SHOE PAVILION INC
Form 10-K405
March 29, 2002

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

[X] ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF
THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended December 29, 2001

Commission File Number 0-23669

SHOE PAVILION, INC.
(Exact name of registrant as specified in its charter)

Delaware	94-3289691
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
3200-F Regatta Boulevard, Richmond, California	94804
(Address of principal executive offices)	(Zip Code)

Telephone Number: (510) 970-9775

Securities Registered Pursuant to Section 12(b) of the Act:

Title of each class	Name of each exchange on which registered
None	None

Securities Registered Pursuant to Section 12(g) of the Act:

Common Stock
(Title of Class)

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any

amendment to this Form 10-K. [X]

At March 19, 2002 the aggregate market value of the registrant's Common Stock held by non-affiliates of the registrant was approximately $3,818,000.

At March 19, 2002 the number of shares outstanding of registrant's Common Stock was 6,800,000.

DOCUMENTS INCORPORATED BY REFERENCE

Definitive Proxy Statement for the Company's 2001 Annual Meeting of Stockholders--Part III of this Form 10-K.

Shoe Pavilion, Inc.

Index to Annual Report on Form 10-K

For the year ended December 29, 2001

		Page
	PART I	
Item 1	Business	3
Item 2	Properties	8
Item 3	Legal Proceedings	8
Item 4	Submission of Matters to a Vote of Security Holders	8
	PART II	
Item 5	Market for the Registrant's Common Equity and Related Stockholder Matters.	9
Item 6	Selected Financial Data	10
Item 7	Management's Discussion and Analysis of Financial Condition and Results of Operations	11
Item 7A	Quantitative and Qualitative Disclosure About Market Risk	20
Item 8	Financial Statements and Supplementary Data	21
Item 9	Changes in and Disagreements with Accountants on Accounting and Financial Disclosure	34
	PART III	
Item 10	Directors and Executive Officers of the Registrant	34
Item 11	Executive Compensation	34
Item 12	Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters	34
Item 13	Certain Relationships and Related Transactions	34
	PART IV	
Item 14	Exhibits, Financial Statement Schedules and Reports on Form 8-K	34

PART I

Item 1--Business

General

Shoe Pavilion, Inc. is the largest independent off-price footwear retailer on the West Coast that offers a broad selection of women's and men's designer label and name brand merchandise. The Company was among the first footwear retailers on the West Coast to expand the off-price concept into the designer and name brand footwear market. As of December 29, 2001 the Company operated 83 retail stores in California, Washington and Oregon under the trade name Shoe Pavilion. In addition, as of December 29, 2001, the Company operated the shoe department of 38 Gordmans, Inc. (formerly Richman Gordman 1/2 Price Stores, Inc.) department stores in Colorado, Illinois, Iowa, Kansas, Missouri, Nebraska, North Dakota, Oklahoma and South Dakota under a licensing agreement entered into in July 1999. On June 29, 2002, the initial term of the license agreement with Gordmans department stores will expire and the Company will no longer operate the 38 licensed shoe departments in Gordmans department stores. See "Item 7--Management's Discussion and Analysis of Financial Condition and Results of Operations--Overview."

The Company offers quality designer and name brand footwear such as Diesel, Fila, Ralph Lauren, Rockport, Steve Madden, Vans and Via Spiga, typically at 30% to 70% below regular department store prices. Such price discounts appeal to value-oriented consumers seeking quality brand name footwear not typically found at other off-price retailers or mass merchandisers. The Company is able to offer lower prices by (i) selectively purchasing from manufacturers at significant discounts, large blocks of production over-runs, over-orders, mid- and late-season deliveries and last season's stock, (ii) sourcing in-season name brand and branded design merchandise directly from factories in Italy, Brazil, China and Spain and (iii) negotiating favorable prices with manufacturers by ordering merchandise during off-peak production periods and taking delivery. During 2001, the Company purchased footwear merchandise from over 100 domestic and international vendors, independent resellers and manufacturers that frequently have excess inventory for sale.

The Company's stores utilize a self-service format that allows inventory to be stored directly under a displayed shoe, thereby eliminating the need for a stockroom and significantly increasing retail floor space. The functionality and simplicity of this format enable flexible store layouts that can be easily reconfigured to accommodate a new mix of merchandise. Moreover, this format allows customers to locate all available sizes of a particular shoe and to try them on for comfort and fit without a salesperson's assistance, thereby reducing in-store staffing needs and allowing customers to make independent, purchasing decisions.

Shoe Pavilion is a standardized concept that offers a bright, clean, low maintenance and functional shopping environment to customers interested in purchasing quality men's and women's value priced footwear. The Company's stores are strategically located in strip malls, outlet centers and downtown locations, frequently in close proximity to other off-price apparel retailers that attract similar customers. Shoe Pavilion stores average approximately 7,500 square feet, while the Gordmans licensed shoe departments average approximately 3,000 square feet. The Company opened, net of closures, 5 stores (including 2 Gordmans shoe departments) in 2001, 5 stores (including 3 Gordmans' shoe departments) in 2000 and 42 stores (including 33 Gordmans' shoe departments) in 1999. During 2002, the Company intends to open 5 to 10 new stores, primarily in California. It also expects to close 3 Shoe Pavilion stores and all 38 of the Gordmans licensed shoe departments as of June 29, 2002.

The Company was incorporated in Delaware in November 1997 and is the successor to Shoe Pavilion Corporation (formerly Shoe Inn, Inc.), which was incorporated in Washington in 1983. The Company's executive offices are located

at 3200-F Regatta Boulevard, Richmond, California 94804, and its telephone number is (510) 970-9775.

Operating Strategy

The Company's objective is to be the leading off-price retailer of designer label and name brand footwear in each of the markets it serves. The operating strategy is designed to allow the Company to offer its customers quality footwear typically at 30% to 70% below department store prices for the same shoes. The following summarizes key elements of the Company's operating strategy:

- Off-Price Concept, Premium Name Brands. The Company differentiates itself from other off-price retailers and deep discount chains by focusing on higher price point merchandise, extending the off-price concept into the designer and name brand footwear market. As a result, the Company generally does not compete with other discount stores in obtaining the majority of its merchandise. Similarly, while some department store and brand name retail chains operate discount outlets, such operations generally obtain merchandise from the existing inventory of their retail affiliates rather than from external sources. Some of the Company's most successful stores have benefited from the heightened consumer awareness and preference to shop at discount malls or outlet centers, both of which typically include other off-price retailers.

- Broad Selection of Designer Footwear. The Company offers a broad selection of quality footwear from over 75 name brands such as Diesel, Fila, Ralph Lauren, Rockport, Steve Madden, Vans and Via Spiga. The availability and wide variety of premium brand names distinguish Shoe Pavilion and serve to attract first time buyers and consumers who otherwise might shop at more expensive department stores. The wide variety of brand names also enables the Company to tailor its merchandise from store to store to accommodate consumer preferences that may vary by location.

- Selective Bulk Purchases; Diverse Vendor Network. The Company is able to offer lower prices by selectively purchasing large blocks of over-runs, over-orders, mid- and late-season deliveries and last season's stock from over 100 domestic and international vendors, independent resellers and manufacturers at significant discounts. The diversity and scope of its vendor network help to provide a constant source of quality merchandise, and the purchase of name brand, traditional styles helps to mitigate the likelihood of inventory writedowns. To augment available merchandise with the latest in-season styles, the Company purchases branded design footwear directly from factories in Italy, Brazil, China and Spain.

- Self-Service Stores. The Company believes that the self-service format reinforces its off-price strategy and appeals to value-oriented consumers. The Company's format allows inventory to be stored directly under a displayed shoe, thereby eliminating the need for a stockroom and significantly increasing retail floor space. The functionality and simplicity of this format enable flexible store layouts that can be easily rearranged to complement the current merchandise. Moreover, this format allows customers to locate all available sizes of a particular shoe and to try them on for comfort and fit without a salesperson's assistance, thereby reducing in-store staffing needs and allowing customers to make independent, purchasing decisions.

Growth Strategy

Since opening its first store in 1979 in Washington, the Company has expanded to 121 stores, including 38 licensed shoe departments, in twelve states. The Company intends to continue to expand by opening new stores and increasing comparable store sales. On June 29, 2002, the initial term of the license agreement with Gordmans department stores will expire and the Company will no longer operate the 38 licensed shoe departments in Gordmans department stores. Net sales for the licensed shoe departments in 2001 were $14.5 million.

- Continue New Store Openings. The Company intends to increase its presence in its current markets and to enter new markets by selectively opening new stores, which can be served by the Company's business support and distribution infrastructure. When entering a new market, the Company prefers to open multiple stores, thereby creating an immediate market presence and enabling television advertising

costs to be spread economically across a number of stores. The Company opened 6 stores and 2 licensed shoe departments in 2001, 7 stores and 3 licensed shoe departments in 2000 and 17 stores and 33 licensed shoe department locations in 1999. The Company closed 3 stores in 2001, 5 stores in 2000, and 8 stores in 1999. During 2002, the Company intends to open 5 to 10 new stores, primarily in California. Management believes that new store openings in the Company's current markets will further increase name recognition, which, in turn, will facilitate expansion into new markets.

- Increase Comparable Store Sales. During the past several years, comparable store sales have been subject to wide fluctuations. Comparable store sales decreased 5.9% in 2001 and increased 9.4% in 2000 after experiencing a 1.2% downturn in 1999. In an effort to improve comparable store sales performance, management intends to focus on refining its sales efforts, including merchandise selection, advertising and promotions.

The Company's ability to execute its operating and growth strategy is subject to numerous risks and uncertainties. Also certain events such as local economic downturns or September 11, 2001 are beyond the control of management. Consequently, there can be no assurance that the Company will be successful in implementing its strategy or that its strategy, even if implemented, will lead to successful achievement of the Company's objectives.

Merchandising

Unlike deep-discount retailers, Shoe Pavilion offers high quality merchandise and a consistent selection of name brand dress and casual shoes for men and women. List prices generally range between $19.99 and $69.99 for women's shoes, and between $39.99 and $99.99 for men's shoes. The principal categories of footwear offered by Shoe Pavilion stores, and selected brands for each, are summarized in the following table:

Women's	Men's	Athletic
BCBG	Airwalk	Adidas
Diesel	Bass	Asics

Hush Puppies	Dexter	Avia
Life Stride	Lugz	Converse
Ralph Lauren	Nunn Bush	Fila
Rockport	Rockport	New Balance
Steve Madden	Skechers	Saucony
Via Spiga	Timberland	Vans

Site Selection, Opening Costs and Leases

The Company uses an exclusive broker on the West Coast to identify potential retail sites as well as possible acquisition candidates. Before entering a new market, management reviews detailed reports on demographics; spending, traffic, and consumption patterns; and other site and market related data. As of December 29, 2001, 43 of the Company's stores were located in strip malls, 12 were located in outlet centers, 10 were located in free standing stores and 18 were located in other types of facilities.

Opening costs for stores are typically minimal, excluding the initial stocking of inventory. The Company estimates that its total capital requirements to open a typical new store average $360,000, consisting of approximately $300,000 for inventory and $60,000 for fixtures and equipment, excluding leasehold improvements which are occasionally paid for by the landlord allowances. Costs vary from store to store depending on, among other things, the location, size, property condition, and the tenant improvement package offered by the landlord. The Company does not own any of its real estate.

In July 1999, the Company entered into a license agreement to operate 33 shoe departments at Gordmans, Inc., a Midwest name brand family apparel, accessories and home fashions off-price retailer. All of the shoe

departments are located within Gordmans department stores, which are primarily located in strip centers or free standing locations. Because there are no leasehold improvement or equipment requirements and licensed shoe departments average approximately one-half the size of Company stores, opening costs are substantially less than Shoe Pavilion stores. Opening costs for licensed shoe departments are primarily for fixtures and inventory, and average $125,000, consisting of approximately $25,000 for fixtures and $100,000 for inventory.

Sourcing And Purchasing

Vendors. During 2001, the Company purchased its inventory from over 100 domestic and international vendors and independent resellers who over bought merchandise. In 2001, the Company's top ten suppliers accounted for approximately 30% of its inventory purchases. No vendor accounted for more than 10% of total inventory purchases in 2001. The Company purchases from its suppliers on an order-by-order basis and has no long-term purchase contracts or other contractual assurances of continued supply or pricing. Since the Company has locations in a number of markets along the West Coast and the Midwest, Shoe Pavilion can accommodate and distribute a wide variety of merchandise that meets the needs of customers in different geographic areas. Management believes that the strength and variety of its supplier network mitigates much of the Company's exposure to inventory supply risks. See "Item 7--Management's Discussion and Analysis of Financial Condition and Results of Operations--Factors Affecting Financial Performance--Inventory and Sourcing Risk."

Direct Sourcing. The Company purchases in-season name brand and branded design merchandise directly from factories in Italy, Brazil, China and Spain. These purchases include both branded and non-branded goods and provide a consistent source of in-season merchandise. Directly sourced goods accounted for approximately 9.1% and 13.4% of the Company's net sales in 2001 and 2000 respectively. The Company purchases from its manufacturing sources on an order-by-order basis and has no long-term purchase contracts or other contractual assurances of continued supply or pricing. See "Item 7--Management's Discussion and Analysis of Financial Condition and Results of Operations--Factors Affecting Financial Performance--International Purchasing."

Marketing

The Company believes that television advertising benefits all stores in a common viewing market. In 2001 the Company spent 3.2% of net sales or $2.8 million, net of vendor contributions. In 2000 the amount was 4.7% of net sales, or $4.3 million, net of vendor contributions. In 1999, the amount was 3.3% of net sales, or $2.4 million, net of vendor contributions. The Company believes that advertising costs for a particular market will be more effectively and economically leveraged as the number of stores increases in that market. The Company occasionally uses print advertising, usually at the time of a new store opening; however, it has found print advertising to be less effective than television advertising. Shoe Pavilion's signage is consistent at all of its locations, with highly visible signage at the front and, when appropriate, rear of the store.

Merchandise Distribution

During the year ended December 29, 2001 the Company's corporate offices and distribution facility were located in a 92,000 square foot facility in Richmond, California, which the Company occupied under a lease that expired in February 2002. The Company decided not to renew the lease and instead engaged a third party that began providing the warehousing and distribution services for the Company in February 2002. The Company will lease separate office space for its merchandising and administrative staff. The Company believes greater operating efficiencies and cost savings will be achieved by outsourcing its warehouse activities. The Company is currently leasing its present office space on a month to month basis.

Information Systems

During 1999, the Company completed an upgrade of its information systems on an enterprise-wide basis, including all critical areas of corporate office, network infrastructure and point of sale (POS). This fully

integrated upgrade, uses an IBM AS 400 that is reliable and scalable, allowing simple upgrades of processing power as the business grows. In addition, the corporate network infrastructure was upgraded to a Windows NT environment with standardized workstations and a common set of desktop applications that may be used throughout the Company. This upgrade provided a stable networking environment as well as a foundation for future growth.

Competition

The retail footwear market is highly competitive, and the Company expects the level of competition to increase. The Company competes with off-price and discount retailers (e.g., Nordstrom Rack, Payless ShoeSource, Ross Dress for Less and Famous Footwear), branded retail outlets (e.g., Nine West), national

retail stores (e.g., Nordstrom, Marshalls, Macy's, Sears, J.C. Penney, Loehmann's, Robinsons-May and Mervyn's), traditional shoe stores and mass merchants. Many of these competitors have stores in the markets in which the Company now operates and in which it plans to expand. Additionally, many of the competitors are larger and have more resources than the Company.

Employees

As of December 29, 2001, the Company had approximately 321 full-time employees and 517 part-time employees. The number of part-time employees fluctuates depending upon seasonal needs. The Company's 31 warehouse employees in Richmond, CA were represented by Local 315, International Brotherhood of Teamsters. In December 1998, the Company signed a collective bargaining agreement with Local 315 that terminated on January 31, 2002. Because the Company has outsourced its warehousing and distribution activities to a third party vendor, the contract with the International Brotherhood of Teamsters was not renewed.

Executive Officers

Certain information regarding the executive officers of the Company is set forth below:

Name	Age	Position
Dmitry Beinus...	49	Chairman of the Board and Chief Executive Officer
Robert R. Hall..	49	Vice President and Chief Operating Officer
John D. Hellmann	52	Vice President of Finance, Chief Financial Officer, and Secretary

Dmitry Beinus has served as Chairman of the Board, President and Chief Executive Officer of the Company since founding the Company in 1979. From 1976 to 1978, Mr. Beinus was employed in the shoe department of Nordstrom, Inc.

Robert R. Hall has served as Vice President and Chief Operating Officer of the Company since January 1997. Mr. Hall joined the Company as a Regional Manager in 1990, and has held various positions within the Company including Operations Manager and Vice President of Merchandising.

John D. Hellmann has served as Vice President of Finance and Chief Financial Officer of the Company since June 2000. From September 1995 until June 2000, Mr. Hellmann served as Vice President and Chief Financial Officer of The Lamaur Corporation, a manufacturer and wholesaler of hair care products. Mr. Hellmann is a Certified Public Accountant.

The Company's executive officers serve at the discretion of the Board of Directors. There is no family relationship between any of the Company's executive officers or between any executive officer and any of the Company's directors.

7

Item 2--Properties

As of December 29, 2001 the Company's corporate offices and distribution facility were located in a 92,000 square foot facility in Richmond, California, which the Company occupied under a lease that expired in February 2002. The

Company decided not to renew the lease and instead engaged a third party that began providing the warehousing and distribution services for the Company in February 2002. The Company will lease separate office space for its merchandising and administrative staff. The Company believes greater operating efficiencies and cost savings will be achieved by outsourcing its warehouse activities. The Company is currently leasing office space on a month to month basis. As of December 29, 2001 the Company's 83 stores occupied an aggregate of approximately 623,000 square feet of space. The 38 licensed shoe departments occupied an aggregate of approximately 114,000 square feet of space as of December 29, 2001. The Company leases all of its stores, with leases expiring between 2002 and 2011. The Company has options to renew most of its leases.

Store Locations

As of December 29, 2001, the Company operated 83 retail stores in the states of California, Washington and Oregon and 38 licensed shoe departments in Colorado, Illinois, Iowa, Kansas, Missouri, Nebraska North Dakota, Oklahoma and South Dakota. The license agreement for the 38 shoe departments in Gordmans department stores expires on June 29, 2002. The number of stores in each geographic area is set forth below:

	Stores at Year End				
Location	2001	2000	1999	1998	1997
Northern California	34	32	31	27	24
Southern California	35	33	30	25	16
Nevada.............	0	0	0	0	1
Oregon.............	4	4	4	4	2
Washington.........	10	10	13	13	12
Oklahoma...........	0	1	0	0	0
Total..........	83	80	78	69	55

	Licensed Shoe Departments		
Location	2001	2000	1999
Colorado....	3	3	3
Illinois....	3	3	1
Iowa........	7	7	6
Kansas......	5	5	5
Missouri....	7	7	7
Nebraska....	8	8	8
North Dakota	2	0	0
Oklahoma....	2	2	2
South Dakota	1	1	1
	38	36	33

Item 3--Legal Proceedings

The Company is not a party to any material pending legal proceedings.

Item 4--Submission of Matters to a Vote of Security Holders

Inapplicable.

8

PART II

Item 5--Market for the Registrant's Common Equity and Related Stockholder Matters

The common stock of the Company is traded on the Nasdaq SmallCap Market(R) under the symbol SHOE. The following table sets forth, for the periods indicated, the highest and lowest closing sale prices for the common stock, as reported by the Nasdaq Market(R).

	High	Low
2001		
First Quarter.	$2.44	$1.19
Second Quarter	1.42	0.90
Third Quarter.	1.14	0.86
Fourth Quarter	1.18	0.83
2000		
First Quarter.	$2.72	$1.75
Second Quarter	2.38	1.50
Third Quarter.	3.38	2.00
Fourth Quarter	3.06	1.13

After the Company went public its common stock was listed on the Nasdaq National Market. On March 1, 2001 the Company received a Nasdaq Staff Determination indicating that the Company had failed to comply with the Minimum Market Value of Public Float requirement for continued listing and that its shares were subject to delisting from The Nasdaq National Market. On April 6, 2001 the Company participated in a hearing with the Nasdaq Listing Qualifications Panel to appeal the Nasdaq Staff Determination. On April 30, 2001 the Company was notified that the Panel determined to transfer the listing of the Company's securities to The Nasdaq SmallCap Market. On May 3, 2001 the listing of Company's securities were transferred from The Nasdaq National Market to The Nasdaq SmallCap Market. The Company's securities continue to be listed under the symbol SHOE.

As of December 29, 2001, there were approximately 15 holders of record of the Company's common stock.

From August 1988 through February 1998, the Company made distributions to its sole stockholder primarily to allow the stockholder to pay taxes on earnings of the Company included or includable in the taxable income of the stockholder as a result of the Company's S corporation status. Upon completion of its initial public offering, the Company made an S corporation distribution in the amount of $7.8 million to its previous sole stockholder, which

approximately equaled the estimated earned and previously undistributed taxable S corporation income of the Company through the day preceding the termination date of its S corporation status. Except as mentioned in the previous sentences, the Company has not paid any cash dividends in the past. The Company currently intends to retain any earnings for use in its business and does not anticipate paying any cash dividends on its Common Stock in the foreseeable future. In addition, the Company's line of credit restricts the Company's ability to pay dividends. See Note 3 of Notes to Consolidated Financial Statements.

Item 6--Selected Financial Data

The selected consolidated financial and operating data set forth below should be read in conjunction with "Item 8--Financial Statements and Supplementary Data--Consolidated Financial Statements of the Company and related Notes thereto" and "Item 7--Management's Discussion and Analysis of Financial Condition and Results of Operations" included herein.

	Year Ended				
	2001	2000	1999	1998(1)	199
	(In thousands, except per share and operating da				
Statement of Operations Data:					
Net sales	$88,135	$91,058	$71,611	$55,907	$45,0
Cost of sales and related occupancy expenses	60,686	61,662	48,076	35,777	28,9
Gross profit	27,449	29,396	23,535	20,130	16,1
Selling expenses	17,606	19,134	13,999	11,472	8,8
General and administrative expenses	6,861	7,014	5,655	3,664	3,1
Income from operations	2,982	3,248	3,881	4,994	4,2
Interest and other expense, net	(626)	(1,295)	(633)	(453)	(5
Income before income taxes	2,356	1,953	3,248	4,541	3,7
Provision for income taxes	(895)	(779)	(1,233)	(1,147)	(2
Net income	$ 1,461	$ 1,174	$ 2,015	$ 3,394	$ 3,4
Net income per share:					
Basic	$ 0.21	$ 0.17	$ 0.30	$ 0.53	$ 0.
Diluted	$ 0.21	$ 0.17	$ 0.30	$ 0.52	$ 0.
Weighted average shares outstanding:					
Basic	6,800	6,800	6,800	6,462	4,5
Diluted	6,801	6,810	6,801	6,474	4,5
Pro Forma:					
Historical income before income taxes	--	--	--	$ 4,541	$ 3,7
Pro forma provision for income taxes(2)	--	--	--	(1,748)	(1,4
Pro forma net income(2)	--	--	--	$ 2,793	$ 2,2
Pro forma net income per share(2)	--	--	--	$ 0.42	
Pro forma weighted average shares outstanding(2)	--	--	--	6,600	

Selected Operating Data:					
Number of stores:					
Opened during period(3).....................	8	10	50	16	
Closed during period........................	3	5	8	2	
Open at end of period.......................	121	116	111	69	
Comparable store sales increase (decrease)......	(5.9)%	9.4%	(1.2)%	6.1%	4

	Year Ended				
	2001	2000	1999	1998	199
Balance Sheet Data:					
Working Capital................................	$22,839	$29,890	$14,305	$13,739	$ 6,0
Total assets..................................	39,162	46,915	41,613	33,534	22,6
Total indebtedness (including current portion)..	4,647	14,037	8,075	8,494	7,6
Stockholders' equity...........................	21,678	20,217	19,043	17,028	7,3

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(1) In 1998, the Company changed its year end to a 52-53 week year ending on the Saturday nearest to December 31. Due to this change, sales for the fourth quarter and year ended January 2, 1999 include two

additional days; had these days not been included comparable store sales would have increased 5.3% for the year ended January 2, 1999. All references herein to 1998 refer to the year ended January 2, 1999.

(2) Prior to February 1998, the Company operated as an S corporation and was not subject to federal and certain state income taxes. Upon the completion of its initial public offering, the Company became subject to federal and state income taxes. Pro forma net income reflects federal and state income taxes as if the Company had not elected S corporation status for income tax purposes. Pro forma net income per share is based on the weighted average number of shares of common stock outstanding during the period plus the estimated number of shares offered by the Company (1,271,722 shares) which were necessary to fund the $7.8 million distribution paid to the Company's stockholder upon termination of the Company's status as an S corporation.

(3) 2001, 2000 and 1999 include 2, 3 and 33 licensed shoe departments, respectively, operated pursuant to a license agreement with Gordmans, Inc.

Item 7--Management's Discussion and Analysis of Financial Condition and Results of Operations

The statements contained in this Form 10-K which are not historical facts are forward-looking statements that are subject to risks and uncertainties that could cause actual results to differ materially from those set forth in or implied by forward-looking statements. Factors that could cause or contribute to such differences include those discussed in the Company's filings with the Securities and Exchange Commission, including, without limitation, the factors discussed in this Form 10-K under the captions--"Factors Affecting Financial Performance" and "Liquidity and Capital Resources," as well as those discussed elsewhere in this Form 10-K.

Overview

Shoe Pavilion is the largest independent off-price footwear retailer on the West Coast that offers a broad selection of women's and men's designer label and name brand merchandise. The Company was among the first footwear retailers

on the West Coast to expand the off-price concept into the designer and name brand footwear market. As of December 29, 2001 the Company operated 83 retail stores in California, Washington and Oregon under the trade name Shoe Pavilion. In addition, as of December 29, 2001, the Company operated the shoe department of 38 Gordmans, Inc. (formerly Richman Gordman 1/2 Price Stores, Inc.) department stores in Colorado, Illinois, Iowa, Kansas, Missouri, Nebraska, North Dakota, Oklahoma and South Dakota under a licensing agreement entered into in July 1999. On June 29, 2002, the initial term of the license agreement with Gordmans department stores will expire and the Company will no longer operate the 38 licensed shoe departments in Gordmans department stores.

The Company opened, net of closures, 5 stores in both 2001 and 2000, and 42 new stores in 1999. During 2002, the Company intends to open approximately 5 to 10 new stores, primarily in California. It also expects to close 3 stores and 38 licensed shoe departments in 2002.

The Company's growth in net sales historically has resulted primarily from the opening of new stores. In 2000 and 1999 the Company also experienced growth in net sales as a result of the opening of 36 shoe departments pursuant to a licensing agreement entered into with Gordmans in 1999. The Company expects that the primary source of future sales growth will continue to be new store openings. Because the Company's comparable store sales have fluctuated widely, the Company does not expect that comparable store sales will contribute significantly to future growth in net sales. The Company defines comparable stores as those stores that have been open for at least 14 consecutive months. Stores open less than 14 consecutive months are treated as new stores, and stores closed during the period are excluded from comparable store sales. The Company's comparable store sales decreased 5.9% in 2001, increased 9.4% in 2000 and decreased 1.2% in 1999. Net sales will be impacted as the Company will no longer operate the 38 licensed shoe departments after June 29, 2002. Net sales generated from the licensed shoe departments were $14.5 million for the year ended December 29, 2001. In addition, these stores generated a store operating contribution before overhead, distribution costs,

11

interest and taxes of approximately $2.9 million. The Company does not allocate overhead, distribution costs, interest or taxes to stores. The majority of the overhead costs which consist of costs such as merchandising, accounting, information systems, rent and insurance are shared expenses of the Shoe Pavilion stores and the licensed shoe departments. The Company does not expect to incur significant costs in connection with the termination of the license agreement.

The Company seeks to acquire footwear merchandise on favorable financing terms and in quantities large enough to support future growth. This strategy causes an increase in inventory levels at various times throughout the year. As a result, similar to other off-price retailers, the Company's inventory turnover rates are typically less than full-price retailers.

Critical Accounting Policies and Estimates

The preparation of financial statements in conformity with generally accepted accounting principles requires the appropriate application of certain accounting policies, many of which require management to make estimates and assumptions about future events and their impact on amounts reported in the Company's financial statements and related notes. Since future events and their impact cannot be determined with certainty, the actual results will inevitably differ from the Company's estimates. Such differences could be material to the financial statements.

Management believes that the Company's application of accounting policies, and the estimates inherently required therein, are reasonable. These accounting policies and estimates are constantly reevaluated, and adjustments are made when facts and circumstances dictate a change. Historically, management has found the Company's application of accounting policies to be appropriate, and actual results have not differed materially from those determined using necessary estimates.

The Company's accounting policies are more fully described in Note 2 to the financial statements, located elsewhere in this Form 10-K. The Company has identified certain critical accounting policies which are described below.

Merchandise inventory. Merchandise inventory is carried at the lower of average cost or market. The Company makes certain assumptions to adjust inventory based on historical experience and current information in order to assess that inventory is recorded properly at the lower of cost or market. These assumptions can have a significant impact on current and future operating results and financial position.

Fixed assets. In evaluating the fair value and future benefits of fixed assets, the Company performs an analysis of the anticipated undiscounted future net cash flows of the related fixed assets and reduce their carrying value by the excess, if any, of the result of such calculation. The Company believes at this time that the fixed assets' carrying values and useful lives continue to be appropriate.

Results of Operations

The following table sets forth, for the periods indicated, the relative percentages that certain income and expense items bear to net sales:

	2001	2000	1999
Net sales........................	100.0%	100.0%	100.0%
Gross profit......................	31.1	32.3	32.9
Selling expenses..................	20.0	21.0	19.6
General and administrative expenses	7.8	7.7	7.9
Income from operations............	3.3	3.6	5.4
Interest and other expenses, net...	(0.7)	(1.4)	(0.9)
Income before income taxes.........	2.6	2.2	4.5
Provision for income taxes.........	(1.0)	(0.9)	(1.7)
Net income........................	1.6%	1.3%	2.8%

2001 Compared with 2000

Net Sales. Net sales decreased 3.2% to $88.1 million for 2001 from net sales of $91.1 million for 2000. The decrease in net sales is principally attributable to the decline in comparable store net sales of 5.9% or $4.6 million. The decline in comparable store net sales was partially offset by

net sales generated from five stores opened in 2001 (net of three closed) and the effect of a full year of sales for five stores opened in 2000 (net of five closed). Net sales in 2002 will be impacted by the effects of the expiration of the initial term of the license agreement with Gordmans department stores. As a result of this expiration the Company will no longer operate the 38 licensed shoe departments after June 29, 2002. Net sales for the licensed shoe departments in 2001 were $14.5 million.

Gross Profit. Cost of sales includes landed merchandise and occupancy costs and the license fee paid to Gordmans for the licensed shoe departments. Gross profit decreased 6.6% to $27.4 million from $29.4 million in 2000. Gross profit as a percentage of net sales decreased to 31.1% in 2001 from 32.3% in 2000, principally due to the increase in occupancy costs of 1.6% as a percentage of net sales. This increase in occupancy costs as a percentage of net sales was primarily driven by the decrease in comparable store net sales in 2001.

Selling Expenses. Selling expenses decreased 8.0% to $17.6 million in 2001 from $19.1 million in 2000 and decreased as a percentage of net sales to 20% in 2001 from 21.0% in 2000. The decrease in selling expenses is principally due to a $1.5 million reduction in advertising in 2001 compared to 2000. For 2001 advertising costs were $2.8 million or 3.2% of net sales compared to $4.3 million or 4.7% of net sales in 2000. This was in part due to a decrease in advertising for the licensed shoe departments of approximately $.8 million. The Company intends to increase advertising as a percentage of net sales in 2002 in an effort to increase sales.

General and Administrative Expenses. General and administrative expenses consist primarily of corporate and administrative expenses, including payroll, employee benefits and warehousing costs. General and administrative expenses remained relatively unchanged at $6.9 million or 7.8% of sales compared with $7.0 million or 7.7% for 2000.

Interest Expense. Interest expense decreased 39.2% to $.7 million in 2001 from $1.1 million in 2000. This decrease was primarily attributable to a lower average interest rate and reduced average borrowings on the Company's revolving line of credit. The weighted average interest on the Company's borrowings in 2001 decreased to 6.4% from 8.4% in 2000. The Company was able to reduce its average borrowings primarily through funds generated from the $6.8 million reduction in inventory during 2001.

Income Taxes. The effective tax rate in 2001 decreased to 38.0% compared to 39.9% in 2000. The decrease in the effective tax rate in 2001 is primarily due to the benefit of certain state tax credits realized in 2001.

2000 Compared with 1999

Net Sales. Net sales increased 27.2% to $91.1 million for 2000 from net sales of $71.6 million for 1999. Approximately $18.8 million of the increase in net sales is attributable to the increase in new store sales, including sales from the new licensed shoe departments. In addition, the Company's comparable store net sales increased $4.8 million or 9.4%. These increases were partially offset by store closings.

Gross Profit. Cost of sales includes landed merchandise and occupancy costs and the license fee paid to Gordmans for the licensed shoe departments. Gross profit increased 24.9% to $29.4 million from $23.5 million for 1999. This increase in gross profit dollars is attributable to the increase in net sales in 2000. Gross profit as a percentage of net sales decreased slightly to 32.3%

for 2000 from 32.9% for 1999. This reduction in the gross profit percentage is principally due to higher merchandise cost as a percentage of sales, which was partially offset by the decrease in occupancy costs as a percentage of sales. The Company was able to reduce its occupancy costs as a percent of sales by leveraging both its increase in comparable store sales and the license fee paid for the shoe departments the Company operates.

Selling Expenses. Selling expenses consist principally of payroll and related costs, advertising and promotional expenses, freight out and credit card processing fees. Selling expenses increased by 36.7% to $19.1 million for 2000 from $14.0 million in 1999 and increased as a percentage of sales to 21.0% in 2000 from 19.6% in 1999. The increase in selling expenses is primarily attributable to the increase in advertising, payroll costs, freight out and credit card fees, which were in part directly related to the increase in net sales in 2000. The increase in selling expenses as a percentage of net sales is principally the result of the increase in advertising costs. For 2000, advertising costs were $4.3 million or 4.7% of net sales compared to $2.4 million or 3.3% of net sales for 1999.

General and Administrative Expenses. General and administrative expenses increased 24% to $7.0 million for 2000 from $5.7 million for 1999 and decreased slightly as a percentage of net sales to 7.7% in 2000 from 7.9% in 1999. The increase in general and administrative expenses was primarily attributable to increased administrative and warehouse payroll costs, information system costs related to the computer system installed in 1999 and increased enrollment in the Company's employee benefit plan.

Interest and Other Expense, Net. Interest and other expense, net, increased to $1.3 million for 2000 from $.6 million for 1999. The increase was primarily attributable to higher average borrowings on the Company's revolving line of credit to fund increased inventory levels related in part to the higher sales in 2000. In addition, the weighted average interest rate in 2000 increased to 8.4% from 6.8% in 1999.

Income Taxes. In 2000 a greater portion of the Company's business was generated in states with a higher tax rate compared with 1999. As a result the effective tax rate for 2000 increased to 39.9% from 38.0% in 1999.

Inflation

The Company does not believe that inflation has had a material impact on its results of operations. There can be no assurance, however, that inflation will not have such an effect in future periods.

Liquidity and Capital Resources

Historically, the Company has funded its cash requirements primarily through cash flows from operations and borrowings under its credit facility. Net cash provided (used) by operating activities was $10.0 million,

($4.8) million and $2.4 million for 2001, 2000 and 1999, respectively. Net cash provided (used) by operating activities historically has been driven primarily by net income before depreciation and fluctuations in inventory and accounts payable. The increase in the cash provided from operating activities in 2001 was principally due to the $6.8 million reduction in inventory for the year ended December 29, 2001. This reduction in inventory was in part a result of the Company's focus on strengthening its financial condition. In 2000 and 1999 the Company's inventory levels had increased primarily due to the net increase

in the number of stores and the increase in net sales.

The Company had $22.8 million in working capital as of December 29, 2001 and $29.9 million in working capital as of December 30, 2000. The decrease in working capital as of December 29, 2001 is principally due to the $6.8 million reduction in inventory. The Company's working capital needs are typically higher in the second and third quarters as a result of increased inventory purchases for the spring and fall selling seasons.

Capital expenditures were $.6 million, $1.3 million and $2.9 million in 2001, 2000 and 1999, respectively. Expenditures for 2001 were primarily for the build out of 6 new stores and 2 new Gordmans' shoe departments and the remodeling of 7 stores. Expenditures for 2000 were primarily for the build out of 7 new stores and 3 new Gordmans' shoe departments and the remodeling of 12 stores. Expenditures for 1999 were primarily for the build-out of 17 new stores, 33 new Gordmans' shoe departments and the Company's new information systems. The Company currently expects capital expenditures to be between $400,000 and $700,000 in 2002, net of construction allowances from the landlord. The actual amount will depend in part upon the number of stores opened in 2002 and the construction allowances received from the landlord. The Company expects to open between 5 and 10 stores in 2002. The number of stores actually opened is, in part, dependent upon the availability of desirable locations and management's ability to negotiate acceptable lease terms.

Financing activities provided (used) cash of ($9.4) million, $6.0 million and ($419,000) in 2001, 2000 and 1999, respectively. The cash used by financing activities in 2001 relates to the pay down on the Company's revolving line of credit primarily driven by the $6.8 million reduction in inventory as of December 29, 2001 compared with December 30, 2000. The cash provided by financing activities in 2000 primarily relates to the net increase in borrowings under the Company's revolving line of credit. The cash used by financing activities in 1999 primarily related to paying down balances on the Company's revolving line of credit.

On February 27, 2001, the Company and its lender entered a new a loan agreement for a revolving line of credit up to $20.0 million, including a $5.0 million sublimit for the issuance of letters of credit, with an original maturity date of June 1, 2002. The new agreement adjusted certain economic terms and financial covenants. Borrowings are based upon eligible inventory. Borrowings under the credit facility are secured by the Company's accounts receivable, general intangibles, inventory and other rights to payment. The agreement prohibits the declaration and payment of cash or stock dividends. The agreement contains various restrictive and financial covenants including minimum EBITDA as determined on a rolling four quarters basis and minimum quarterly pre tax profit and minimum net income. On June 1, 2001 the credit agreement was amended to extend the maturity date of the line of credit to June 1, 2003. On September 1, 2001 the credit agreement was amended to lower the EBITDA requirement for the third and fourth quarters of 2001. On March 1, 2002, the credit agreement was amended to lower the EBITDA requirements for 2002 and to lower the pre-tax profit requirement for the first quarter of 2002.

Interest on outstanding borrowings is at the bank's floating prime rate or LIBOR plus from 1.3% to 1.8%, depending on the Company's achievement of certain financial ratios. The weighted average interest rate on outstanding borrowings at December 29, 2001 was 3.37%. As of December 29, 2001, outstanding borrowings on the revolving line of credit were $4.6 million and the unused and available portion of the credit facility was approximately $10.9 million.

The Company expects that anticipated cash flow from operations and available borrowings under the Company's credit facility will satisfy its cash requirements for at least the next 12 months. The Company's capital requirements may vary significantly from anticipated needs, depending upon such

factors as operating results, the number and timing of new store openings.

Recently Issued Accounting Standards

Statement of Financial Accounting Standards ("SFAS") No. 133, "Accounting for Derivative Instruments and Hedging Activities," was issued in June 1998 and amended by SFAS Nos. 137 and 138, issued in June 2000. The standard establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts and for hedging activities. Under the standard, certain contracts that were not formerly considered derivatives may now meet the definition of a derivative. The Company adopted the standard effective December 31, 2000. The adoption of SFAS No. 133, as amended by SFAS Nos. 137 and 138, did not have a material impact on the financial position or results of operations of the Company.

In June 2001, the Financial Accounting Standards Board (FASB) issued SFAS No. 141, "Business Combinations" and SFAS No. 142, "Goodwill and Other Intangible Assets." SFAS No. 141 requires that all business combinations initiated after June 30, 2001 be accounted for under the purchase method and addresses the initial recognition and measurement of goodwill and other intangible assets acquired in a business combination. SFAS No. 142 addresses the initial recognition and measurement of intangible assets acquired outside of a business combination and the accounting for goodwill and other intangible assets subsequent to their acquisition. SFAS No. 142 provides that intangible assets with finite useful lives be amortized and that goodwill and intangible assets with indefinite lives will not be amortized, but will rather be tested at least annually for impairment. SFAS No. 142 is effective for the Company beginning December 30, 2001. Adoption of this new standard will not have a significant impact on the Company's financial statements.

In June 2001, the FASB issued SFAS No. 143, "Accounting for Asset Retirement Obligations," and in October 2001 issued SFAS No. 144, "Accounting for the Impairment of Disposal of Long-Lived Assets." These Statements will be effective for the Company's fiscal year 2003. The Company has not determined the impact, if any, that these Statements will have on its consolidated financial statements.

Weather and Seasonality

The Company has experienced, and expects to continue to experience, seasonal fluctuations in its net sales and net income. Historically, net sales and net income have been weakest during the first quarter. The Company's quarterly results of operations may also fluctuate significantly as a result of a variety of factors, including timing of new store openings, the level of net sales contributed by new stores, merchandise mix, the timing and level of price markdowns, availability of inventory, store closures, advertising costs, competitive pressures and changes in the demand for off-price footwear.

Factors Affecting Financial Performance

In addition to the other information in this Form 10-K, the following factors should be considered carefully in evaluating an investment in the shares of common stock of the Company. The statements contained in this Form10-K which are not historical facts are forward-looking statements that are subject to risks and uncertainties that could cause actual results to differ materially from those set forth in or implied by forward-looking statements. Factors that could cause or contribute to such differences include those discussed below, as well as those discussed elsewhere in this Form 10-K.

Risks Associated with Expansion

The Company has experienced rapid and substantial growth in net sales as well as in its employee headcount. The Company's continued growth will depend to a significant degree on its ability to expand its operations through the opening of new stores and to operate these stores on a profitable basis. The success of the Company's planned expansion will be significantly dependent upon the Company's ability to locate suitable store sites and negotiate acceptable lease terms. In addition, several other factors could affect the Company's ability to expand, including the adequacy of the Company's capital resources, the ability to hire, train and

16

integrate employees and the ability to adapt the Company's operational systems. There can be no assurance that the Company will achieve its planned expansion or that any such expansion will be profitable. In addition, there can be no assurance that the Company's expansion within its existing markets will not adversely affect the individual financial performance of the Company's existing stores or its overall operating results, or that new stores will achieve net sales and profitability levels consistent with existing stores. To manage its planned expansion, the Company regularly evaluates the adequacy of its existing systems and procedures, including product distribution facilities, store management, financial controls and management information systems. However, there can be no assurance that the Company will anticipate all of the changing demands that expanded operations may impose on such systems. Failure to adapt its internal systems or procedures as required could have a material adverse effect on the Company's business, financial condition and results of operations.

The Company actively monitors individual store performance and has closed underperforming stores in the past. The Company intends to continue to close underperforming stores in the future, and if it were to close a number of stores, it could incur significant closure costs and reductions in net sales. In certain instances, the Company may be unable to close an underperforming store on a timely basis because of lease terms. A significant increase in closure costs or the inability to close one or more underperforming stores on a timely basis could have a material adverse effect on the Company's business, financial condition and results of operations.

License Agreement

In July 1999, the Company entered into a license agreement to operate the shoe departments in Gordmans Inc. department stores located in the Midwest. On June 29, 2002, the initial term of the license agreement with Gordmans department stores will expire and the Company will no longer operate the 38 licensed shoe departments in Gordmans department stores. Net sales will be impacted as the Company will no longer operate the 38 licensed shoe departments subsequent to June 29, 2002. Net sales generated from the licensed shoe departments were $14.5 million for the year ended December 29, 2001. In addition, these stores generated a store operating contribution before overhead, distribution costs, interest and taxes of approximately $2.9 million. The Company does not allocate overhead, distribution costs, interest or taxes to stores. The majority of the overhead costs which consist of costs such as merchandising, accounting, information systems, rent and insurance are shared expenses of the Shoe Pavilion stores and the licensed shoe departments. The focus of the Company during the coming year will be to replace the Gordmans business by improving comparable store sales results and opening new stores in carefully targeted markets. There can be no assurance that the Company will be able to increase comparable store sales or open new stores to an extent

sufficient to offset the loss of net sales and operating contribution received under the Gordmans license agreement. Failure to successfully implement these plans could have a material adverse impact on the Company's results of operations.

Uncertainty of Future Operating Results; Fluctuations in Comparable Store Sales

Although the Company has been profitable, there can be no assurance that the Company will continue to remain profitable. Future operating results will depend upon many factors, including general economic conditions, the level of competition and the ability of the Company to acquire sufficient inventory, achieve its expansion plans and effectively monitor and control costs. There can be no assurance that the Company's recent gross margin levels will be sustainable in the future.

Although the Company achieved a substantial portion of its 1999 net sales growth through the licensing agreement with Gordmans, historically its growth in net sales has resulted primarily from new store openings. At the present time, the Company expects that the primary source of future sales growth will be from new store openings.

Historically, the Company's comparable store sales have fluctuated widely. Although the Company is endeavoring to achieve consistent growth in comparable store sales, there can be no assurance that the Company will not continue to experience volatility in comparable store sales. The Company defines comparable stores as

those stores that have been open for at least 14 consecutive months. Stores open less than 14 consecutive months are treated as new stores, and stores closed during the period are excluded from comparable store sales. The Company's comparable store sales decreased 5.9% in 2001, increased 9.4% in 2000 and decreased 1.2% in 1999.

Inventory and Sourcing Risk

The Company's future success will be significantly dependent on its ability to obtain merchandise that consumers want to buy, particularly name brand merchandise with long-term retail appeal, and to acquire such merchandise under favorable terms and conditions. In 2001, the Company's top ten suppliers accounted for approximately 30% of its inventory purchases. The deterioration of the Company's relationship with any key vendor or vendors could result in delivery delays, merchandise shortages or less favorable terms than the Company currently enjoys. The Company deals with its suppliers on an order-by-order basis and has no long-term purchase contracts or other contractual assurances of continued supply or pricing. As the Company's operations expand, its demand for off-price inventory will continue to increase. The Company's footwear purchases typically involve manufacturing over-runs, over-orders, mid- or late-season deliveries or last season's stock. The inability of the Company to obtain a sufficient supply of readily salable, high margin inventory, to negotiate favorable discount and payment agreements with its suppliers or to sell large inventory purchases without markdowns could have a material adverse effect on the Company's business, financial condition and results of operations. See "Item 1--Business--Sourcing and Purchasing."

Warehousing and Distribution Services

As of December 29, 2001 the Company's corporate offices and distribution

facility were located in a 92,000 square foot facility in Richmond, California, which the Company occupied under a lease that expired in February 2002. The Company decided not to renew the lease and instead engaged a third party that began providing the warehousing and distribution services for the Company in February 2002. Although the Company believes greater operating efficiencies and cost savings will be achieved by outsourcing its warehouse activities there can be no assurances that these operating efficiencies and cost savings will be realized or that the Company will not encounter any transition difficulties that could affect the flow of inventory to its store.

Reliance on Key Personnel

The Company's future success will be dependent, to a significant extent, on the efforts and abilities of its executive officers. The loss of the services of any one of the Company's executive officers could have a material adverse effect on the Company's operating results. In addition, the Company's continued growth will depend, in part, on its ability to attract, motivate and retain skilled managerial and merchandising personnel. Competition for such personnel is intense, and there can be no assurance that the Company will be able to retain a substantial percentage of its existing personnel or attract additional qualified personnel in the future.

Risks Associated with Possible Acquisitions

The Company may pursue the acquisition of companies and assets that complement its existing business. Acquisitions involve a number of special risks, including the diversion of management's attention to the assimilation of the operations and personnel of the acquired businesses, potential adverse short-term effects on the Company's operating results and amortization of acquired intangible assets. The Company has limited experience in identifying, completing and integrating acquisitions. The Company does not have any current plans to acquire any other companies, and there can be no assurance that the Company will identify attractive acquisition candidates, that acquisitions will be consummated on acceptable terms or that any acquired companies will be integrated successfully into the Company's operations.

Seasonality and Quarterly Fluctuations

The Company has experienced, and expects to continue to experience, seasonal fluctuations in its net sales and net income. Historically, net sales and net income have been weakest during the first quarter. The

Company's quarterly results of operations may also fluctuate significantly as a result of a variety of factors, including timing of new store openings, the level of net sales contributed by new stores, merchandise mix, the timing and level of price markdowns, availability of inventory, store closures, advertising costs, competitive pressures and changes in the demand for off-price footwear.

Dependence on Consumer Spending and Preferences

The success of the Company's operations depends upon a number of general economic factors relating to consumer spending, including employment levels, business conditions, interest rates, inflation and taxation. There can be no assurance that consumer spending will not decline in response to economic conditions, thereby adversely affecting the Company's operating results.

All of the Company's products are subject to changing consumer preferences.

Consumer preferences could shift to types of footwear other than those that the Company currently offers. Any such shift could have a material adverse effect on the Company's operating results. The Company's future success will depend, in part, on its ability to anticipate and respond to changes in consumer preferences, and there can be no assurance that the Company will be able to effectively anticipate or respond to such changes on a timely basis or at all. Failure to anticipate and respond to changing consumer preferences could lead to, among other things, lower net sales, excess inventory and lower gross margins, any of which could have a material adverse effect on the Company's business, financial condition and results of operations.

International Purchasing

The Company purchases in-season name brand and branded-design merchandise directly from factories in Italy, Brazil, China and Spain. Directly-sourced goods accounted for approximately 9.1% and 13.4% of net sales in 2001 and 2000, respectively. The Company has no long-term contracts with direct manufacturing sources and competes with other companies for production facilities. All of the manufacturers with which the Company conducts business are located outside of the United States, and the Company is subject to the risks generally associated with an import business, including foreign currency fluctuations, unexpected changes in foreign regulatory requirements, disruptions or delays in shipments and the risks associated with United States import laws and regulations, including quotas, duties, taxes, tariffs and other restrictions. There can be no assurance that the foregoing factors will not disrupt the Company's supply of directly-sourced goods or otherwise adversely impact the Company's business, financial condition and results of operations in the future. See "Item 1--Business--Sourcing and Purchasing."

Inventory Shrinkage

The retail industry is subject to theft by customers and employees. Because the Company uses a self-service format, where shoppers have access to both shoes of a pair, the Company must maintain substantial store security. Although the Company has implemented enhanced security procedures, there can be no assurance that the Company will not suffer from significant inventory shrinkage in the future, which could have a material adverse effect on the Company's business, financial condition and results of operations.

Competition

The retail footwear market is highly competitive, and the Company expects the level of competition to increase. The Company competes with off-price and discount retailers (e.g., Nordstrom Rack, Payless ShoeSource, Ross, Dress for Less and Famous Footwear), branded retail outlets (e.g., Nine West), national retail stores (e.g., Nordstrom, Marshalls, Macy's, Sears, J.C. Penney, Loehmann's, Robinsons-May and Mervyn's), traditional shoe stores and mass merchants. Many of these competitors have stores in the markets in which the Company now operates and in which it plans to expand. Many of the Company's competitors have significantly greater financial, marketing and other resources than the Company. In addition, there can be no assurance that in the future new participants will not enter the off-price segment of the footwear market. Competitive pressures resulting from competitors' pricing policies could materially adversely affect the Company's gross margins.

There can be no assurance that the Company will not face greater competition from other national, regional or local retailers or that the Company will be able to compete successfully with existing and new competitors. The inability

of the Company to respond to such competition could have a material adverse effect on the Company's business, financial condition and results of operations.

Future Capital Needs

The Company expects that anticipated cash flows from operations and available borrowings under the Company's credit facility will satisfy its cash requirements for at least the next 12 months. To the extent that the foregoing cash resources are insufficient to fund the Company's activities, including new store openings planned for 2002, additional funds will be required. There can be no assurance that additional financing will be available on reasonable terms or at all. Failure to obtain such financing could delay or prevent the Company's planned expansion, which could adversely affect the Company's business, financial condition and results of operations.

Substantial Control by Single Stockholder

Dmitry Beinus, the Company's Chairman of the Board, President and Chief Executive Officer owns approximately 66.2% of the Company's outstanding Common Stock. As a result, Mr. Beinus is able to decide all matters requiring stockholder approval, including the election of directors and approval of significant corporate transactions. Concentration of stock ownership could also have the effect of preventing a change in control of the Company.

Possible Volatility of Stock Price

The Company's common stock is quoted on the Nasdaq SmallCap Market, which has experienced and is likely to experience in the future significant price and volume fluctuations, either of which could adversely affect the market price of the common stock without regard to the operating performance of the Company. In addition, the trading price of the Company's common stock could be subject to wide fluctuations in response to quarterly variations in operating results, fluctuations in the Company's comparable store sales, announcements by other footwear retailers, the failure of the Company's earnings to meet the expectations of investors, as well as other events or factors.

Item 7A--Quantitative and Qualitative Disclosure about Market Risk

The Company is exposed to market risks, which include changes in U.S. interest rates and foreign exchange rates. The Company does not engage in financial transactions for trading or speculative purposes.

Interest Rate Risk. The interest payable on the Company's bank line of credit is based on variable interest rates and therefore is affected by changes in market rates. The Company does not use derivative financial instruments in its investment portfolio and believes that the market risk is insignificant.

Commodity Prices. The Company is not exposed to fluctuation in market prices for any commodities.

Foreign Currency Risks. As of December 29, 2001, the Company had a foreign exchange contract outstanding to hedge certain purchases in Eurodollars. The purpose of the Company's foreign currency hedging activities is to protect the Company from the risk that the eventual dollar net cash outflow resulting from inventory purchases will be affected by changes in exchange rates.

As of December 29, 2001 the notional amount and fair value of the Company's foreign exchange contract in U.S. dollars were $500,000 and $12,535, respectively.

The Company makes minimal purchases outside of the United States that involve foreign currencies and, therefore, has only minimal exposure to foreign

currency exchange risks. The Company does not typically hedge against foreign currency risks and believes that foreign currency exchange risk is insignificant.

Item 8--Financial Statements and Supplementary Data

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

Shoe Pavilion, Inc.

Independent Auditors' Report..

Consolidated Balance Sheets at December 29, 2001 and December 30, 2000........................

Consolidated Statements of Income for Years Ended December 29, 2001, December 30, 2000 and January 1, 2000..

Consolidated Statements of Changes in Stockholders' Equity for Years Ended December 29, 2001, December 30, 2000 and January 1, 2000...

Consolidated Statements of Cash Flows for Years Ended December 29, 2001, December 30, 2000 and January 1, 2000..

Notes to Consolidated Financial Statements for Years Ended December 29, 2001, December 30, 200 and January 1, 2000...

INDEPENDENT AUDITORS' REPORT

To the Board of Directors and Stockholders of
Shoe Pavilion, Inc.

We have audited the accompanying consolidated balance sheets of Shoe Pavilion, Inc. and subsidiary (the "Company") as of December 29, 2001 and December 30, 2000 and the related consolidated statements of income, stockholders' equity, and cash flows for each of the three years in the period ended December 29, 2001. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of the Company as of December 29,

2001 and December 30, 2000, and the results of its operations and its cash flows for each of the three years in the period ended December 29, 2001 in conformity with accounting principles generally accepted in the United States of America.

DELOITTE & TOUCHE LLP

San Francisco, California
February 8, 2002 (March 1, 2002 as to the last sentence of the first paragraph of Note 3)

22

SHOE PAVILION, INC.

CONSOLIDATED BALANCE SHEETS

	December 29, 2001	Decembe 200
ASSETS		
CURRENT ASSETS:		
Cash	$ 802,671	$ 814
Receivables	609,389	740
Inventories	31,398,178	38,187
Deferred taxes and prepaid expenses	1,063,741	940
Total current assets	33,873,979	40,682
FIXED ASSETS:		
Store fixtures and equipment	4,373,962	4,136
Leasehold improvements	3,628,986	3,296
Information technology systems	2,256,274	2,240
Total	10,259,222	9,672
Less accumulated depreciation	5,899,556	4,389
Net fixed assets	4,359,666	5,283
Deferred income taxes and other	927,912	948
TOTAL	$39,161,557	$46,915
LIABILITIES AND STOCKHOLDERS' EQUITY		
CURRENT LIABILITIES		
Accounts payable	$ 8,515,004	$ 8,750
Accrued expenses	2,473,666	2,027
Current portion of capitalized lease obligations	46,759	14
Total current liabilities	11,035,429	10,792
Long-term debt	4,600,000	13,975
Deferred rent	1,847,893	1,883
Capitalized lease obligations, less current portion	--	46
Commitments and contingencies	--	
STOCKHOLDERS' EQUITY:		
Preferred stock--$.001 par value; 1,000,000 shares authorized; no shares issued or outstanding	--	
Common stock--$.001 par value: 15,000,000 shares authorized;		

6,800,000 shares issued and outstanding	6,800	6
Additional paid-in capital	13,967,258	13,967
Retained earnings	7,704,177	6,243
Total stockholders' equity	21,678,235	20,217
TOTAL	$39,161,557	$46,915

See notes to consolidated financial statements.

SHOE PAVILION, INC.

CONSOLIDATED STATEMENTS OF INCOME

	December 29, 2001	December 30, 2000	January 1, 2000
Net sales	$88,135,199	$91,058,092	$71,611,220
Cost of sales and related occupancy expenses	60,685,541	61,662,190	48,076,135
Gross profit	27,449,658	29,395,902	23,535,085
Selling expenses	17,606,694	19,134,430	13,999,417
General and administrative expenses	6,860,705	7,013,724	5,654,248
Income from operations	2,982,259	3,247,748	3,881,420
Other income (expense):			
Interest	(682,578)	(1,121,904)	(618,647)
Other--net	56,906	(173,257)	(14,312)
Total other expense--net	(625,672)	(1,295,161)	(632,959)
Income before income taxes	2,356,587	1,952,587	3,248,461
Provision for income taxes	(895,420)	(778,504)	(1,233,846)
Net income	$ 1,461,167	$ 1,174,083	$ 2,014,615
Net income per share:			
Basic	$ 0.21	$ 0.17	$ 0.30
Diluted	$ 0.21	$ 0.17	$ 0.30
Weighted average shares outstanding:			
Basic	6,800,000	6,800,000	6,800,000
Diluted	6,800,804	6,810,258	6,801,417

See notes to consolidated financial statements.

SHOE PAVILION, INC.

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

	Common Stock		Additional		
	Number of Shares	Amount	Paid-in Capital	Retained Earnings	Total
Balance at January 2, 1999..	6,800,000	$6,800	$13,967,258	$3,054,312	$17,028,370
Net income..............				2,014,615	2,014,615
Balance at January 1, 2000..	6,800,000	6,800	13,967,258	5,068,927	19,042,985
Net income..............				1,174,083	1,174,083
Balance at December 30, 2000	6,800,000	6,800	13,967,258	6,243,010	20,217,068
Net income..............				1,461,167	1,461,167
Balance at December 29, 2001	6,800,000	$6,800	$13,967,258	$7,704,177	$21,678,235

See notes to consolidated financial statements.

SHOE PAVILION, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

	December 29, 2001	December 30, 2000	Janu 2
OPERATING ACTIVITIES:			
Net income..	$ 1,461,167	$ 1,174,083	$ 2,
Adjustments to reconcile net income to net cash provided (used) by operating activities:			
Depreciation..	1,562,497	1,432,809	1,
Other...	526	116,863	
Deferred income taxes.....................................	(55,779)	(466,840)	(
Effect of changes in:			
Inventories...	6,789,200	(5,202,595)	(6,
Receivables...	131,071	(162,390)	(
Prepaid expenses and other................................	(46,453)	158,461	(
Accounts payable..	(235,080)	(2,389,222)	5,
Accrued expenses and deferred rent........................	410,245	555,806	1,
Net cash provided (used) by operating activities..........	10,017,394	(4,783,025)	2,
INVESTING ACTIVITIES:			
Purchase of fixed assets..................................	(638,966)	(1,293,422)	(2,

FINANCING ACTIVITIES:			
Borrowings (payments) on credit facility, net	(9,375,231)	5,975,231	(
Principal payments on capital leases	(14,754)	(13,232)	
Net cash provided (used) by financing activities	(9,389,985)	5,961,999	(
Net decrease in cash	(11,557)	(114,448)	(
Cash, beginning of period	814,228	928,676	1,
Cash, end of period	$ 802,671	$ 814,228	$
CASH PAID FOR:			
Interest	$ 777,725	$ 1,066,700	$
Income taxes	$ 939,650	$ 1,502,792	$ 1,

See notes to consolidated financial statements.

SHOE PAVILION, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. BASIS OF PRESENTATION AND OPERATIONS

General--Shoe Pavilion, Inc. (the "Company"), a Delaware corporation, operates as a single business segment of off-price shoe stores located in California, Washington and Oregon, under the name Shoe Pavilion. The Company had 83 and 80 stores open as of December 29, 2001 and December 30, 2000, respectively. In July 1999, the Company entered into a licensing agreement to operate the shoe department of Gordmans, Inc. (formerly Richman Gordman 1/2 Price Stores, Inc.) department stores located in the Midwest. The Company operated 38 and 36 shoe departments of Gordmans, Inc. at December 29, 2001 and December 30, 2000, respectively. On June 29, 2002, the initial term of the license agreement with Gordmans department stores will expire and the Company will no longer operate the 38 licensed shoe departments in Gordmans department stores. Net sales for the licensed shoe departments in 2001 were $14.5 million. The Company purchases inventory from international and domestic vendors. For 2001, the Company's top ten suppliers accounted for approximately 30.0% of inventory purchases.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

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

Consolidation Policy--The consolidated financial statements include the Company and its wholly-owned subsidiary, Shoe Pavilion Corporation. All significant intercompany balances and transactions have been eliminated.

Year End--The Company's year end is based upon a 52/53 week year ending on the Saturday nearest to December 31. All references herein to 2001, 2000 and 1999 refer to the years ended December 29, 2001, December 30, 2000 and January

1, 2000, respectively, which are all 52 week years.

Cash represents cash on hand and cash held in banks.

Estimated Fair Value of Financial Instruments--The carrying value of cash, accounts receivable, accounts payable and debt approximates their estimated fair values at December 29, 2001. As of December 29, 2001, the notional amount and fair value of the Company's foreign exchange contract in U.S. dollars were $500,000 and $12,535, respectively.

Inventories are stated at the lower of average cost or market.

Fixed Assets are stated at cost. Depreciation and amortization are provided on the straight-line method over the estimated useful lives of the assets ranging from three to seven years. Leasehold improvements are amortized on the straight-line method over the shorter of the useful lives of the assets or lease term, generally five years.

Income Taxes--Income taxes are accounted under the asset and liability method in accordance with Statement of Financial Accounting Standards ("SFAS") No. 109, "Accounting for Income Taxes". Deferred income taxes result primarily from fixed asset basis differences, deferred rent and UNICAP adjustments.

Deferred Rent--Certain of the Company's store leases provide for free or reduced rent during an initial portion of the lease term. Deferred rent consists of the aggregate obligation for lease payments under these leases

amortized on a straight-line basis over the lease term, in excess of amounts paid. In addition, deferred rent includes construction allowances received from landlords, which are amortized on a straight-line basis over the initial lease term.

Preopening Costs--Store preopening costs are charged to expense as incurred.

Long-lived Assets--The Company periodically reviews its long-lived assets for impairment to determine whether any events or circumstances indicate that the carrying amount of the assets may not be recoverable. Such review includes estimating expected future cash flows. No impairment loss provisions have been required to date.

Net Income Per Share--Basic income per share is computed as net income divided by the weighted average number of common shares outstanding during the period. Diluted income per share reflects the potential dilution that could occur from the exercise of outstanding stock options and is computed by dividing net income by the weighted average number of common shares outstanding for the period plus the dilutive effect of outstanding stock options.

Comprehensive Income is equal to net income.

Stock-Based Compensation--The Company accounts for its stock option plans in accordance with Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" and its related interpretations. Accordingly, no compensation expense has been recognized in the financial statements for stock option arrangements.

Recently Issued Accounting Standards--SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," was issued in June 1998 and amended by SFAS Nos. 137 and 138, issued in June 2000. The standard establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts and for hedging activities. Under the standard, certain contracts that were not formerly considered derivatives may now meet the definition of a derivative. The Company adopted the standard effective December 31, 2000. The adoption of SFAS No. 133, as amended by SFAS Nos. 137 and 138, did not have a material impact on the financial position or results of operations of the Company.

In June 2001, the Financial Accounting Standards Board (FASB) issued SFAS No. 141, "Business Combinations" and SFAS No. 142, "Goodwill and Other Intangible Assets." SFAS No. 141 requires that all business combinations initiated after June 30, 2001 be accounted for under the purchase method and addresses the initial recognition and measurement of goodwill and other intangible assets acquired in a business combination. SFAS No. 142 addresses the initial recognition and measurement of intangible assets acquired outside of a business combination and the accounting for goodwill and other intangible assets subsequent to their acquisition. SFAS No. 142 provides that intangible assets with finite useful lives be amortized and that goodwill and intangible assets with indefinite lives will not be amortized, but will rather be tested at least annually for impairment. SFAS No. 142 is effective for the Company beginning December 30, 2001. Adoption of this new standard will not have a significant impact on the Company's financial statements.

In June 2001, the FASB issued SFAS No. 143, "Accounting for Asset Retirement Obligations," and in October 2001 issued SFAS No. 144, "Accounting for the Impairment of Disposal of Long-Lived Assets." These Statements will be effective for the Company's fiscal year 2003. The Company has not determined the impact, if any, that these Statements will have on its consolidated financial statements.

3. FINANCING AGREEMENTS

On February 27, 2001, the Company and its lender entered into a new loan agreement for a revolving line of credit up to $20.0 million, including a $5.0 million sublimit for the issuance of letters of credit, with an original maturity date of June 1, 2002. The new agreement adjusted certain economic terms and financial covenants. Borrowings are based upon eligible inventory. Borrowings under the credit facility are secured by the Company's accounts receivable, general intangibles, inventory and other rights to payment. The agreement prohibits the declaration and payment of cash or stock dividends. The agreement contains various restrictive and financial covenants including minimum EBITDA as determined on a rolling four quarters basis and minimum quarterly pre tax profit and minimum net income. On June 1, 2001 the credit agreement was amended to extend the maturity date of the line of credit to June 1, 2003. On September 1, 2001 the credit agreement was amended to lower the EBITDA requirement for the third and fourth quarters of 2001. On March 1, 2002 the credit agreement was amended to lower the EBITDA requirements for 2002 and to lower the pretax profit requirement for the first quarter of 2002.

Interest on outstanding borrowings is at the bank's floating prime rate or LIBOR plus from 1.3% to 1.8%, depending on the Company's achievement of certain financial ratios. The weighted average interest rate on outstanding borrowings at December 29, 2001 was 3.37%. As of December 29, 2001, the unused and available portion of the credit facility was approximately $10.9 million.

4. COMMITMENTS AND CONTINGENCIES

Leases--The Company is obligated under operating leases for store and warehouse locations and equipment. While most of the agreements provide for minimum lease payments and include rent escalation clauses, certain of the store leases provide for additional rentals contingent upon prescribed sales volumes. Additionally, the Company is required to pay common area maintenance and other costs associated with the centers in which the stores operate. Most of the leases provide for renewal at the option of the Company.

The Company's assets under capital leases as of December 29, 2001 and December 30, 2000 are as follows:

	December 29, 2001	December 30, 2000
Total assets under capital leases................	$105,995	$105,995
Less accumulated amortization....................	59,838	47,417
	$ 46,157	$ 58,578

SHOE PAVILION, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS--(Continued)

Future minimum lease payments required are as follows:

	Capital Leases	Operating Leases
Year ending:		
2002..	$48,050	$10,286,292
2003..		8,793,002
2004..		7,165,670
2005..		5,341,551
2006..		4,106,229
Thereafter..............................		7,630,745
Total minimum lease payments....................	48,050	$43,323,489
Less amounts representing interest..............	1,291	
Present value of capital lease obligations.......	46,759	

Less current portion............................	46,759
Total long-term portion.........................	$ 0

Rental expense for the years ended December 29, 2001, December 30, 2000 and January 1, 2000 was $11,723,231, $11,395,249 and $9,361,284, respectively, including contingent rentals of $1,590,724, $1,584,793 and $821,863, respectively.

Letters of Credit--The Company has obtained letters of credit in connection with overseas purchase arrangements. The total amount outstanding was $383,936 as of December 29, 2001. The Company also has a standby letter of credit relating to a rental agreement of $14,667 as of December 29, 2001.

Contingencies--The Company is party to various legal proceedings arising from normal business activities. Management believes that the resolution of these matters will not have an adverse material effect on the Company's financial position or results of operations.

5. INCOME TAXES

The provision for income taxes consisted of the following:

	December 29, 2001	December 30, 2000	January 1, 2000
Current:			
Federal...............	$791,576	$1,003,195	$1,535,150
State.................	159,623	242,149	361,316
Total current.....	951,199	1,245,344	1,896,466
Deferred.................	(55,779)	(466,840)	(662,620)
Total provision..........	$895,420	$ 778,504	$1,233,846

SHOE PAVILION, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS--(Continued)

A reconciliation of the statutory federal income tax rate with the Company's effective tax rate is as follows:

	December 29, 2001	December 30, 2000	January 1, 2000

Statutory federal rate	34.0%	34.0%	34.0%
State income taxes, net of federal income tax benefit	5.8	5.7	4.6
State tax credits	(1.9)	0.0	0.0
Other	0.1	0.2	(0.6)
Effective tax rate	38.0%	39.9%	38.0%

The components of deferred tax assets (liabilities) are as follows:

	December 29, 2001	December 30, 2000
Current:		
Uniform capitalization of inventory costs	$ 649,635	$ 662,112
Accrued vacation	111,865	83,724
Inventory reserves	227,415	98,539
Prepaid expenses	(19,379)	(4,015)
State taxes	(163,922)	(112,904)
Other	27,731	0
Current, net	833,345	727,456
Non-Current:		
Difference in basis of fixed assets	207,217	229,220
Deferred rent and tenant improvements	630,123	658,230
Total non-current	837,340	887,450
Net deferred tax asset	$1,670,685	$1,614,906

6. STOCKHOLDERS' EQUITY

Stock Options--In January 1998, the Company adopted the 1998 Equity Incentive Plan (the "1998 Plan") authorizing the issuance of 1,000,000 shares of common stock to key employees and consultants of the Company. The 1998 Plan provides for awards of incentive stock options and nonqualified stock option grants to purchase common stock at prices equal to fair market value at the date of grant. During 2001, the Company granted options under this plan for the purchase of 25,000 shares of common stock at an exercise price of $1.04 per share, the fair market value of the shares at the date of grant. Such options vest 25% each year, beginning on each anniversary date from the date of grant and expire ten years from that date. At December 29, 2001, 748,000 options were available for grants and 114,334 options were exercisable.

Directors' Stock Options--In January 1998, the Company adopted the Directors' Stock Option Plan (the "Directors' Plan") authorizing the issuance of 100,000 shares of common stock to non-employee directors of the Company. The Directors' Plan provides for awards of nonqualified stock options to purchase common stock at prices equal to fair market value at the date of grant. During 2001, the Company granted options under this plan for the purchase of 12,500 shares of common stock at an exercise price of $1.22 per share, the fair market value of the shares at the date of grant. Such options vest 100% one year from grant date and expire six years from that date. At December 29, 2001, 62,500

options were available for grant and 25,000 options were exercisable.

SHOE PAVILION, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS--(Continued)

The following tables summarize information about the stock options under both plans outstanding at December 29, 2001:

	Number of shares	Weighted Average Exercise price
Balance at January 2, 1999..	308,000	$6.91
Options granted..........	86,000	4.36
Options canceled.........	(82,750)	6.67
Balance at January 1, 2000..	311,250	6.27
Options granted..........	170,500	1.91
Options canceled.........	(186,000)	4.64
Balance at December 30, 2000	295,750	4.78
Options granted..........	37,500	1.10
Options canceled.........	(43,750)	5.73
Balance at December 29, 2001	289,500	$4.16

Weighted average fair value of options granted during 2001, 2000 and 1999 were $0.99, $1.61 and $4.35, respectively.

Range of Exercise Prices	Number Outstanding at December 29, 2001	Weighted Average Remaining Contractual Life (in years)	Weighted Average Exercise Price	Number Exerciseable at December 29, 2001	Weighted Average Exercise Price
$1.04-$1.94....	155,500	8.25	$1.72	39,084	$1.91
$5.00-$6.75....	15,500	5.89	6.13	10,250	5.85
$7.00-$10.25...	118,500	5.66	7.11	90,000	7.09
$1.04-$10.25...	289,500	7.06	$4.16	139,334	$5.54

SFAS No. 123, "Accounting for Stock-Based Compensation," requires the disclosure of pro forma net income and net income per share as though the Company had adopted the fair value method as of the beginning of 1995. Under SFAS No. 123, the fair value of stock-based awards to employees is calculated through the use of option pricing models, even though such models were developed to estimate the fair value of freely tradable, fully transferable

options without vesting restrictions, which significantly differ from the Company's stock option awards. These models also require subjective assumptions, including future stock price volatility and expected time to exercise, which greatly affect the calculated values. The Company's calculations were made using the Black-Scholes option pricing model with the following weighted average assumptions and forfeitures being recognized as they occur.

	Year Ended December 29, 2001	Year Ended December 30, 2000	Year Ended January 1, 2000
Expected life in years following vesting	7.3 years	9.2 years	9.2 years
Stock price volatility..................	124.08%	94.70%	87.01%
Risk free interest rate.................	4.8%	6.0%	6.0%
Dividends during term...................	None	None	None

SHOE PAVILION, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS--(Continued)

If the computed fair values of all awards had been amortized over the vesting period of the awards, net income would have been reduced to the pro forma amounts indicated below.

	Year Ended December 29, 2001	Year Ended December 30, 2000	Year Ended January 1, 2000
Net Income:			
As reported...............	$1,461,167	$1,174,083	$2,014,615
Pro forma.................	$1,382,175	$1,152,053	$1,787,608
Net Income per share:			
As reported:			
Basic and diluted.....	$ 0.21	$ 0.17	$ 0.30
Pro forma:			
Basic and diluted.....	$ 0.20	$ 0.17	$ 0.26

7. EMPLOYEE BENEFIT PLAN

The Company maintains a 401(k) Savings Plan (the "Plan"). Employees become eligible to participate in the Plan after completing one year of service and attainment of the age 21. Generally, employees may contribute up to 15% of their compensation or a maximum of $10,500 in accordance with IRC Sections 402(g), 401(k) and 415. For every dollar contributed to the Plan, the Company will match 50 cents, up to a maximum of 3% of the employee's compensation. The Company expensed $18,794, $27,130 and $21,911 for the years ended December 29, 2001, December 30, 2000 and January 1, 2000, respectively. The Company's contributions vest over a five-year period.

8. QUARTERLY FINANCIAL DATA (UNAUDITED)

	Sales	Gross Profit	Net Income (loss)	Net Income (loss) Per Share Basic	Net Income (loss) Per Share Diluted
	(In thousands, except per share data)				
2001 Quarters					
4th Quarter.	$23,864	$7,532	$ 315	$ 0.05	$ 0.05
3rd Quarter.	21,304	6,418	229	0.03	0.03
2nd Quarter.	23,604	7,844	946	0.14	0.14
1st Quarter.	19,363	5,655	(29)	0.00	0.00
2000 Quarters					
4th Quarter.	$23,637	$7,137	$ (590)	$(0.09)	$(0.09)
3rd Quarter.	23,148	7,621	389	0.06	0.06
2nd Quarter.	24,951	8,551	1,146	0.17	0.17
1st Quarter.	19,322	6,087	229	0.03	0.03

Item 9--Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

None.

PART III

Item 10--Directors and Executive Officers of the Registrant

The information required by this item is incorporated by reference from the Company's Definitive Proxy Statement for the Company's 2001 Annual Meeting of Stockholders under the captions "Election of Directors" and "Section 16(a) Beneficial Ownership Reporting Compliance." See also Item 1 above.

Item 11--Executive Compensation

The information required by this item is incorporated by reference from the Company's Definitive Proxy Statement for the Company's 2001 Annual Meeting of Stockholders under the caption "Executive Compensation."

Item 12--Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

The information required by this item is incorporated by reference from the Company's Definitive Proxy Statement for the Company's 2001 Annual Meeting of Stockholders under the caption "Ownership of Management and Principal Stockholders."

Item 13--Certain Relationships and Related Transactions

The information required by this item is incorporated by reference from the Company's Definitive Proxy Statement for the Company's 2001 Annual Meeting of Stockholders under the captions "Compensation Committee Interlocks and Insider Participation" and "Transactions with the Company."

PART IV

Item 14--Exhibits, Financial Statement Schedules and Reports on Form 8-K

(a) The following documents are filed as part of this report:

(1) Consolidated Financial Statements of the Company are included in Part II, Item 8:

Independent Auditors' Report

Consolidated Balance Sheets

Consolidated Statements of Income

Consolidated Statements of Cash Flows

Consolidated Statements of Shareholders' Equity

Notes to Consolidated Financial Statements

(2) Consolidated Supplementary Financial Statement Schedule for the years ended December 29, 2001 and December 30, 2000:

None.

All other schedules are omitted because of the absence of conditions under which they are required or because the required information is included in the consolidated financial statements or notes thereto.

(3) Exhibits:

See attached Exhibit Index.

(b) Reports on Form 8-K

(1) No reports on Form 8-K were filed during the quarter ended December 29, 2001.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Date: March 27, 2002

SHOE PAVILION, INC.

By: /s/ DMITRY BEINUS

Dmitry Beinus
Chairman of the Board, President and
Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities indicated.

Signature	Capacity	Date
/s/ DMITRY BEINUS Dmitry Beinus	Chairman, President and Chief Executive Officer (Principal Executive Officer)	March 27, 2002
/s/ JOHN D. HELLMANN John D. Hellmann	Vice President, Chief Financial Officer (Principal Financial Officer and Principal Accounting Officer)	March 27, 2002
/s/ DENISE ELLWOOD Denise Ellwood	Director	March 27, 2002
/s/ DAVID H. FOLKMAN David H. Folkman	Director	March 27, 2002
/s/ PETER G. HANELT Peter G. Hanelt	Director	March 27, 2002

36

EXHIBIT INDEX

Set forth below is a list of exhibits that are being filed or incorporated by reference into this Form 10-K:

Exhibit Number	Exhibit
2.1	Exchange Agreement dated February 23, 1998 by and among Shoe Pavilion, Inc., Shoe Inn, In Dmitry Beinus (Incorporated by reference from Exhibit 2.1 to Registration Statement No. 333-41877).
3.1	Certificate of Incorporation of the Registrant (Incorporated by reference from Exhibit 3. Registration Statement No. 333-41877).
3.2	Bylaws of the Registrant (Incorporated by reference from Exhibit 3.2 to Registration Stat No. 333-41877).
4.1	Specimen Common Stock Certificate (Incorporated by reference from Exhibit 4.1 to Registra Statement No. 33-41877).
10.1	Lease Agreement between Lincoln-Whitehall Pacific, LLC and Shoe Inn, Inc. dated October 2 1996 (Incorporated by reference from Exhibit 10.1 to Registration Statement No. 333-418

10.2 First Amendment to Lease Agreement between Lincoln-Whitehall Pacific, LLC and Shoe Pavili Corporation dated September 17, 1998. (Incorporated by reference from Exhibit 10.2 to t Company's 10-K filed March 23, 1999.)

10.3 Second Amendment to Lease Agreement between Lincoln-Whitehall Pacific, LLC and Shoe Pavil Corporation dated January 11, 1999. (Incorporated by reference from Exhibit 10.3 to the Company's 10-K filed March 23, 1999.)

10.4 1998 Equity Incentive Plan with forms of non-qualified and incentive stock option agreeme (Incorporated by reference from Exhibit 10.2 to Registration Statement No. 333-41877).

10.5 Directors' Stock Option Plan with form of stock option agreement (Incorporated by referen Exhibit 10.3 to Registration Statement No. 333-41877).

10.6 Credit Agreement dated December 1, 1998 between Shoe Pavilion Corporation and Wells Fargo Bank, National Association. (Incorporated by reference from Exhibit 10.6 to the Company filed March 23, 1999.)

10.7 Revolving Line of Credit Note dated December 1, 1998 between Shoe Pavilion Corporation an Wells Fargo Bank, National Association. (Incorporated by reference from Exhibit 10.7 to Company's 10-K filed March 23, 1999.)

10.8 Continuing Guaranty dated December 1, 1998 between Shoe Pavilion, Inc. and Wells Fargo Ba National Association. (Incorporated by reference from Exhibit 10.8 to the Company's 10- March 23, 1999.)

10.9 Tax Allocation Agreement dated February 18, 1998 between Shoe Inn, Inc. and Dmitry Beinus (Incorporated by reference from Exhibit 10.5 to Registration Statement No. 333-41877).

10.10 Agreement of Purchase and Sale dated as of April 14, 1997 among Standard Shoe Company and Shoe Inn, Inc. (Incorporated by reference from Exhibit 10.6 to Registration Statement No. 333-41877).

10.11 Form of Indemnification Agreement between the Registrant and certain of its officers and (Incorporated by reference from Exhibit 10.7 to Registration Statement No. 333-41877).

10.12 License Agreement dated July 7, 1999 between Richman Gordman 1/2 Price Stores, Inc. and S Pavilion, Inc. (Incorporated by reference from Exhibit 10.1 to the Company's 10-Q filed 1999.)

(continued on following page)

EXHIBIT INDEX--(Continued)

(continued from previous page)

Exhibit Number	Exhibit
10.13	First Amendment to License Agreement between Richman Gordman 1/2 Price Stores, Inc. and Shoe Pavilion, Inc. dated December 20, 1999. (Incorporated by reference from Exhibit 10 Company's 10-K filed March 27, 2000.)

10.14 First Amendment to Credit Agreement between Shoe Pavilion Corporation and Wells Fargo Ban
National Association dated October 30, 1999. (Incorporated by reference from Exhibit 10
Company's 10-K filed March 27, 2000.)

10.15 Second Amendment to Credit Agreement between Shoe Pavilion Corporation and Wells Fargo Ba
National Association dated February 8, 2000. (Incorporated by reference from Exhibit 10
Company's 10-K filed March 27, 2000.)

10.16 Third Amendment to Credit Agreement between Shoe Pavilion Corporation and Wells Fargo Ban
National Association dated March 9, 2000. (Incorporated by reference from Exhibit 10.16
Company's 10-K filed March 27, 2000.)

10.17 Credit Agreement dated February 27, 2001 between Shoe Pavilion Corporation and Wells Farg
Bank, National Association. (Incorporated by reference from exhibit 10.17 to the Compan
filed March 30, 2001.)

10.18 First Amendment to Credit Agreement between Shoe Pavilion Corporation and Wells Fargo Ban
National Association dated June 1, 2001. (Incorporated by reference from exhibit 10.18
Company's 10-Q filed November 13, 2001.)

10.19 Second Amendment to Credit Agreement between Shoe Pavilion Corporation and Wells Fargo Ba
National Association dated September 1, 2001. (Incorporated by reference from exhibit 1
the Company's 10-Q filed November 13, 2001.)

10.20 Revolving Line of Credit Note dated February 27, 2001 between Shoe Pavilion Corporation a
Wells Fargo Bank, National Association

10.21 Revolving Line of Credit Note dated June 1, 2001 between Shoe Pavilion Corporation and We
Fargo Bank, National Association

10.22 Third Amendment to Credit Agreement between Shoe Pavilion Corporation and Wells Fargo Ban
National Association dated March 1, 2002.

21 List of Subsidiaries

23 Independent Auditors' Consent