voting power of our common stock, which may prevent other stockholders from influencing corporate decisions and may result in conflicts of interest.

Our common stock consists of two classes: Class A and Class B. Holders of Class A common stock are entitled to one vote per share, and holders of Class B common stock are entitled to 10 votes per share, on all matters to be voted on by our common stockholders. All of the shares of Class B common stock are beneficially owned by Hezy Shaked, Tilly Levine and their children through related trusts, which we refer to as the Shaked and Levine family entities. In addition, Mr. Shaked serves as Executive Chairman of the Board of Directors, and is the voting trustee, pursuant to a voting trust agreement, covering the shares owned by Ms. Levine. As a result, Mr. Shaked is in a position to dictate the outcome of any corporate actions requiring stockholder approval, including the election of directors and mergers, acquisitions and other significant corporate transactions. Mr. Shaked may delay or prevent a change of control from occurring, even if the change of control could appear to benefit the stockholders. Mr. Shaked may also have interests that differ from yours and may vote in a way with which you disagree and which may be adverse to your interests. This ownership concentration may adversely impact the trading of our Class A common stock because of a perceived conflict of interest that may exist, thereby depressing the value of our Class A common stock.

We have entered into tax indemnification agreements with the former shareholders of World of Jeans & Tops and could become obligated to make payments to them for any additional federal, state or local income taxes assessed against them for fiscal periods prior to the completion of our initial public offering in May 2012.

World of Jeans & Tops historically was treated as an “S” Corporation for United States federal income tax purposes. Effective upon completion of the Reorganization Transaction, World of Jeans & Tops’ “S” Corporation status terminated and it thereafter became subject to federal income taxes and increased state income taxes. In the event of an adjustment to World of Jeans & Tops’ reported taxable income for a period or periods prior to termination of its “S” Corporation status, its shareholders during those periods could be liable for additional income taxes for those prior periods. Therefore, we entered into tax indemnification agreements with the former shareholders of World of Jeans & Tops prior to the Reorganization Transaction. Pursuant to the tax indemnification agreements, we agreed to indemnify, defend and hold harmless each such shareholder on an after-tax basis against additional income taxes, plus interest and penalties resulting from adjustments made, as a result of a final determination made by a competent tax authority, to the taxable income World of Jeans & Tops reported as an “S” Corporation. Such indemnification also includes any losses, costs or expenses, including reasonable attorneys’ fees, arising out of a claim for such tax liability.

War, terrorism, civil unrest or other violence could negatively affect our business.

All of our stores are located in public areas where large numbers of people typically gather. Terrorist attacks, threats of terrorist attacks or civil unrest involving public areas could cause people not to visit areas where our stores are located. Further, armed conflicts or acts of war throughout the world may create uncertainty, causing consumers to spend less on discretionary purchases, including on apparel and accessories, and disrupting our ability to obtain merchandise for our stores. Such decreases in consumer spending or disruptions in our ability to obtain merchandise would likely decrease our sales and materially adversely affect our financial condition and results of operations. Other types of violence, such as shootings in malls or in public areas, could lead to lower customer traffic in shopping malls or centers in which we operate stores. In addition, local authorities or management from the mall or shopping center could close the mall or shopping center in response to security concerns. Such closures, as well as lower customer traffic due to security concerns, could result in decreased sales.

Litigation costs and the outcome of litigation could have a material adverse effect on our business.

From time to time we may be subject to litigation claims through the ordinary course of our business operations regarding, but not limited to, employment matters, compliance with the Americans with Disabilities Act of 1990, apparel, footwear and accessory safety standards, security of customer and employee personal information, contractual relations with vendors, marketing and infringement of trademarks and other intellectual property rights. Litigation to defend ourselves against claims by third parties, or to enforce any rights that we may have against third parties, may be necessary, which could result in substantial costs and diversion of our resources, causing a material adverse effect on our business, financial condition, results of operations or cash flows.

Management does not believe the nature of any pending legal proceeding will have a material adverse effect on our financial condition and results of operations. However, management’s assessment may change at any time based upon

the discovery of facts or circumstances that are presently not known to us. Therefore, there can be no assurance that any pending or future litigation will not have a material adverse effect on our financial condition and results of operations.
We may be subject to unionization, work stoppages, slowdowns or increased labor costs.
Currently, none of our employees are represented by a union. However, our employees have the right under the National Labor Relations Act to form or affiliate with a union. If some or all of our workforce were to become unionized and the terms of the collective bargaining agreement were significantly different from our current compensation arrangements, it could increase our

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costs and adversely impact our profitability. Moreover, participation in labor unions could put us at increased risk of labor strikes and disruption of our operations.

Violations of and/or changes in laws, including employment laws and laws related to our merchandise, could make conducting our business more expensive or change the way we do business.

We are subject to numerous regulations, including labor and employment, customs, truth-in-advertising, consumer protection and zoning and occupancy laws and ordinances that regulate retailers generally and/or govern the importation, promotion and sale of merchandise and the operation of stores and warehouse facilities. If these regulations were violated by our management, employees or vendors, the costs of certain goods could increase, or we could experience delays in shipments of our goods, be subject to fines or penalties or suffer reputational harm, which could reduce demand for our merchandise and hurt our business and results of operations.

Similarly, changes in laws could make operating our business more expensive or require us to change the way we do business. For example, changes in laws related to employee healthcare, hours, wages, job classification and benefits could significantly increase operating costs. In March 2010, the Patient Protection and Affordable Care Act, as amended by the Health Care Education Reconciliation Act of 2010, or, collectively, the Act, was signed into law. The Act includes a number of health care provisions taking effect over several years, including expanded dependent coverage, incentives for business to provide health care benefits, a prohibition on denial of coverage and denial of claims on pre-existing conditions, a prohibition on limiting essential benefits, and other expansion of health care benefits and coverage. Some of the associated taxes and fees, as well as certain health care changes required by these acts, are expected to result in increased health care costs for us. The costs of such legislation may adversely impact our results of operations.

In addition, changes in product safety or other consumer protection laws could lead to increased costs for certain merchandise, or additional labor costs associated with readying merchandise for sale. It may be difficult for us to foresee regulatory changes impacting our business and our actions needed to respond to changes in the law could be costly and may negatively impact our operations.

As a result of being a publicly traded company, our management is required to devote substantial time to complying with public company regulations.

As a result of being a publicly traded company, we are obligated to file periodic reports with the SEC under the Exchange Act. We are also subject to other reporting and corporate governance requirements, including certain requirements of the New York Stock Exchange, or NYSE, and certain provisions of the Sarbanes-Oxley Act of 2002, or SOX, and the regulations promulgated thereunder, which impose significant compliance obligations on us.

SOX, as well as rules subsequently implemented by the SEC and NYSE, have imposed increased regulation and disclosure and have required enhanced corporate governance practices of public companies. Our efforts to comply with evolving laws, regulations and standards result in increased administrative expenses and a diversion of management’s time and attention from revenue-generating activities. In addition, if we fail to implement or maintain the requirements with respect to our internal accounting and audit functions, our ability to continue to report our operating results on a timely and accurate basis could be impaired and we could be subject to sanctions or investigation by regulatory authorities, such as the SEC or NYSE. Any such action could harm our reputation and the confidence of investors and customers in our company and could materially adversely affect our business.

Our failure to maintain adequate internal controls over our financial and management systems may cause errors in our financial reporting, which could in turn cause a loss of investor confidence.

Our public company reporting obligations and our anticipated growth will likely strain our financial and management systems, internal controls and our employees. In addition, pursuant to Section 404 of SOX, and the Jumpstart Our Business Startups Act, or JOBS Act of 2012, or the JOBS Act, we are required to provide annually an assessment of the effectiveness of our internal controls over financial reporting and, starting with the year after we are no longer an “emerging growth company” as defined in the JOBS Act, our independent registered public accounting firm will be required to provide an attestation on our assessment of our internal controls over financial reporting.

The process required to comply with Section 404 of SOX is time consuming and costly. If during this process we identify one or more material weaknesses in our internal controls, it is possible that our management may not be able to certify that our internal controls are effective by the certification deadline.

Moreover, if we identify any material weaknesses or significant deficiencies in our internal controls we will have to implement appropriate changes to these controls, which may require specific compliance training for our directors, officers and employees, require the hiring of additional finance, accounting, legal and other personnel, entail substantial costs to modify our existing accounting systems and take a significant period of time to complete. Such changes may not, however, be effective in maintaining the adequacy of our internal controls, and any failure to maintain that adequacy, or consequent inability to produce accurate financial statements on a timely basis, could increase our operating costs and could materially impair our ability to operate our business. Effective internal controls are necessary for us to produce reliable financial reports and are important to prevent fraud. As a result, our failure to satisfy the requirements of Section 404 on a timely basis could result in us being subject to regulatory action and a loss of investor confidence in the reliability of our financial statements, both of which in turn could cause the market value of our Class A common stock to decline.

Prior to our initial public offering, we were treated as an "S" Corporation under Subchapter S of the Internal Revenue Code, and claims of taxing authorities related to its prior status as an "S" Corporation could harm us.

Concurrent with and as a result of the Reorganization Transaction, our "S" Corporation status terminated. Since that time, we have been treated as a "C" Corporation for federal and applicable state income tax purposes and are subject to increased federal and state income taxes. In addition, if the unaudited, open tax years in which we were an "S" Corporation are audited by the Internal Revenue Service, and we are determined not to have qualified for, or to have violated, our "S" Corporation status, we will be obligated to pay back taxes, interest and penalties, and we will not have the right to reclaim tax distributions it made to its shareholders during those periods. These amounts could include taxes on all of our taxable income while we were an "S" Corporation. Any such claims could result in additional costs to us and could have a material adverse effect on our results of operations and financial condition.

The terms of our credit facility impose operating and financial restrictions on us that may impair our ability to respond to changing business and economic conditions.

We maintain a credit facility with Wells Fargo Bank, National Association. The credit facility contains customary affirmative and negative covenants, including limitations on indebtedness; limitations on consolidations, mergers and sales of assets; and limitations on transactions with affiliates. The credit facility also contains financial covenants setting forth requirements for certain levels of liquidity and profitability. These limitations and covenants may restrict our ability to respond to changing business and economic conditions, and may therefore have a material adverse effect on our business. Although we do not currently have any outstanding borrowings under credit facility, we may in the future. If we are unable to meet these limitations and covenants, we may be in default under the credit facility, which could also have a material adverse effect on our business.

We may engage in strategic transactions that could negatively impact our liquidity, increase our expenses and present significant distractions to our management.

We may consider strategic transactions and business arrangements, including, but not limited to, acquisitions, asset purchases, partnerships, joint ventures, restructurings, divestitures and investments. Any such transaction may require us to incur non-recurring or other charges, may increase our near and long-term expenditures and may pose significant integration challenges or disrupt our management or business, which could harm our operations and financial results.

Our e-commerce platform subjects us to numerous risks that could have an adverse effect on our results of operations.

We sell merchandise over the internet through our e-commerce website, www.tillys.com. Our e-commerce platform and its continued growth subject us to certain risks that could have an adverse effect on our results of operations, including:

- diversion of traffic from our stores;
- liability for online content;
- government regulation of the Internet; and
- risks related to the computer systems that operate our website and related support systems, including computer viruses, electronic break-ins and similar disruptions.

Our failure to address and respond to these risks successfully could reduce e-commerce sales, increase costs and damage the reputation of our brand.

Changes to accounting rules or regulations could significantly affect our financial results.

Our consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States of America, or GAAP. New accounting rules or regulations and changes to existing accounting rules or regulations have occurred and may occur in the future. Future changes to accounting rules or regulations, such as changes to lease accounting guidance or a requirement to convert to international financial reporting standards, could negatively affect our results of operations and financial condition through increased cost of compliance. For example, the Financial Accounting Standards Board, or FASB, recently issued a proposed update on lease accounting that would require entities to recognize assets and liabilities arising from lease contracts on our balance sheet. We cannot presently determine the potential impact the proposed standard will have on our results of operations. While we believe that the proposed standard, as currently drafted, likely will have a material impact on our timing and recognition of rent expense, we do not believe the standard will have a material

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impact on our liquidity. The actual impact of the proposed standard, including the cost of complying with such standard, will not be known until it is finalized.

We may incur substantial expenses related to our issuance of share-based compensation, which may have a negative impact on our operating results for future periods.

We follow the provisions of FASB Accounting Standards Codification, or ASC, 718, Compensation-Stock Compensation, for share-based compensation. Our share-based compensation expenses may be significant in future periods, which could have an adverse impact on our operating and net income. FASB ASC 718 requires the use of subjective assumptions, including the options' expected lives and the price volatility of our Class A common stock. Changes in the subjective input assumptions can materially affect the amount of our share-based compensation expense. In addition, an increase in the competitiveness of the market for qualified employees could result in an increased use of share-based compensation awards, which in turn would result in increased share-based compensation expense in future periods.

Risks Related to Ownership of Our Class A Common Stock

We are a controlled company within the meaning of the NYSE rules, and, as a result, we may rely on exemptions from certain corporate governance requirements that provide protection to stockholders of other companies.

Mr. Shaked controls more than 50% of the total voting power of our common stock and we are considered a controlled company under the NYSE corporate governance listing standards. As a controlled company, certain exemptions under the NYSE listing standards will exempt us from the obligation to comply with certain NYSE corporate governance requirements, including the requirements:

- that a majority of our board of directors consist of independent directors, as defined under the rules of the NYSE;
- that we have a corporate governance and nominating committee that is composed entirely of independent directors with a written charter addressing the committee's purpose and responsibilities; and
- that we have a compensation committee that is composed entirely of independent directors with a written charter addressing the committee's purpose and responsibilities.

Although we intend to continue to comply with these listing requirements even though we are a controlled company, there is no guarantee that we will not take advantage of these exemptions in the future. Accordingly, so long as we are a controlled company, holders of our Class A common stock may not have the same protections afforded to stockholders of companies that are subject to all of the NYSE corporate governance requirements.

If securities or industry analysts publish inaccurate or unfavorable research about our business, the price and trading volume of our Class A common stock could decline.

The trading market for our Class A common stock depends in part on the research and reports that securities or industry analysts publish about us or our business. If one or more of the analysts who covers us downgrades our Class A common stock or publishes inaccurate or unfavorable research about our business, the price of our Class A common stock would likely decline. If one or more of these analysts ceases coverage of us or fails to publish reports on us regularly, demand for our Class A common stock could decrease, which could cause the price of our Class A common stock and trading volume to decline.

Financial forecasting by us and financial analysts who may publish estimates of our performance may differ materially from actual results.

Given the dynamic nature of our business, the current uncertain economic climate and the inherent limitations in predicting the future, forecasts of our revenues, comparable sales, margins, net income and other financial and operating forecasts may differ materially from actual results. Such discrepancies could cause a decline in the trading price of our Class A common stock.

We have a small public float and this may result in price swings in our Class A common stock or make it difficult to acquire or dispose of our Class A common stock.

A small public float can result in large swings in our stock price with relatively low trading volume. In addition, a purchaser that seeks to acquire a significant number of shares may be unable to do so without increasing our common stock price, and conversely, a seller that seeks to dispose of a significant number of shares may experience a decreasing stock price.

The price of our Class A common stock has been, and may continue to be volatile and may decline in value.
The market for retail apparel stocks can be highly volatile. As a result, the market price of our Class A common stock is likely to be volatile and investors may experience a decrease in the value of the Class A common stock, unrelated to our operations. The price of our Class A common stock has, and could in the future, fluctuate significantly in response to a number of factors, as discussed in this "Risk Factors" section.

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Further, securities class action litigation has often been initiated against companies following periods of volatility in their stock price. This type of litigation could result in substantial costs and divert our management's attention and resources, and could also require us to make substantial payments to satisfy judgments or to settle litigation. The threat or filing of class action litigation lawsuits could cause the price of our Class A common stock to decline.

Future sales of our common stock by us or by existing stockholders could cause the price of our Class A common stock to decline.

Any sales of a substantial number of shares of our common stock in the public market, or the perception that such sales might occur, may cause the market price for our Class A common stock to decline. All of the shares, other than the shares of Class B common stock held by the Shaked and Levine family entities, are freely tradable without restriction under the Securities Act of 1933, as amended, or Securities Act. The shares held by the Shaked and Levine family entities and our directors, officers and other affiliates are restricted securities under the Securities Act, and may not be sold in the public market unless the sale is registered under the Securities Act or an exemption from registration is available.

Our corporate organizational documents and Delaware law have anti-takeover provisions that may inhibit or prohibit a takeover of us and the replacement or removal of our management.

In addition to the concentration of ownership and voting power in the Shaked and Levine family entities, the anti-takeover provisions under Delaware law, as well as the provisions contained in our corporate organizational documents, may make an acquisition of us more difficult.

For example:

- our certificate of incorporation includes a provision authorizing our board of directors to issue blank check preferred stock without stockholder approval, which, if issued, would increase the number of outstanding shares of our capital stock and could make it more difficult for a stockholder to acquire us;
- our certificate of incorporation provides that if all shares of our Class B common stock are converted into Class A common stock or otherwise cease to be outstanding, our board of directors will be divided into three classes in the manner provided by our certificate of incorporation. After the directors in each class serve for the initial terms provided in our certificate of incorporation, each class will serve for a staggered three-year term;
- our certificate of incorporation permits removal of a director only for cause by the affirmative vote of the holders of a majority of the voting power of the company once the board of directors is divided into three classes and provides that director vacancies can only be filled by an affirmative vote of a majority of directors then in office;
- our amended and restated bylaws require advance notice of stockholder proposals and director nominations; and
- Section 203 of the Delaware General Corporation Law may prevent large stockholders from completing a merger or acquisition of us.

These provisions may prevent a merger or acquisition of us which could limit the price investors would pay for our common stock in the future.

Our amended and restated bylaws designate the Court of Chancery of the State of Delaware as the sole and exclusive forum for certain types of actions and proceedings that may be initiated by our stockholders, which could limit our stockholders' ability to obtain a favorable judicial forum for disputes with us or our directors, officers or other employees.

Our amended and restated bylaws provide that, unless we consent in writing to an alternative forum, the Court of Chancery of the State of Delaware will be the sole and exclusive forum for (i) any derivative action or proceeding brought on our behalf, (ii) any action asserting a claim of breach of a fiduciary duty owed by any director, officer or other employee to us or our stockholders, (iii) any action asserting a claim arising pursuant to any provision of the Delaware General Corporation Law, or (iv) any action asserting a claim that is governed by the internal affairs doctrine. Any person purchasing or otherwise acquiring any interest in any shares of our capital stock shall be deemed to have notice of and to have consented to this provision of our amended and restated bylaws. This choice-of-forum provision may limit our stockholders' ability to bring a claim in a judicial forum that it finds favorable for disputes with us or our directors, officers or other employees, which may discourage such lawsuits. Alternatively, if a court were to find this provision of our amended and restated bylaws inapplicable or unenforceable with respect to one or more of the specified types of actions or proceedings, we may incur additional costs associated with resolving such matters in other jurisdictions, which could adversely affect our business and financial condition.

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We do not intend to pay cash dividends on our common stock, which may make our Class A common stock less desirable to investors and decrease its value.

We intend to retain all of our earnings to finance our operations and growth and do not anticipate paying any cash dividends on our common stock for the foreseeable future. In addition, our current credit facility precludes, and any future debt agreements may preclude, us from paying dividends. Therefore, capital appreciation, if any, of our Class A common stock will be the sole source of gain for our Class A common stockholders for the foreseeable future.

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Item 6. Exhibits

Exhibit No.	Description of Exhibit
10.1*	Form of Indemnification Agreement between Tilly’s and each of its directors and officers .
10.2*	Offer Letter dated May 12, 2015 from Tilly's, Inc. to Michael Henry.
10.3	Amendment No. 2 to Amended and Restated Credit Agreement, dated July 9, 2015, by and between World of Jeans & Tops and Wells Fargo Bank, National Association (incorporated by reference to Exhibit 10.1 to the Registrant’s Current Report on Form 8-K filed on July 10, 2015).
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 1, 2015, 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 (iv) Notes to Consolidated Financial Statements.

* Filed herewith

** Furnished herewith and not “filed” for purposes of Section 18 of the Securities Exchange Act of 1934, as amended.

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.

Tilly’s, Inc.

Date: September 9, 2015

/s/ Daniel Griesemer
Daniel Griesemer
President, Chief Executive Officer and Director
(Principal Executive Officer)

Date: September 9, 2015

/s/ Michael Henry
Michael Henry
Chief Financial Officer
(Principal Financial Officer)