

TILLY'S, INC.  
Form 10-Q  
December 09, 2014  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**Washington, DC 20549**

**FORM 10-Q**

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

**For the quarterly period ended November 1, 2014**

**OR**

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

**For the transition period from \_\_\_\_\_ to \_\_\_\_\_**

**Commission file number: 001-35535**

**TILLY S, INC.**

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

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

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

**10 Whatney**  
**Irvine, CA 92618**

**(Address of principal executive offices)**

**(949) 609-5599**

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

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer  Accelerated filer   
Non-accelerated filer  (do not check if a smaller reporting company) Smaller reporting company   
Indicate by check mark whether the registrant is a shell company (as defined in Exchange Act Rule 12b-2) Yes  No

As of December 5, 2014, the registrant had the following shares of common stock outstanding:

Class A common stock \$0.001 par value	11,503,186
Class B common stock \$0.001 par value	16,574,265



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**TILLY S, INC.**

**FORM 10-Q**

**For the Quarter Ended November 1, 2014**

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

(In thousands, except per share data)

(Unaudited)

	November 1, 2014	February 1, 2014
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 31,358	\$ 25,412
Marketable securities	29,969	34,943
Receivables	5,856	8,545
Merchandise inventories	62,196	46,266
Prepaid expenses and other current assets	12,656	11,772
Total current assets	142,035	126,938
Property and equipment, net	105,607	100,936
Other assets	5,011	4,533
Total assets	\$ 252,653	\$ 232,407
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 27,948	\$ 19,645
Deferred revenue	4,725	6,214
Accrued compensation and benefits	3,837	4,975
Accrued expenses	14,118	9,241
Current portion of deferred rent	6,098	5,395
Current portion of capital lease obligation/Related party (Note 10)	794	758
Total current liabilities	57,520	46,228
Long-term portion of deferred rent	42,574	42,756
Long-term portion of capital lease obligation/Related party (Note 10)	1,900	2,500
Total long-term liabilities	44,474	45,256
Total liabilities	101,994	91,484

## Commitments and contingencies (Note 5)

## Stockholders' equity:

Common stock (Class A), \$0.001 par value; November 1, 2014 - 100,000 shares authorized, 11,499 shares issued and outstanding; February 1, 2014 - 100,000 shares authorized, 11,361 shares issued and outstanding	11	11
Common stock (Class B), \$0.001 par value; November 1, 2014 - 35,000 shares authorized, 16,574 shares issued and outstanding; February 1, 2014 - 35,000 shares authorized, 16,642 shares issued and outstanding	17	17
Preferred stock, \$0.001 par value; November 1, 2014 and February 1, 2014 - 10,000 shares authorized, no shares issued or outstanding		
Additional paid-in capital	125,652	122,886
Retained earnings	24,967	17,997
Accumulated other comprehensive income	12	12
<b>Total stockholders' equity</b>	<b>150,659</b>	<b>140,923</b>
<b>Total liabilities and stockholders' equity</b>	<b>\$ 252,653</b>	<b>\$ 232,407</b>

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

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

(In thousands, except per share data)

(Unaudited)

	<b>Thirteen Weeks Ended</b>		<b>Thirty-Nine Weeks Ended</b>	
	<b>November 1, 2014</b>	<b>November 2, 2013</b>	<b>November 1, 2014</b>	<b>November 2, 2013</b>
Net sales	\$ 131,283	\$ 123,779	\$ 365,477	\$ 355,941
Cost of goods sold (includes buying, distribution, and occupancy costs)	90,735	85,936	258,947	248,403
Gross profit	40,548	37,843	106,530	107,538
Selling, general and administrative expenses	31,971	27,693	94,548	86,271
Operating income	8,577	10,150	11,982	21,267
Other (expense) income, net	(22)	116	(18)	20
Income before income taxes	8,555	10,266	11,964	21,287
Income tax expense	3,442	4,121	4,994	8,566
Net income	\$ 5,113	\$ 6,145	\$ 6,970	\$ 12,721
Basic earnings per share of Class A and Class B common stock	\$ 0.18	\$ 0.22	\$ 0.25	\$ 0.46
Diluted earnings per share of Class A and Class B common stock	\$ 0.18	\$ 0.22	\$ 0.25	\$ 0.45
Weighted average basic shares outstanding	28,024	27,884	28,007	27,768
Weighted average diluted shares outstanding	28,046	28,166	28,082	28,091

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

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

(In thousands)

(Unaudited)

	<b>Thirteen Weeks Ended</b>		<b>Thirty-Nine Weeks Ended</b>	
	<b>November 1, 2014</b>	<b>November 2, 2013</b>	<b>November 1, 2014</b>	<b>November 2, 2013</b>
Net income	\$ 5,113	\$ 6,145	\$ 6,970	\$ 12,721
Other comprehensive income:				
Net change in unrealized gain/loss on available-for-sale securities	13	(12)		(19)
Other comprehensive income (loss)	13	(12)		(19)
Comprehensive income	\$ 5,126	\$ 6,133	\$ 6,970	\$ 12,702

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



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

(In thousands)

(Unaudited)

	Number of Shares				Accumulated		Total
	Common Stock (Class A)	Common Stock (Class B)	Common Stock	Additional Paid-in Capital	Retained Earnings	Other Comprehensive Income	Stockholders Equity
Balance at February 1, 2014	11,361	16,642	\$ 28	\$ 122,886	\$ 17,997	\$ 12	\$ 140,923
Net income					6,970		6,970
Restricted stock	49						
Shares converted by founders	68	(68)					
Excess tax deficiencies from stock-based compensation				(125)			(125)
Stock-based compensation expense				2,710			2,710
Exercise of stock options	21			181			181
Net change in unrealized gain/loss on available-for-sale securities							
Balance at November 1, 2014	11,499	16,574	\$ 28	\$ 125,652	\$ 24,967	\$ 12	\$ 150,659

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

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

(In thousands)

(Unaudited)

	<b>Thirty-Nine Weeks Ended</b>	
	<b>November 1, 2014</b>	<b>November 2, 2013</b>
<b>Cash flows from operating activities</b>		
Net income	\$ 6,970	\$ 12,721
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	15,630	14,470
Loss on disposal of assets	79	133
Gain on sales and maturities of marketable securities	(86)	(161)
Deferred income taxes	598	351
Stock-based compensation expense	2,710	2,373
Excess tax benefit from stock-based compensation		(157)
Changes in operating assets and liabilities:		
Receivables	2,689	33
Merchandise inventories	(15,930)	(9,783)
Prepaid expenses and other assets	(2,085)	(2,410)
Accounts payable	8,155	8,144
Accrued expenses	4,436	443
Accrued compensation and benefits	(1,138)	(2,687)
Deferred rent	521	5,121
Deferred revenue	(1,489)	(1,335)
<b>Net cash provided by operating activities</b>	<b>21,060</b>	<b>27,256</b>
<b>Cash flows from investing activities</b>		
Purchase of property and equipment	(19,806)	(36,015)
Proceeds from sale of property and equipment	14	21
Purchases of marketable securities	(34,939)	(29,935)
Maturities of marketable securities	40,000	40,000
<b>Net cash used in investing activities</b>	<b>(14,731)</b>	<b>(25,929)</b>
<b>Cash flows from financing activities</b>		
Payment of capital lease obligation	(564)	(530)
Proceeds from exercise of stock options	181	3,025
Tax withholding payments related to exercise of stock options		(636)
Excess tax benefit from stock-based compensation		157

Net cash (used in) provided by financing activities	(383)	2,016
Change in cash and cash equivalents	5,946	3,343
Cash and cash equivalents, beginning of period	25,412	17,314
Cash and cash equivalents, end of period	\$ 31,358	\$ 20,657
<b>Supplemental disclosures of cash flow information</b>		
Interest paid	\$ 141	\$ 194
Income taxes paid	\$ 624	\$ 8,025
<b>Supplemental disclosure of non-cash activities</b>		
Unpaid purchases of property and equipment	\$ 2,937	\$ 3,708

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

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**TILLY'S, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

(Unaudited)

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

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

Tilly's operates a chain of specialty retail stores featuring casual clothing, footwear and accessories for teens and young adults. The Company operated a total of 207 and 195 stores as of November 1, 2014 and February 1, 2014, respectively. The stores are located in malls, lifestyle centers, power centers, community centers, outlet centers and street-front locations. Customers may also shop online, where the Company features a similar assortment of product as is carried in its brick-and-mortar stores.

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

In the opinion of management, the accompanying unaudited consolidated financial statements contain all normal and recurring adjustments necessary to present fairly the financial condition, results of operations and cash flows of the Company for the interim periods presented. The results of operations for the thirteen and thirty-nine weeks ended November 1, 2014 and November 2, 2013 are not necessarily indicative of results to be expected for the full fiscal year. These interim consolidated financial statements should be read in conjunction with the consolidated financial statements and notes included in the Company's Annual Report on Form 10-K for the fiscal year ended February 1, 2014.

***Fiscal Periods***

The Company's fiscal year ends on the Saturday closest to January 31. References to the fiscal quarters ended November 1, 2014 and November 2, 2013 refer to the thirteen-week periods ended as of those dates.

***Correction to the Consolidated Statement of Income***

The Company identified a prior period error related to the classification of stock-based compensation. Accordingly, the Company has corrected the accompanying consolidated statement of income for the thirteen and thirty-nine weeks ended November 2, 2013. The Company identified \$0.3 million and \$1.0 million of stock-based compensation for the thirteen and thirty-nine weeks ended November 2, 2013, respectively, previously included in selling, general and

administrative expenses that should have been presented as a component of cost of goods sold. The error had no impact on the amounts previously reported in the Company's consolidated balance sheet and statement of comprehensive income, and had no impact on net income. Management has evaluated the materiality of the error quantitatively and qualitatively and has concluded that the correction of this error is immaterial to the consolidated statement of income and the consolidated financial statements as a whole.

**Table of Contents****2. Summary of Significant Accounting Policies**

Information regarding significant accounting policies is contained in Note 2, Summary of Significant Accounting Policies, of the consolidated financial statements in the Company's Annual Report on Form 10-K for the fiscal year ended February 1, 2014.

**3. Marketable Securities**

Marketable securities are classified as available-for-sale and, as of November 1, 2014 and February 1, 2014, consisted entirely of commercial paper, all of which was less than one year from maturity.

The following table summarizes the Company's investments in marketable securities at November 1, 2014 and February 1, 2014 (in thousands):

		<b>November 1, 2014</b>		
	<b>Cost</b>	<b>Gross Unrealized Holding Gains</b>	<b>Gross Unrealized Holding Losses</b>	<b>Fair Value</b>
Commercial paper	\$ 29,948	\$ 21	\$	\$ 29,969

		<b>February 1, 2014</b>		
	<b>Cost</b>	<b>Gross Unrealized Holding Gains</b>	<b>Gross Unrealized Holding Losses</b>	<b>Fair Value</b>
Commercial paper	\$ 34,923	\$ 23	\$ (3)	\$ 34,943

For the thirteen and thirty-nine weeks ended November 1, 2014, the Company recognized gains on investments of \$9 thousand and \$86 thousand, respectively, for commercial paper which matured during the period. Upon recognition of the gains, the Company reclassified these amounts out of accumulated other comprehensive income and into other (expense) income, net on the consolidated statements of income.

**4. Line of Credit**

On May 3, 2012, the Company entered into an amended and restated credit agreement with Wells Fargo Bank, N.A., which the Company amended on March 17, 2014 to extend the maturity date, reduce the borrowing rate, eliminate a fee of 0.10% on the average daily unused amount on the line of credit, eliminate certain financial covenants related to current liabilities, funded debt and net profits, and add certain new covenants relating to total net losses and maximum balance sheet leverage. The amended credit facility, which was effective as of February 3, 2014, continues to provide for a \$25.0 million revolving line of credit, with a maturity date of May 31, 2017. The interest charged on borrowings is either at the London Interbank Offered Rate, or LIBOR, plus 1.00%, or at the bank's prime rate. The Company has the ability to select between the prime rate or LIBOR-based rate at the time of a cash advance. The revolving credit facility is secured by substantially all of the Company's assets. As a sub-feature under the revolving credit facility, Wells Fargo may issue stand-by and commercial letters of credit up to \$15.0 million.

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

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As of November 1, 2014, the Company was in compliance with all of its covenants and had no outstanding borrowings under the revolving credit facility.

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

From time to time, the Company may become involved in lawsuits and other claims arising from our ordinary course of business. Management is currently unable to predict the ultimate outcome of any litigation or claim, determine whether a liability has been incurred or make an estimate of the reasonably possible liability that could result from an unfavorable outcome because of the uncertainties related to the incurrence, amount and range of loss on any pending litigation or claim. Because of the unpredictable nature of these matters, the Company cannot provide any assurances regarding the outcome of any litigation or claim to which it is a party or that the ultimate outcome of any of the matters threatened or pending against it, including those disclosed below, will not have a material adverse effect on the Company's financial condition, results of operations or cash flows. See Risk Factors in the company's Annual Report on Form 10-K for the fiscal year ended February 1, 2014 for important factors that could adversely impact us and our results of operations.

*Kristin Christiansen, Shellie Smith and Paul Haug, on behalf of themselves and all others similarly situated vs. World of Jeans & Tops, Superior Court of California, County of Sacramento, Case No. 34-2013-00139010.* On January 29, 2013, the plaintiffs in this matter filed a putative class action lawsuit against the Company alleging violations of California Civil Code Section 1747.08, which prohibits requesting or requiring personal identification information from a customer paying for goods with a credit card and recording such information, subject to exceptions. In June 2013, the Court granted the Company's motion to strike portions of the plaintiffs' complaint and granted plaintiffs leave to amend. Plaintiffs have amended the complaint and the parties are proceeding with discovery on class certification issues. A tentative class certification briefing schedule has been set for the first half of 2015. The complaint seeks certification of a class, unspecified damages, injunctive relief and attorneys' fees. The Company intends to defend this case vigorously.

*Maria Rebolledo, individually and on behalf of all others similarly situated and on behalf of the general public vs. Tilly's, Inc.; World of Jeans & Tops, Superior Court of the State of California, County of Orange, Case No. 30-2012-00616290-CU-OE-CXC.* On December 5, 2012, the plaintiff in this matter filed a putative class action lawsuit against the Company alleging violations of California's wage and hour, meal break and rest break rules and regulations, and unfair competition law, among other things. An amended complaint was filed on February 28, 2013, to include enforcement of California's private attorney general act. The complaint seeks an unspecified amount of damages and penalties. In April 2013, the Company filed a motion to compel arbitration, which was denied in May 2013 and affirmed on appeal. In October 2014, the Company filed an answer to the amended complaint. The Company intends to defend this case vigorously.

*Karina Whitten, on behalf of herself and all others similarly situated, v. Tilly's Inc., Superior Court of California, County of Los Angeles, Case No, BC 548252.* On June 10, 2014, plaintiff filed a putative class action and representative Private Attorney General Act lawsuit against the Company alleging violations of California's wage and hour, meal break and rest break rules and regulations, and unfair competition law, among other things. The complaint seeks class certification, penalties, restitution, injunctive relief and attorneys' fees and costs. The case is currently stayed pending a further case management conference on December 9, 2014. The Company intends to defend the case vigorously.





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

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

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

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

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

During the thirteen and thirty-nine weeks ended November 1, 2014 and November 2, 2013, the Company did not make any transfers between Level 1 and Level 2 financial assets. Furthermore, as of November 1, 2014 and February 1, 2014, the Company did not have any Level 3 financial assets. The Company conducts reviews on a quarterly basis to verify pricing, assess liquidity, and determine if significant inputs have changed that would impact the fair value hierarchy disclosure.

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

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

	November 1, 2014			February 1, 2014		
	Level 1	Level 2	Level 3	Level 1	Level 2	Level 3
Cash equivalents:						
Money market securities	\$ 28,378	\$	\$	\$ 25,316	\$	\$
Marketable securities:						

Commercial paper	29,969	34,943
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**7. Stock-Based Compensation**

On March 24, 2014, the Company granted stock options to purchase a total of 812,500 shares of Class A common stock under the Tilly's 2012 Equity and Incentive Award Plan, or the 2012 Plan. The exercise price of these awards is \$12.31, which was the closing price of Tilly's Class A common stock on the date of grant. During the thirty-nine weeks ended November 1, 2014, the Company also granted options to purchase a total of 20,000 shares of Class A common stock under the 2012 Plan to certain employees. The weighted average exercise price of these awards is \$8.08 per share, and was set equal to the closing price of Tilly's Class A common stock on the dates

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of grant. The stock options granted in fiscal year 2014 vest in four equal annual installments beginning on the first anniversary of the date of grant, provided that the award recipient continues to be employed by the Company through each of those vesting dates.

The total grant date fair value of stock options granted during the thirteen and thirty-nine weeks ended November 1, 2014 was \$32 thousand and \$4.3 million, respectively, before applying an estimated forfeiture rate. The Company is recognizing the expense relating to these stock options, net of estimated forfeitures, on a straight-line basis over the four year service period of the awards.

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

The fair value of stock options granted during the thirteen and thirty-nine weeks ended November 1, 2014 and November 2, 2013 was estimated on the grant date using the following assumptions:

	<b>Thirteen Weeks Ended November 1, 2014</b>	<b>Thirteen Weeks Ended November 2, 2013</b>	<b>Thirty-Nine Weeks Ended November 1, 2014</b>	<b>Thirty-Nine Weeks Ended November 2, 2013</b>
Expected option term(1)	5.0 years	5.0 years	5.0 years	5.0 years
Expected volatility factor(2)	44.4% - 44.6%	55.0%	44.4% - 46.9%	55.0% - 56.2%
Risk-free interest rate(3)	1.7% - 1.8%	1.7%	1.6% - 1.8%	0.8% - 1.7%
Expected annual dividend yield	0%	0%	0%	0%

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

The following table summarizes the Company's stock option activity for the thirty-nine weeks ended November 1, 2014 (aggregate intrinsic value in thousands):

<b>Stock Options</b>	<b>Grant Date Weighted Average</b>	<b>Weighted Average Remaining</b>	<b>Aggregate Intrinsic Value(1)</b>
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		<b>Exercise Price</b>	<b>Contractual Life (in Years)</b>	
Outstanding at February 1, 2014	2,356,790	\$ 13.31		
Granted	832,500	12.21		
Exercised	(21,750)	8.34		
Forfeited	(200,000)	13.87		
Outstanding at November 1, 2014	2,967,540	\$ 13.00	7.2	\$ 85
Vested and expected to vest at November 1, 2014	2,848,391	\$ 13.00	7.2	\$ 85
Exercisable at November 1, 2014	1,349,540	\$ 12.58	5.6	\$ 85

- (1) Intrinsic value for stock options is defined as the difference between the market price of the Company's Class A common stock on the last business day of the fiscal quarter and the weighted average exercise price of in-the-money stock options outstanding at the end of each fiscal period. The market value per share was \$7.12 at October 31, 2014.

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On June 11, 2014, the Company granted 9,674 restricted shares of Class A common stock to each of its four independent directors under the 2012 Plan. These shares vest in two equal annual installments beginning on June 11, 2015, provided that the respective award recipient continues to serve on the Company's board of directors through each of those vesting dates. The grant date fair value of these awards totaled \$0.3 million. The Company is recognizing the expense related to these awards on a straight-line basis over the two-year service period commencing on the grant date.

On June 11, 2014, the Company's stockholders approved the Amended and Restated Tilly's 2012 Equity and Incentive Award Plan, or the Amended Plan, which increases the aggregate number of shares reserved for issuance thereunder by 1,500,000 shares, from 2,913,900 shares to a total of 4,413,900 shares, of which 2,366,351 shares were still available for issuance as of November 1, 2014. The Company recorded a total of \$0.8 million and \$2.7 million of stock-based compensation expense in the thirteen and thirty-nine weeks ended November 1, 2014, respectively. At November 1, 2014, there was \$7.8 million of total unrecognized stock-based compensation expense related to unvested stock options and restricted stock grants. This cost has a weighted average remaining recognition period of 2.5 years.

**8. Income Taxes**

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

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

The Company's effective income tax rate for the thirteen and thirty-nine weeks ended November 1, 2014, was 40.2% and 41.7%, respectively. The higher effective income tax rate for the thirty-nine weeks ended November 1, 2014, reflects the write-off of deferred tax assets related to the forfeiture of vested stock options in the first three quarters of fiscal 2014, which represent discrete items.

The Company's fiscal 2012 income tax return is currently under examination by the Internal Revenue Service. The Company does not expect that the results of the examination will have a material impact on its financial condition or statement of operations in fiscal 2014.

**9. Earnings Per Share**

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



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	Thirteen Weeks Ended		Thirty-Nine Weeks Ended	
	November 1, 2014	November 2, 2013	November 1, 2014	November 2, 2013
Net income	\$ 5,113	\$ 6,145	\$ 6,970	\$ 12,721
Weighted average basic shares outstanding	28,024	27,884	28,007	27,768
Dilutive effect of stock options and restricted stock	22	282	75	323
Weighted average shares for diluted earnings per share	28,046	28,166	28,082	28,091
Basic earnings per share	\$ 0.18	\$ 0.22	\$ 0.25	\$ 0.46
Diluted earnings per share	\$ 0.18	\$ 0.22	\$ 0.25	\$ 0.45

**10. Related Parties**

The Company leases its corporate headquarters and distribution center (10 and 12 Whatney, Irvine, California) from a company that is owned by the co-founders of Tilly's. On June 29, 2012, the Company exercised the first of its three five-year renewal options on this lease, with the renewal commencing on January 1, 2013. The lease now expires on December 31, 2017. The land component of this lease is accounted for as an operating lease and the building component is accounted for as a capital lease. The Company incurred rent expense of \$0.2 million for both of the thirteen weeks ended November 1, 2014 and November 2, 2013 and \$0.7 million for both of the thirty-nine weeks ended November 1, 2014 and November 2, 2013 for the operating component of this lease. The initial obligation at inception under the capital lease was \$9.2 million, with an outstanding balance of \$2.7 million and \$3.3 million as of November 1, 2014 and February 1, 2014, respectively. The gross amount of the building under capital lease was \$7.8 million as of both November 1, 2014 and February 1, 2014. The gross amount of accumulated depreciation of the building under capital lease was \$6.2 million and \$5.8 million as of November 1, 2014 and February 1, 2014, respectively.

During the thirteen and thirty-nine weeks ended November 1, 2014, the Company leased warehouse space (15 Chrysler, Irvine, California) from a company that is owned by one of the co-founders of Tilly's. The lease was originally set to expire on October 31, 2014; however, the Company and the landlord agreed to terminate the lease as of September 30, 2014. This lease was accounted for as an operating lease and the Company incurred rent expense of \$32 thousand and \$0.1 million for the thirteen weeks ended November 1, 2014 and November 2, 2013, respectively, and \$0.1 million and \$0.2 million for the thirty-nine weeks ended November 1, 2014 and November 2, 2013, respectively. As of September 30, 2014, in connection with the termination of this lease, the Company also terminated its sublease of part of the premises to an unrelated third party.

The Company leases office and warehouse space (11 Whatney, Irvine, California) from a company that is owned by one of the co-founders of Tilly's. The lease expires on June 30, 2022 and is being accounted for as an operating lease. The Company occupied the building on June 29, 2012 and incurred rent expense of \$0.1 million for both of the thirteen weeks ended November 1, 2014 and November 2, 2013 and \$0.3 million for both of the thirty-nine weeks ended November 1, 2014 and November 2, 2013.

The Company leases a building (17 Pasteur, Irvine, California) from a company that is owned by one of the co-founders of Tilly's. The lease terminates on October 31, 2021 and is being accounted for as an operating lease. The



Company uses this building as its e-commerce distribution center. Pursuant to the lease agreement, the Company requested during fiscal year 2012 that the landlord expand the building. Upon commencement of the building expansion, the Company returned the building to the landlord. As of February 2, 2013, the landlord returned the expanded building to the Company and monthly lease payments re-commenced by the Company in February 2013. The Company incurred rent expense of \$0.3 million for both of the thirteen weeks ended November 1, 2014 and November 2, 2013, and \$0.8 million for both of the thirty-nine weeks ended November 1, 2014 and November 2, 2013.

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

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

*The following discussion and analysis of the financial condition and results of our operations should be read together with the financial statements and related notes of Tilly's, Inc. included in Item 1 of this Quarterly Report on Form 10-Q and with our audited consolidated financial statements and the related notes included in our Annual Report on Form 10-K for the fiscal year ended February 1, 2014. As used in this Quarterly Report on Form 10-Q, except where the context otherwise requires or where otherwise indicated, the terms "company", "World of Jeans & Tops", "we", "our", "us" and "Tilly's" refer to Tilly's, Inc. and its subsidiary.*

**Cautionary Statement Regarding Forward-Looking Statements**

This Quarterly Report on Form 10-Q contains forward-looking statements that involve risks and uncertainties, as well as assumptions that, if they never materialize or prove incorrect, could cause our results to differ materially from those expressed or implied by such forward-looking statements. The statements contained in this Quarterly Report on Form 10-Q that are not purely historical are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, or the Exchange Act. Forward-looking statements are often identified by the use of words such as, but not limited to, "anticipate", "believe", "can", "continue", "could", "estimate", "expect", "intend", "may", "plan", "project", "seek", "should", "target", "will", "expressions or variations intended to identify forward-looking statements. These statements are based on the beliefs and assumptions of our management based on information currently available to management. These forward-looking statements are subject to numerous risks and uncertainties, including the risks and uncertainties described under the section titled "Risk Factors" in our Annual Report on Form 10-K for the fiscal year ended February 1, 2014, those identified in this "Management's Discussion and Analysis of Financial Condition and Results of Operations" and elsewhere in this Quarterly Report on Form 10-Q, and in other filings we may make with the Securities and Exchange Commission from time to time. Moreover, we operate in an evolving environment. New risk factors and uncertainties emerge from time to time and it is not possible for our management to predict all risk factors and uncertainties, nor can we assess the impact of all factors on our business or the extent to which any factor, or combination of factors may cause actual results to differ materially from those contained in any forward-looking statement. We qualify all of our forward-looking statements by these cautionary statements.

**Overview**

Tilly's is a fast-growing destination specialty retailer of West Coast inspired apparel, footwear and accessories. We believe we bring together an unparalleled selection of the most sought-after brands rooted in action sports, music, art and fashion. Our West Coast heritage dates back to 1982 when Hezy Shaked and Tilly Levine opened our first store in Orange County, California. As of November 1, 2014, we operated 207 stores, averaging 7,700 square feet, in 33 states. We also sell our products through our e-commerce website, [www.tillys.com](http://www.tillys.com) (the information available at our website is not incorporated by reference into this report).

Net sales increased \$7.5 million, or 6.1%, to \$131.3 million for the thirteen weeks ended November 1, 2014 from \$123.8 million for the thirteen weeks ended November 2, 2013. Operating income decreased 15%, to \$8.6 million for the thirteen weeks ended November 1, 2014 from \$10.2 million for the thirteen weeks ended November 2, 2013, primarily due to a decline in our comparable store sales and increased costs related to new stores growing at a faster rate than sales. Our comparable store sales decreased 1.2% for the thirteen weeks ended November 1, 2014, which followed a 1.9% decrease for the full fiscal year 2013 and compares to a 2.4% decrease in the third quarter of fiscal year 2013.

Since the beginning of fiscal 2009, we have more than doubled our store count from 99 stores to 207 stores as of November 1, 2014. We have added 12 net new stores in fiscal year 2014 and plan to add five additional net stores by

the end of the year. We expect to fund this store expansion through our cash on hand and cash flows from operations.

We believe our business strategy will continue to offer significant opportunity, but it also presents risks and challenges. These risks and challenges include, but are not limited to, that we may not be able to effectively identify and respond to changing fashion trends and customer preferences, that we may not be able to find desirable locations for new stores and that we may not be able to effectively manage our future growth. In addition, our financial results

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can be expected to be directly impacted by trends in the general economy. A decline in consumer spending or a substantial increase in product costs due to commodity cost increases or general inflation could lead to a reduction in our sales as well as greater margin pressure as costs may not be able to be passed on to consumers and the competitive environment could become more highly promotional. See **Risk Factors** in our Annual Report on Form 10-K for the fiscal year ended February 1, 2014 for other important factors that could adversely impact us and our results of operations.

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

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

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

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

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

#### ***Comparable Store Sales***

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

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

overall economic trends;

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

competition;

the timing of our releases of new and seasonal styles;

changes in our product mix;

pricing;

the level of customer service that we provide in stores;

our ability to source and distribute products efficiently;

calendar shifts of holiday or seasonal periods;

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

the timing and success of promotional and advertising efforts.

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

### ***Gross Profit***

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

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

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

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

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

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



**Table of Contents****Operating Income**

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

**Results of Operations**

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

	<b>Thirteen Weeks Ended</b>		<b>Thirty-Nine Weeks Ended</b>	
	<b>November 1, 2014</b>	<b>November 2, 2013 (1)</b>	<b>November 1, 2014</b>	<b>November 2, 2013 (1)</b>
	<b>(in thousands)</b>		<b>(in thousands)</b>	
<b>Statements of Income Data:</b>				
Net sales	\$ 131,283	\$ 123,779	\$ 365,477	\$ 355,941
Cost of goods sold	90,735	85,936	258,947	248,403
Gross profit	40,548	37,843	106,530	107,538
Selling, general and administrative expenses	31,971	27,693	94,548	86,271
Operating income	8,577	10,150	11,982	21,267
Other (expense) income, net	(22)	116	(18)	20
Income before income taxes	8,555	10,266	11,964	21,287
Income tax expense	3,442	4,121	4,994	8,566
Net income	\$ 5,113	\$ 6,145	\$ 6,970	\$ 12,721
<b>Percentage of Net Sales:</b>				
Net sales	100.0%	100.0%	100.0%	100.0%
Cost of goods sold	69.1%	69.4%	70.9%	69.8%
Gross profit	30.9%	30.6%	29.1%	30.2%
Selling, general and administrative expenses	24.4%	22.4%	25.9%	24.2%
Operating income	6.5%	8.2%	3.3%	6.0%
Other (expense) income, net	0.0%	0.1%	0.0%	0.0%
Income before income taxes	6.5%	8.3%	3.3%	6.0%
Income tax expense	2.6%	3.3%	1.4%	2.4%
Net income	3.9%	5.0%	1.9%	3.6%



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

	<b>Thirteen Weeks Ended</b>		<b>Thirty-Nine Weeks Ended</b>	
	<b>November 1, 2014</b>	<b>November 2, 2013</b>	<b>November 1, 2014</b>	<b>November 2, 2013</b>
<b>Store Operating Data:</b>				
Stores operating at end of period	207	189	207	189
Comparable store sales change (2)	-1.2%	-2.4%	-5.0%	-0.7%
Total square feet at end of period	1,588,707	1,472,045	1,588,707	1,472,045
Average net sales per store (in thousands) (3)	\$ 571	\$ 592	\$ 1,623	\$ 1,777
Average net sales per square foot (3)	\$ 74	\$ 76	\$ 210	\$ 227

- (1) Gross profit in the thirteen and thirty-nine weeks ended November 2, 2013 includes a \$0.3 and \$1.0 million reclassification, respectively, of stock-based compensation expense from selling, general and administrative expenses to cost of goods sold to correct for an immaterial prior period error.
- (2) Comparable store sales include sales through our e-commerce store, but exclude gift card breakage income and e-commerce shipping and handling fee revenue.
- (3) E-commerce sales, e-commerce shipping fee revenue and gift card breakage are excluded from net sales in deriving average net sales per store and average net sales per square foot.

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**Table of Contents*****Thirteen Weeks Ended November 1, 2014 Compared to Thirteen Weeks Ended November 2, 2013****Net Sales*

Net sales increased \$7.5 million, or 6.1% to \$131.3 million for the thirteen weeks ended November 1, 2014 from \$123.8 million for the thirteen weeks ended November 2, 2013. The increase was due to net sales of \$9.2 million from stores open in the third quarter of fiscal 2014 that were not open during the same period last year. This was partially offset by a comparable store net sales decrease of 1.2%, or \$1.4 million, in the thirteen weeks ended November 1, 2014 compared to the thirteen weeks ended November 2, 2013. Footwear, accessories and kids outperformed the total company comparable store sales trend, while men's and junior's underperformed the total company comparable store sales trend. There were 184 comparable brick-and-mortar stores and 23 non-comparable brick-and-mortar stores open as of November 1, 2014.

*Gross Profit*

Gross profit increased \$2.7 million, or 7%, to \$40.5 million for the thirteen weeks ended November 1, 2014 from \$37.8 million for the thirteen weeks ended November 2, 2013. As a percentage of net sales, gross profit was 30.9% and 30.6% for the thirteen weeks ended November 1, 2014 and November 2, 2013, respectively. The increase in gross profit margin was primarily due to a 30 basis point increase in product margin. Occupancy deleverage was offset primarily by favorable deferred rent credits in the quarter related to new stores and store closures.

*Selling, General and Administrative Expenses*

SG&A expenses increased \$4.3 million, or 16%, to \$32.0 million for the thirteen weeks ended November 1, 2014 from \$27.7 million for the thirteen weeks ended November 2, 2013. As a percentage of net sales, SG&A expenses were 24.4% and 22.4% for the thirteen weeks ended November 1, 2014 and November 2, 2013, respectively.

Selling expenses increased \$3.7 million, or 19%, to \$22.7 million for the thirteen weeks ended November 1, 2014 from \$19.0 million for the thirteen weeks ended November 2, 2013. As a percentage of net sales, selling expenses were 17.3% and 15.4% for the thirteen weeks ended November 1, 2014 and November 2, 2013, respectively.

The following contributed to the 1.9% increase in selling expenses as a percentage of net sales:

100 basis point impact related to increased store and field payroll, payroll benefits and related personnel costs, as these costs increased at a higher rate than net sales primarily due to the addition of new stores; and

90 basis point impact related to increased marketing costs, supplies and other store support costs, primarily due to higher catalog and other marketing spend compared to last year.

General and administrative expenses increased \$0.6 million, or 7%, to \$9.3 million for the thirteen weeks ended November 1, 2014 from \$8.7 million for the thirteen weeks ended November 2, 2013. As a percentage of net sales, general and administrative expenses were 7.1% and 7.0% for the thirteen weeks ended November 1, 2014 and November 2, 2013, respectively. The 10 basis point impact related to increased depreciation, consulting and other office expenses, as they grew at a higher rate than net sales.



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*Operating Income*

Operating income decreased \$1.6 million, or 16%, to \$8.6 million for the thirteen weeks ended November 1, 2014 from \$10.2 million for the thirteen weeks ended November 2, 2013. As a percentage of net sales, operating income was 6.5% and 8.2% for the thirteen weeks ended November 1, 2014 and November 2, 2013, respectively. The decrease in operating income as a percentage of net sales was primarily due to occupancy and SG&A costs increasing at a higher rate than net sales, as discussed above.

*Other Expense / Income, Net*

Net other expense was \$22 thousand compared to income of \$116 thousand for the thirteen weeks ended November 1, 2014 and November 2, 2013, respectively. Net other expense reflects interest expense paid on the capitalized lease of our corporate office and distribution center, partially offset by interest income earned on cash balances and on tenant construction allowances due from landlords.

*Provision for Income Tax Expense*

Income taxes were \$3.4 million and \$4.1 million for the thirteen weeks ended November 1, 2014 and November 2, 2013, respectively. This reflects effective tax rates of 40.2% and 40.1% for the thirteen weeks ended November 1, 2014 and November 2, 2013, respectively.

*Net Income*

Net income decreased \$1.0 million, or 17%, to \$5.1 million for the thirteen weeks ended November 1, 2014 from \$6.1 million for the thirteen weeks ended November 2, 2013, due to the factors discussed above.

Basic and diluted earnings per share of Class A and Class B common stock decreased 18% to \$0.18 for the thirteen weeks ended November 1, 2014 from \$0.22 for the thirteen weeks ended November 2, 2013.

***Thirty-Nine Weeks Ended November 1, 2014 Compared to Thirty-Nine Weeks Ended November 2, 2013***

*Net Sales*

Net sales increased \$9.6 million, or 2.7%, to \$365.5 million for the thirty-nine weeks ended November 1, 2014 from \$355.9 million for the thirty-nine weeks ended November 2, 2013. The increase was due to net sales of \$27.7 million from stores open in the first thirty-nine weeks of fiscal 2014 that were not open during the same period last year. This was partially offset by a comparable store net sales decrease of 5.0%, or \$17.2 million, in the thirty-nine weeks ended November 1, 2014 compared to the thirty-nine weeks ended November 2, 2013. Junior's and kid's outperformed the total company comparable store sales trend, while men's, accessories and footwear underperformed the total company comparable store sales trend. There were 184 comparable brick-and-mortar stores and 23 non-comparable brick-and-mortar stores open as of November 1, 2014.

*Gross Profit*

Gross profit decreased \$1.0 million, or 1%, to \$106.5 million for the thirty-nine weeks ended November 1, 2014 from \$107.5 million for the thirty-nine weeks ended November 2, 2013. As a percentage of net sales, gross profit was 29.1% and 30.2% for the thirty-nine weeks ended November 1, 2014 and November 2, 2013, respectively. The decrease in gross profit margin was primarily due to occupancy costs increasing at a higher rate than net sales,

partially offset by approximately 20 basis points of product margin improvement.

*Selling, General and Administrative Expenses*

SG&A expenses increased \$8.2 million, or 10%, to \$94.5 million for the thirty-nine weeks ended November 1, 2014 from \$86.3 million for the thirty-nine weeks ended November 2, 2013. As a percentage of net sales, SG&A expenses were 25.9% and 24.2% for the thirty-nine weeks ended November 1, 2014 and November 2, 2013, respectively.

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Selling expenses increased \$6.4 million, or 11%, to \$67.1 million for the thirty-nine weeks ended November 1, 2014 from \$60.7 million for the thirty-nine weeks ended November 2, 2013. As a percentage of net sales, selling expenses were 18.4% and 17.0% for the thirty-nine weeks ended November 1, 2014 and November 2, 2013, respectively.

The following contributed to the 1.4% increase in selling expenses as a percentage of net sales:

110 basis point impact related to increased store, regional and e-commerce fulfillment payroll, payroll benefits and related personnel costs, as these costs increased at a higher rate than net sales primarily due to the addition of new stores, e-commerce fulfillment labor costs being reclassified into selling expenses from general and administrative expenses; and

30 basis point impact related to increased marketing costs, supplies and other store support costs, primarily due to higher net catalog and promotional spend compared to last year.

General and administrative expenses increased \$1.8 million to \$27.4 million for the thirty-nine weeks ended November 1, 2014 from \$25.6 million for the thirty-nine weeks ended November 2, 2013. As a percentage of net sales, general and administrative expenses were 7.5% and 7.2% for the thirty-nine weeks ended November 1, 2014 and November 2, 2013, respectively. The 30 basis point impact related to increased depreciation, consulting, ongoing stock-based compensation and other office expenses.

### *Operating Income*

Operating income decreased \$9.3 million, or 44%, to \$12.0 million for the thirty-nine weeks ended November 1, 2014 from \$21.3 million for the thirty-nine weeks ended November 2, 2013. As a percentage of net sales, operating income was 3.3% and 6.0% for the thirty-nine weeks ended November 1, 2014 and November 2, 2013, respectively. The decrease in operating income as a percentage of net sales was primarily due to occupancy and SG&A costs increasing at a higher rate than net sales, as discussed above.

### *Other Expense / Income, Net*

Net other expense was \$18 thousand compared to income of \$20 thousand for the thirty-nine weeks ended November 1, 2014 and November 2, 2013, respectively. Net other expense reflects interest expense paid on the capitalized lease of our corporate office and distribution center, partially offset by interest income earned on cash balances and on tenant construction allowances due from landlords.

### *Provision for Income Tax Expense*

Income taxes were \$5.0 million and \$8.6 million for the thirty-nine weeks ended November 1, 2014 and November 2, 2013, respectively. This reflects effective tax rates of 41.7% and 40.2% for the thirty-nine weeks ended November 1, 2014 and November 2, 2013, respectively. The higher effective tax rate for the thirty-nine week period ended November 1, 2014 over the prior period reflects the write-off of deferred tax assets related to the forfeiture of certain vested stock options in the first, second and third quarters of fiscal 2014.

### *Net Income*

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Net income decreased \$5.7 million, or 45%, to \$7.0 million for the thirty-nine weeks ended November 1, 2014 from \$12.7 million for the thirty-nine weeks ended November 2, 2013, due to the factors discussed above.

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Basic earnings per share of Class A and Class B common stock decreased 46%, to \$0.25 for the thirty-nine weeks ended November 1, 2014 from \$0.46 for the thirty-nine weeks ended November 2, 2013. Diluted earnings per share of Class A and Class B common stock decreased 44%, to \$0.25 for the thirty-nine weeks ended November 1, 2014 from \$0.45 for the thirty-nine weeks ended November 2, 2013.



**Table of Contents****Liquidity and Capital Resources*****General***

Our business relies on cash flows from operating activities as well as cash on hand as our primary sources of liquidity. In addition, we have access to additional liquidity through a \$25.0 million revolving credit facility with Wells Fargo Bank, N.A. We have never drawn funds from or issued letters of credit financing from the revolving credit facility and do not expect to draw from the revolving credit facility over the next 12 months. We expect to finance company operations and store growth with existing cash on hand, marketable securities and cash flows from operations.

Historically our primary cash needs have been for merchandise inventories, payroll, store rent, capital expenditures associated with opening new stores, improvements to our distribution facilities, marketing and information technology expenditures. In addition to cash and cash equivalents, the most significant components of our working capital are merchandise inventories, accounts payable and other current liabilities. We believe that cash flows from operating activities, the availability of cash under our revolving credit facility, if necessary, and our cash and marketable securities on hand will be sufficient to cover working capital requirements and anticipated capital expenditures for the next 12 months. If cash flows from operations and borrowings under our revolving credit facility are not sufficient to meet our capital requirements, then we will be required to obtain additional equity or debt financing in the future. There can be no assurance that equity or debt financing will be available to us when we need it or, if available, that the terms will be satisfactory to us and not dilutive to our then-current stockholders.

**Cash Flow Analysis**

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

	<b>November 1, 2014</b>	<b>November 2, 2013</b>
	<b>(in thousands)</b>	
Net cash provided by operating activities	\$ 21,060	\$ 27,256
Net cash used in investing activities	(14,731)	(25,929)
Net cash (used in) provided by financing activities	(383)	2,016

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

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

We generated \$21.1 million of net cash provided by operating activities for the thirty-nine weeks ended November 1, 2014. The significant components of cash flows from operating activities were net income of \$7.0 million and the add-back of non-cash depreciation and amortization expense of \$15.6 million, non-cash stock-based compensation expense of \$2.7 million, a decrease in receivables of \$2.7 million, and the change in deferred income taxes of \$0.6 million. In addition, accounts payable and accrued expenses increased by \$12.6 million due to the timing of payments and deferred rent increased \$0.5 million due to the opening of new stores. The above was partially offset by an increase in merchandise inventories of \$15.9 million due to inventory purchases in anticipation of the upcoming holiday season and the opening of new stores, an increase in prepaid expenses and other assets of \$2.1 million, a decrease in deferred revenue of \$1.5 million due to the redemption of gift cards throughout the period, and a decrease

of \$1.1 million in accrued compensation and benefits due to the timing of payments.

We generated \$27.3 million of net cash provided by operating activities for the thirty-nine weeks ended November 2, 2013. The significant components of cash flows from operating activities were net income of \$12.7 million, the add-back of non-cash depreciation and amortization expense of \$14.5 million and non-cash stock-based compensation expense recognized during the period of \$2.4 million. In addition, accounts payable and accrued expenses increased \$8.6 million due to the timing of payments and deferred rent increased \$5.1 million due to the

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opening of new stores. The above was partially offset by an increase in merchandise inventories of \$9.8 million due to inventory purchases in anticipation of the upcoming holiday season and the opening of new stores, an increase in prepaid expenses and other assets of \$2.4 million mainly due to increases in prepaid rent resulting from the opening of new stores, a decrease in accrued compensation and benefits of \$2.7 million due to reduced bonus accruals and a decrease in deferred revenue of \$1.3 million due to the redemption of gift cards throughout the period.

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

Investing activities consist primarily of capital expenditures for growth related to new store openings as well as for remodels and changes in fixtures and equipment at existing stores, investments in information technology, distribution center enhancements, investments in assets at our corporate headquarters and the addition or replacement of company vehicles, less net proceeds from sales, maturities, and purchases of marketable securities.

Net cash used in investing activities was \$14.7 million for the thirty-nine weeks ended November 1, 2014, compared to \$25.9 million for the thirty-nine weeks ended November 2, 2013. We received proceeds of \$40.0 million from the maturities of marketable securities and purchased \$34.9 million of marketable securities during the period. Capital expenditures for the thirty-nine weeks ended November 1, 2014 totaled \$19.8 million, the majority of which related to stores and our new e-commerce fulfillment center. Spending on new stores and the remodeling or other improvements of existing stores were \$13.4 million and \$20.3 million for the thirty-nine weeks ended November 1, 2014 and November 2, 2013, respectively.

***Net Cash (Used in) Provided by Financing Activities***

Financing activities consist of payments on our capital lease obligation, proceeds from the exercise of stock options and excess tax benefits from stock-based compensation.

Net cash used in financing activities was \$0.4 for the thirty-nine weeks ended November 1, 2014, consisting of payments on our capital lease obligation totaling \$0.6 million partially offset by \$0.2 million of proceeds from the exercise of stock options. Net cash provided by financing activities was \$2.0 million for the thirty-nine weeks ended November 2, 2013. This included \$3.2 million of proceeds from the exercise of stock options and excess tax benefits from stock-based compensation; partially offset by \$1.2 million of tax payments related to employee withholdings on the exercise of stock options and payments towards our capital lease obligation during the period.

**Line of Credit**

On May 3, 2012, the Company entered into an amended and restated credit agreement with Wells Fargo Bank, N.A., which the Company amended on March 17, 2014 to extend the maturity date, reduce the borrowing rate, eliminate a fee of 0.10% on the average daily unused amount on the line of credit, eliminate certain financial covenants related to current liabilities, funded debt and net profits, and add certain new covenants relating to total net losses and maximum balance sheet leverage. The amended credit facility, which was effective as of February 3, 2014, continues to provide for a \$25.0 million revolving line of credit with a maturity date of May 31, 2017. The interest charged on borrowings is either at LIBOR plus 1.00%, or at the bank's prime rate. The Company has the ability to select between the prime rate or LIBOR-based rate at the time of a cash advance. The revolving credit facility is secured by substantially all of the Company's assets. As a sub-feature under the revolving credit facility the bank may issue stand-by and commercial letters of credit up to \$15.0 million.

The Company is required to maintain certain financial and nonfinancial covenants in accordance with the revolving credit facility. The financial covenants require certain levels of leverage and profitability, such as (i) an aggregate

maximum net loss after taxes not to exceed \$5 million (measured at the end of each fiscal quarter), with no more than one annual net loss after taxes for any fiscal year (in either case, excluding all charges for impairment of goodwill, other intangibles and store assets impairment on the balance sheet of WOJT, in an aggregate amount of up to \$2.0 million for the relevant period), and (ii) a maximum ratio of 2.00 to 1.00 for balance sheet leverage, defined as total liabilities divided by total tangible net worth.

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As of November 1, 2014, the Company was in compliance with all of its covenants and had no outstanding borrowings under the revolving credit facility.

**Contractual Obligations**

As of November 1, 2014, there were no material changes to our contractual obligations described in the Management's Discussion and Analysis of Financial Condition and Results of Operations section of our Annual Report on Form 10-K for the fiscal year ended February 1, 2014.

**Off-Balance Sheet Arrangements**

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

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**Critical Accounting Policies and Estimates**

The preparation of financial statements in accordance with accounting principles generally accepted in the U.S. requires the appropriate application of certain accounting policies, some of which require us to make estimates and assumptions about future events and their impact on amounts reported in our consolidated financial statements. Since future events and their impact cannot be determined with absolute certainty, the actual results will inevitably differ from our estimates. A summary of the Company's significant accounting policies is included in Note 2 to the consolidated financial statements of Tilly's, Inc. in the Company's Annual Report on Form 10-K for the fiscal year ended February 1, 2014.

Certain of the Company's accounting policies and estimates are considered critical, as these policies and estimates are the most important to the depiction of the Company's consolidated financial statements and require significant, difficult or complex judgments, often about the effect of matters that are inherently uncertain. Such policies are summarized in the Management's Discussion and Analysis of Financial Condition and Results of Operations section of our Annual Report on Form 10-K for the fiscal year ended February 1, 2014.

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

As of November 1, 2014, there were no material changes in the market risks described in the Quantitative and Qualitative Disclosure of Market Risks section of our Annual Report on Form 10-K for the fiscal year ended February 1, 2014.

**Item 4. Controls and Procedures**

**Evaluation of Disclosure Controls and Procedures**

Our management, with the participation of our Disclosure Committee, including our Chief Executive Officer and our Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures as of November 1, 2014. The term disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act, means controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the Company's management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure. Based on the evaluation of our disclosure controls and procedures as of November 1, 2014, our Chief Executive Officer and Chief Financial Officer concluded that, as of such date, our disclosure controls and procedures were effective at the reasonable assurance level.

**Changes in Internal Control Over Financial Reporting**

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

**Inherent Limitations on Effectiveness of Controls**

Our management, including our Chief Executive Officer and Chief Financial Officer, believes that our disclosure controls and procedures and internal control over financial reporting are designed to provide reasonable assurance of achieving their objectives and are effective at the reasonable assurance level. However, our management does not expect that our disclosure controls and procedures or our internal control over financial reporting will prevent all errors and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be

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considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, have been detected. These inherent limitations include the realities that judgments in decision making can be faulty, and that breakdowns can occur because of a simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people or by management override of the controls. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions; over time, controls may become inadequate because of changes in conditions, or the degree of compliance with policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.



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From time to time, we may become involved in lawsuits and other claims arising from our ordinary course of business. Management is currently unable to predict the ultimate outcome of any litigation or claim, determine whether a liability has been incurred or make an estimate of the reasonably possible liability that could result from an unfavorable outcome because of the uncertainties related to the incurrence, amount and range of loss on any pending litigation or claim. Because of the unpredictable nature of these matters, we cannot provide any assurances regarding the outcome of any litigation or claim to which we are a party or that the ultimate outcome of any of the matters threatened or pending against us, including those disclosed below, will not have a material adverse effect on our financial condition or results of operations. See **Risk Factors** in the company's Annual Report on Form 10-K for the fiscal year ended February 1, 2014 for important factors that could adversely impact us and our results of operations.

*Kristin Christiansen, Shellie Smith and Paul Haug, on behalf of themselves and all others similarly situated vs. World of Jeans & Tops, Superior Court of California, County of Sacramento, Case No. 34-2013-00139010.* On January 29, 2013, the plaintiffs in this matter filed a putative class action lawsuit against us alleging violations of California Civil Code Section 1747.08, which prohibits requesting or requiring personal identification information from a customer paying for goods with a credit card and recording such information, subject to exceptions. In June 2013, the Court granted our motion to strike portions of the plaintiffs' complaint and granted plaintiffs leave to amend. Plaintiffs have amended the complaint and the parties are proceeding with discovery on class certification issues. A tentative class certification briefing schedule has been set for the first half of 2015. The complaint seeks certification of a class, unspecified damages, injunctive relief and attorneys' fees. We intend to defend this case vigorously.

*Maria Rebolledo, individually and on behalf of all others similarly situated and on behalf of the general public vs. Tilly's, Inc.; World of Jeans & Tops, Superior Court of the State of California, County of Orange, Case No. 30-2012-00616290-CU-OE-CXC.* On December 5, 2012, the plaintiff in this matter filed a putative class action lawsuit against us alleging violations of California's wage and hour, meal break and rest break rules and regulations, and unfair competition law, among other things. An amended complaint was filed on February 28, 2013, to include enforcement of California's private attorney general act. The complaint seeks an unspecified amount of damages and penalties. In April 2013, we filed a motion to compel arbitration, which was denied in May 2013 and affirmed on appeal. In October 2014, we filed an answer to the amended complaint. We intend to defend this case vigorously.

*Karina Whitten, on behalf of herself and all others similarly situated, v. Tilly's Inc., Superior Court of California, County of Los Angeles, Case No. BC 548252.* On June 10, 2014, plaintiff filed a putative class action and representative Private Attorney General Act lawsuit against us alleging violations of California's wage and hour, meal break and rest break rules and regulations, and unfair competition law, among other things. The complaint seeks class certification, penalties, restitution, injunctive relief and attorneys' fees and costs. The case is currently stayed pending a further case management conference on December 9, 2014. We intend to defend the case vigorously.

**Item 1A. Risk Factors**

We operate in a rapidly changing environment that involves a number of risks that could materially and adversely affect our business, financial condition, prospects, operating results or cash flows. For a detailed discussion of the risks that affect our business, please refer to the section entitled **Risk Factors** in our Annual Report on Form 10-K for the fiscal year ended February 1, 2014. There have been no material changes to our risk factors as previously

disclosed in our Annual Report on Form 10-K.

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**Item 6. Exhibits**

**Exhibit**

<b>No.</b>	<b>Description of Exhibit</b>
31.1	Certification of Chief Executive Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended.
31.2	Certification of Chief Financial Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended.
32.1*	Certification of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
101	Interactive data files from Tilly's, Inc.'s Quarterly Report on Form 10-Q for the quarter ended November 1, 2014, formatted in XBRL (eXtensible Business Reporting Language): (i) the Consolidated Balance Sheets; (ii) the Consolidated Statements of Income; (iii) the Consolidated Statements of Comprehensive Income; (iv) the Consolidated Statement of Stockholders' Equity; (v) the Consolidated Statements of Cash Flows and (vi) Notes to Consolidated Financial Statements.

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

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**SIGNATURES**

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

Date: December 9, 2014

Tilly's, Inc.

/s/ Daniel Griesemer

Daniel Griesemer

*President, Chief Executive Officer and Director*

*(Principal Executive Officer)*

Date: December 9, 2014

/s/ Jennifer L. Ehrhardt

Jennifer L. Ehrhardt

*Chief Financial Officer*

*(Principal Financial Officer)*