TILLY'S, INC.
Form 10-K
March 30, 2018

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-K

(Mark One)
x ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended February 3, 2018
OR
¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
Commission File Number: 001-35535
TILLY’S, INC.
(Exact name of registrant as specified in its charter)

Delaware	45-2164791
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
10 Whatney, Irvine, CA	92618
(Address of principal executive offices)	(Zip Code)

(949) 609-5599
(Registrant’s telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class	Name of Each Exchange on Which Registered
Class A Common Stock, $0.001 par value per share	New York Stock Exchange

Securities registered pursuant to Section 12(g) of the Act: None
Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ¨ No x
Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ¨ No x
Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.
Yes x No ¨
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨
Indicate by check mark 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
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a nonaccelerated filer, or a smaller reporting company. See the definitions of “large accelerated filer,” “accelerated filer” and “small reporting company,” and "emerging growth company" in Rule 12b-2 of the Exchange Act:

Large accelerated filer: ¨		Accelerated filer:	x
Nonaccelerated filer:	¨ (Do not check if a smaller reporting company)	Smaller reporting company: ¨	
		Emerging growth company: ¨	

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. ¨

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

Yes ¨ No x

As of July 29, 2017, the aggregate market value of voting stock held by non-affiliates of the registrant as of the last business day of the registrant's most recently completed second fiscal quarter, at July 29, 2017, was $131,459,893 based on the closing sale price of $10.12 per share at July 28, 2017.

As of March 28, 2018, the registrant had 15,106,824 shares of Class A common stock, par value $0.001 per share, outstanding, and 14,028,497 shares of Class B common stock, par value $0.001 per share, outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Proxy Statement for the registrant's Annual Meeting of Stockholders to be held June 12, 2018 are incorporated by reference into Part III of this Annual Report on Form 10-K.

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Forward-Looking Statements

This annual report contains forward-looking statements that are subject to risks and uncertainties. All statements other than statements of historical or current fact included in this annual report are forward-looking statements. Forward-looking statements refer to our current expectations and projections relating to our financial condition, results of operations, plans, objectives, strategies, future performance and business. You can identify forward-looking statements by the fact that they do not relate strictly to historical or current facts. These statements may include words such as "anticipate", "estimate", "expect", "project", "plan", "intend", "believe", "may", "might", "will", "should", "can have" words and terms of similar meaning in connection with any discussion of the timing or nature of future operating or financial performance or other events. For example, all statements we make relating to our estimated and projected earnings, revenues, comparable store sales, operating income, earnings per share, costs, expenditures, cash flows, growth rates and financial results, our plans and objectives for future operations, growth or initiatives, strategies or the expected outcome or impact of pending or threatened litigation are forward-looking statements. All forward-looking statements are subject to risks and uncertainties that may cause actual results to differ materially from those that we expected, including:

- our ability to successfully open new stores and profitably operate our existing stores;
- our ability to attract customers to our e-commerce website;
- our ability to efficiently utilize our e-commerce fulfillment center;
- effectively adapting to new challenges associated with our expansion into new geographic markets;
- our ability to establish, maintain and enhance a strong brand image;
- generating adequate cash from our existing stores to support our growth;
- identifying and responding to new and changing customer fashion preferences and fashion-related trends;
- competing effectively in an environment of intense competition both in stores and online;
- containing the increase in the cost of mailing catalogs, paper and printing;
- the success of the malls, power centers, neighborhood and lifestyle centers, outlet centers and street-front locations in which our stores are located;
- our ability to attract customers in the various retail venues and geographies in which our stores are located;
- our ability to adapt to downward trends in traffic for our stores and changes in our customers' purchasing patterns;
- adapting to declines in consumer confidence and decreases in consumer spending;
- our ability to adapt to significant changes in sales due to the seasonality of our business;
- our ability to compete in social media marketing platforms;
- price reductions or inventory shortages resulting from failure to purchase the appropriate amount of inventory in advance of the season in which it will be sold;
- natural disasters, unusually adverse weather conditions, boycotts and unanticipated events;
- changes in the competitive environment in our industry and the markets we serve, including increased competition from other retailers;
- our dependence on third-party vendors to provide us with sufficient quantities of merchandise at acceptable prices;
- increases in costs of energy, transportation or utility costs and in the costs of labor and employment;
- our ability to balance proprietary branded merchandise with the third-party branded merchandise we sell;
- most of our merchandise is made in foreign countries, making price and availability of our merchandise susceptible to international trade conditions;
- failure of our vendors and their manufacturing sources to use acceptable labor or other practices;
- our dependence upon key executive management or our inability to hire or retain the talent required for our business;
- our ability to effectively adapt to our rapid expansion in recent years and our planned expansion;
- failure of our information technology systems to support our current and growing business, before and after our planned upgrades;
- disruptions in our supply chain and distribution center;
- our indebtedness and lease obligations, including restrictions on our operations contained therein;
- our reliance upon independent third-party transportation providers for certain of our product shipments;
- our ability to increase comparable store sales or sales per square foot, which may cause our operations and stock price to be volatile;

- disruptions to our information systems in the ordinary course or as a result of systems upgrades;

- our inability to protect our trademarks or other intellectual property rights;
- acts of war, terrorism or civil unrest;
- the impact of governmental laws and regulations and the outcomes of legal proceedings;
- our ability to secure the personal financial information of our customers and comply with the security standards for the credit card industry;
- our failure to maintain adequate internal controls over our financial and management systems; and
- continuing costs incurred as a result of being a public company.

We derive many of our forward-looking statements from our operating budgets and forecasts, which are based upon detailed assumptions. While we believe that our assumptions are reasonable, we caution that it is very difficult to predict the impact of known factors, and it is impossible for us to anticipate all factors that could affect our actual results.

See “Risk Factors” for a more complete discussion of the risks and uncertainties mentioned above and for discussion of other risks and uncertainties. All forward-looking statements attributable to us are expressly qualified in their entirety by these cautionary statements as well as others made in this annual report and hereafter in our other SEC filings and public communications. You should evaluate all forward-looking statements made by us in the context of these risks and uncertainties.

We caution you that the risks and uncertainties identified by us may not be all of the factors that are important to you. Furthermore, the forward-looking statements included in this annual report are made only as of the date hereof. We undertake no obligation to publicly update or revise any forward-looking statement as a result of new information, future events or otherwise, except as otherwise required by law.

PART I

Item 1. Business

Tillys is a leading destination specialty retailer of casual apparel, footwear and accessories for young men, young women, boys and girls. We believe we bring together an unparalleled selection of iconic global, emerging and proprietary brands rooted in an active and outdoor lifestyle. Our stores and website are designed to be a seamless extension of our teen and young adult consumers' lifestyles in a stimulating environment. Tillys is headquartered in Irvine, California and we operated 219 stores in 32 states as of February 3, 2018. Our stores are located in malls, lifestyle centers, ‘power’ centers, community centers, outlet centers and street-front locations. Customers may also shop online, where we feature the same assortment of products as is carried in our brick-and-mortar stores, supplemented by additional online-only styles. We believe our success across a variety of real estate venues and geographies in the United States demonstrates Tillys' portability. Our goal is to serve as a destination for the most relevant merchandise and brands important to our customers.

The Tillys concept began in 1982 when our co-founders, Hezy Shaked and Tilly Levine, opened their first store in Orange County, California. Tilly's, Inc., a Delaware corporation, conducted an initial public offering on May 2, 2012, becoming the publicly-traded entity that operates the Tillys business through its wholly-owned subsidiary, World of Jeans & Tops, a California corporation.

Our fiscal year ends on the Saturday closest to January 31. For example, "fiscal 2017" refers to the fiscal year ended February 3, 2018, "fiscal 2016" refers to the fiscal year ended January 28, 2017; and "fiscal 2015" refers to the fiscal year ended January 30, 2016.

As used in this annual report on Form 10-K, except where the context otherwise requires or where otherwise indicated, the terms "the Company", "World of Jeans and Tops", "WOJT", "we", "our", "us", and "Tillys" refer to World of Jeans & Tops before our initial public offering, and to Tilly's, Inc. and its subsidiary after our initial public offering.

Our Strengths

We believe that the following competitive strengths contribute to our success and distinguish us from our competitors:

- Destination retailer with a broad and differentiated assortment. We believe the combined depth and breadth of apparel, footwear and accessories offered at our stores exceeds the selection offered at many other specialty retailers. We offer an extensive selection of over 400 third-party lifestyle brands over the course of a given year, which are complemented by our proprietary brands. Our merchandise includes a wide assortment of brands, styles, colors, sizes and price points to ensure we have what our customers want every time they visit our stores. We offer a balanced mix of merchandise across the apparel, footwear and accessories categories serving young men, young women, boys and girls. We believe that by combining proven and emerging fashion trends and core style products with a vibrant blend of carefully selected music and visuals, we provide an in-store experience that is authentic, fun, and engaging for our core customers. We believe that our differentiated in-store environment, evolving selection of relevant brands, and broader and deeper assortment positions us as a retail destination that appeals to a larger demographic than many other specialty retailers and encourages customers to visit our stores more frequently and spend more on each trip.
- Dynamic merchandise model. We believe our extensive selection of third-party and proprietary merchandise allows us to identify and offer several trends simultaneously, offer a greater range of price points, and manage our inventories more dynamically. By closely monitoring trends and shipping product to our stores multiple times per week, we are able to adjust our merchandise mix based on store size and location. We also keep our merchandise mix relevant by introducing emerging brands not available at many other retailers. Our merchandising capabilities enable us to adjust our merchandise mix with a frequency that promotes a current look to our stores and website and encourages frequent visits.
- Flexible real estate strategy across real estate venues and geographies. Our stores have proven to be successful in different real estate venues and geographies. We operate stores in malls, power centers, neighborhood and lifestyle centers, outlet centers and street-front locations across 85 markets in 32 states. We believe our success operating in these different retail venues and geographies demonstrates the portability of the Tillys brand.
- Multi-pronged marketing approach. We utilize a multi-pronged marketing strategy to connect with our customers and drive traffic to our stores and online platforms. We distribute catalogs, newspapers and postcards to potential and

existing customers from our proprietary database to familiarize them with the Tillys brand, our products, and to drive traffic to our stores and website. We offer an integrated digital platform between our online and mobile applications for our customers to shop how and when they like and to drive further connection with them. We partner and collaborate with our vendors on exclusive, compelling in-store events and contests to build credibility with our target customers, actively involve them in our brands, and enhance the connection between Tillys and our customers' active lifestyle. We use social media to communicate directly with our customers while also encouraging customers to interact with one another and provide feedback on our events and products. We have a customer loyalty program to further engage with our customers, build customer loyalty, reward our most loyal customers, and gain customer insights. All of these programs are complemented by digital and email marketing, as well as print advertising, to build customer awareness and loyalty, highlight key merchandise offerings, drive traffic to our stores and online platforms, and promote the Tillys brand. Also, through our "We Care Program", we support and participate in various academic, art, and athletic programs at local schools and other organizations in communities surrounding our stores.

- Systems and distribution/fulfillment infrastructure to support growth. We have previously made investments in distribution, fulfillment and allocation infrastructure that we believe are adequate to support continued growth for several years. Our distribution center allows us to quickly sort and process merchandise and deliver it to our stores in a floor-ready format for immediate display. We also have a dedicated e-commerce fulfillment center to support our future online growth potential. Our systems enable us to respond to changing fashion trends, manage inventory in real time, and provide a customized selection of merchandise at each location. We believe our distribution and fulfillment infrastructure can support significant growth in our stores and e-commerce platform with minimal incremental capital investment.
- Experienced management team. Our senior management team, led by Hezy Shaked and Edmond Thomas, has extensive experience across a wide range of disciplines in the specialty retail and direct-to-consumer industries, including store operations, merchandising, distribution, real estate, and finance. Mr. Shaked, our Co-Founder, Executive Chairman of the Board of Directors, and Chief Strategy Officer, plays an important role in developing our long-term growth initiatives and cultivating our unique culture. Mr. Thomas, our President and Chief Executive Officer, rejoined Tillys in October 2015 with over 30 years of retail experience. He previously served as our President and Co-Chief Executive Officer from September 2005 to October 2007.

Growth Strategy

We are pursuing several strategies to drive long-term sales and profitability, including:

- Drive Comparable Store Sales. We seek to maximize our comparable store sales by consistently offering new, on-trend and relevant merchandise, including exclusive and proprietary branded merchandise, across a broad assortment of categories, increasing our brand awareness through our multi-pronged marketing approach, providing an authentic store and online experience for our core customers, and maintaining a high level of customer service. We believe the combination of these factors, together with the operating strategies described below, will improve our comparable store sales results over time.
- Increase Our Operating Margins. We believe we have the opportunity to drive operating margin expansion through scale efficiencies and continued process improvements. We believe comparable store sales increases will permit us to take advantage of largely fixed occupancy costs, favorable buying costs from larger volume purchases, leverage of our costs for store management and corporate overhead, as well as the fixed portion of shipping and handling costs over higher sales volumes. In addition, we expect to improve operating margins and support growth by leveraging previous investments in infrastructure, including our dedicated fulfillment center for e-commerce, upgraded e-commerce platform, ongoing investments to upgrade our point-of-sale, merchandise allocation and merchandise planning systems. We also will continue to use established business processes to identify and execute initiatives focused on lowering our unit costs and improving operational efficiency throughout our organization.
- Continue Growing E-Commerce. We believe our e-commerce platform is an extension of our brand and retail stores, providing our customers a seamless shopping experience. Our e-commerce platform allows us to provide our customers with extensions of the same assortment offered in our brick-and-mortar stores, reach new customers, and build our brand in markets where we currently do not have stores. For example, we generate e-commerce sales in all 50 states although we have physical stores in only 32 states. Our target customer regularly shops online and via mobile devices in addition to visiting stores, giving us a continued opportunity to grow our e-commerce platform over time. In fiscal 2017, we commenced implementation of a new platform for our e-commerce website. In fiscal 2018, we plan to upgrade our mobile application to provide an enhanced customer experience. Key factors we expect to drive growth include continuing our catalog, online and mobile application marketing efforts, enhancing the efficiency and responsiveness of our digital capabilities, and supplementing the assortment available in our brick-and-mortar stores with additional online-only styles. We also expect to expand marketing efforts and build

brand awareness in the communities surrounding our existing stores to drive growth in both brick-and-mortar and e-commerce sales.

- Improve Inventory Management. We believe we can improve our operating results through improved micro-merchandising based on specific store characteristics. We regularly update individual store profiles for every store to highlight the differences in brand performance, gender penetrations, and customer interests that exist within our fleet of stores. By adapting allocation strategies to capitalize on these individual store differences, we believe we can improve sales results in our existing store base.

- Develop Omni-Channel Capabilities. We have a direct-to-consumer program that allows online orders to be fulfilled and shipped directly to our customers from our brick-and-mortar stores when inventory is otherwise unavailable in our e-commerce fulfillment center. In addition, during fiscal 2017, we invested in additional omni-channel capabilities allowing for online orders to be picked up in stores at our customers' discretion, allowing us to satisfy an order from existing inventories within our stores as well as shipping product from our e-commerce fulfillment center to our stores. We believe these omni-channel capabilities will drive additional traffic to our stores and increase sales opportunities with customers who come to the store to pick up their online orders.
- Reinvest in Existing Stores. We believe that re-investing in our existing stores is strategically important to enhance customer loyalty, elevate the customer experience and, in turn, drive additional comparable store sales. We have remodeled or refreshed many of our stores in recent years, and intend to continue to do so in the future to keep the physical representation of the Tillys brand updated and compelling for our customers.
- Real Estate Opportunities. With 219 total stores at the end of fiscal 2017, we believe there are numerous attractive opportunities for Tillys to continue to open new stores in the future. During fiscal 2018, we plan to open up to 15 new stores. Additionally, we expect to open three RSQ-branded pop-up stores to improve the brand awareness of both Tillys and our proprietary RSQ brand. With regard to existing stores, we have an aggregate of approximately 120 lease decisions to make over the course of fiscal 2018 and 2019 covering a range of stores across all markets. These lease decisions include lease extension options, lease kick-out options, and lease expirations that require negotiated renewals. In each case, our real estate decisions will be driven by the overarching goal of improving our profitability. As a result, we may likely close stores from time to time if acceptable levels of profitability cannot be obtained through occupancy negotiations with landlords.

Merchandising, Purchasing, and Planning and Allocation

Merchandising

We seek to be viewed by our customers as the destination for the apparel, footwear and accessories that best represent their active, connected lifestyle. We believe we offer an unparalleled selection of relevant brands, styles, colors, sizes and price points to ensure we have what our customers want every time they visit our stores. Our extensive selection of third-party and proprietary merchandise allows us to identify and address trends more quickly, offer a greater range of price points and manage our inventories more dynamically. We offer a balanced mix of merchandise for young men, young women, boys and girls across the apparel, footwear and accessories categories. We believe this category mix contributes to our broad demographic appeal. Our apparel merchandise includes branded, fashion and core styles for tops, outerwear, bottoms, and dresses. Accessories merchandise includes backpacks, hats, sunglasses, headphones, handbags, watches, jewelry and more. We focus on our merchandise presentation and vary the visual displays in our stores and windows throughout the month, presenting new looks and fashion combinations to our customers.

Our ability to maintain an image consistent with our customers' lifestyle is important to our branded vendors and provides us better access to a wide assortment of products and styles. Our third-party branded merchandise includes a selection of over 400 globally recognized, lifestyle, and emerging brands over the course of a year. In each of the last three fiscal years, over 100 of these brands each generated net sales in excess of $0.5 million for us. We strive to keep our merchandise mix current by continuously introducing emerging brands and styles not available at many other specialty retailers in order to identify and respond to the evolving desires of our customers. Our third-party brands represented approximately 74%, 72% and 72% of our total net sales in fiscal 2017, 2016 and 2015, respectively. No single third-party brand exceeded 7% of our total net sales in the last three years.

Selected third-party brands include, in alphabetical order:

• AYC	• Jansport	• Roxy
• Adidas	• Levi’s	• RVCA
• Billabong	• LRG	• Salty Crew
• Brixton	• Neff	• Santa Cruz
• Converse	• Nike SB	• Spy
• Diamond Supply	• Nixon	• Stance
• Dickies	• O’Neill	• The North Face
• Ethika	• Primitive	• Vans

- G-Shock
- Hurley
- HUF
- RayBan
- Riot Society
- Rip Curl
- Volcom

...and many more

We supplement our third-party merchandise assortment with our own proprietary brands across many of our product categories. We utilize our own branded merchandise to expand our price point range, identify and respond to changing fashion trends quickly, fill merchandise gaps and provide a deeper selection of styles and colors for proven fashion items. Our proprietary brands represented approximately 26%, 28% and 28% of our total net sales in fiscal 2017, 2016 and 2015, respectively.

Examples of our proprietary branded merchandise include:

Brand	Category
	Denim, apparel and fragrance brand for young men, young women and kids
	Apparel and accessories brand for young women and girls
	Apparel and accessories brand for young men and boys
	Fragrance brand for young men
	Apparel and fragrance brand for young women
	Apparel for young women
	Apparel for girls

We believe that our extensive selection of merchandise, from established and emerging third-party brands as well as our proprietary brands, caters to a wide demographic of core customers and enhances our store image as a destination that carries the most sought-after apparel, footwear and accessories.

Merchandise Purchasing

Our merchandising team is organized by category and product type under our Chief Merchandising Officer and includes divisional merchandise managers, a technical design and fashion trend team, buyers, associate buyers and assistant buyers. We believe a key element of our success is our team’s ability to identify and source the proven and emerging fashion trends and core styles that are most relevant to our customers.

Our purchasing approach focuses on product relevance, quality, fit, availability, cost and speed of production in order to provide timely frequent delivery of merchandise to our stores. Our purchasing group and planning and allocation team are highly coordinated and maintain a disciplined buying strategy.

To ensure a relevant assortment, our teams:

- perform comprehensive analysis of sales trends from our stores and e-commerce site;
- perform in-store visits and gather feedback from our customers and our staff;
- maintain regular dialogue with our existing vendor network and potential new vendors;
- utilize trend and color forecasting services;
- participate in trade shows and action sport related events;

- review trade publications; and
- evaluate merchandise assortments offered by other retail and online merchants.

We have developed and maintain strong and, in many cases, long-standing relationships with our third-party vendors and we have a history of identifying and growing with emerging brands. We believe the Tillys brand, shopping experience and core customer lifestyle is highly consistent with the image and philosophy of our key vendors. This, in addition to our customer connectivity, facilitates a partnership culture with our key vendors and provides us access to an extensive variety of products and styles, as well as certain merchandise that is exclusive to our stores and website.
Our merchandise purchasing group also works closely with independent third parties who design and procure merchandise for our proprietary brands. Our proprietary brand capabilities enhance our ability to rapidly identify and respond to trends and consistently offer proven fashion items that provide a broader demographic appeal. We work with more than 100 vendors based in the United States to supply us with our proprietary branded product. These vendors source from both domestic and international markets and either have their own factories or contract with owners of factories to source finished product. By sourcing merchandise for our proprietary brands both domestically and internationally, we have the flexibility to benefit from shorter lead times associated with domestic manufacturing and lower costs associated with international manufacturing.

Planning and Allocation

We have developed inventory planning and allocation processes to support our merchandising strategies. Working closely with our merchandise purchasing team, the planning and allocation team utilizes a disciplined approach to buying, forecasting, inventory control and allocation processes. Our planning and allocation team continually analyzes information from our management information system, including inventory levels and sell-through data, to regularly adjust the assortment at each store and the inventory levels for our company as a whole. Our broad third-party vendor base allows us to shift merchandise purchases to react quickly to changing consumer preferences and market conditions. Furthermore, the vendor base for our proprietary products provides us flexibility to develop our own branded products to quickly address emerging fashion trends and provide a deeper selection of styles, colors, and price points for proven fashion items. We modify our merchandising mix based upon store size, the season, and consumer preferences in different parts of the country. We are also able to react quickly to changing customer needs due to our shipment of merchandise to our stores multiple times per week. Finally, we coordinate closely with our visual merchandise managers and marketing group in order to manage inventory levels in connection with our promotions and seasonality.

Stores

As of February 3, 2018, we operated 219 stores in 32 states with an average size of approximately 7,600 square feet. Our stores are located in mall, off-mall and outlet locations. Our stores generated average net sales of $2.3 million per store, or $296 per square foot, in fiscal 2017.
The table below shows our number of stores by type of retail center as of the end of each of the last three fiscal years:

	2017	2016	2015
Regional Mall	119	114	114
Off-Mall (1)	85	90	90
Outlet	15	19	20
	219	223	224

(1) Includes power centers, neighborhood and lifestyle centers and street-front locations.

The table below shows the total number of stores by state as of February 3, 2018:

State	Number of Stores	State	Number of Stores
Arizona	19	New Jersey	5
California	91	New Mexico	1
Colorado	5	New York	4
Florida	20	North Carolina	2
Georgia	2	Ohio	4
Illinois	6	Oklahoma	3
Indiana	5	Oregon	2
Iowa	1	Pennsylvania	3
Kansas	2	Rhode Island	1
Maryland	1	South Dakota	1
Massachusetts	2	Tennessee	4
Michigan	3	Texas	9
Minnesota	2	Utah	3
Missouri	2	Virginia	4
Nebraska	1	Washington	2
Nevada	6	Wisconsin	3

Distinctive Store Experience

Tillys is a customer-driven lifestyle brand. We are energized and inspired by our customers' individuality and passion for an active, connected lifestyle. Our stores bring these interests together in a vibrant, stimulating and authentic environment that is an extension of our customers' multi-tasking lifestyle. We do this by blending the most relevant brands and styles with music videos, product-related visuals and a dedicated team of store associates. Our associates share the same passion as our customers for action sports, music, art and fashion, enabling them to easily engage with our customers and make shopping at Tillys a fun, social experience. Outside of our stores, we connect with our consumers using the same authentic approach, including social media, community outreach and sponsorship of contests, demos, and other events. We believe the Tillys experience drives customer awareness, loyalty and repeat visits while generating a buzz and excitement for our brand.

Store Expansion Opportunities and Site Selection

The following table shows the number of stores opened and closed in each of our last five fiscal years:

Fiscal Year	Stores Opened	Stores Closed	Total Number of Stores at End of Period
2013	28	1	195
2014	19	2	212
2015	15	3	224
2016	3	4	223
2017	2	6	219
	67	16	

During fiscal 2018, we plan to open up to 15 new stores and three new RSQ-branded pop-up stores. We focus on opening new stores in locations that have above-average incomes and an ability to draw from a sufficient population with attractive demographics. Given the recent industry trends of declining customer traffic in physical stores, we will remain opportunistic and selective about additional new store opportunities.

Store Management, Culture and Training

We believe that a key to our success is our ability to attract, train, retain and motivate qualified employees at all levels of our organization. Each of our stores typically operates with a three to five member store management team. In addition, each store has 10 or more full time equivalent store associates who represent an active lifestyle and promote the Tillys brand not only inside the store, but also in their schools and communities. The number of store associates we employ generally increases during peak selling seasons, particularly the back-to-school and the winter holiday seasons, and will increase to the extent that we open new stores.

We have developed a corporate culture that we believe empowers the individual store managers to make store-level business decisions and we reward them when they exceed sales targets. We are committed to improving the skills and careers of our workforce and providing advancement opportunities for employees. We evaluate our store associates weekly on measures such as sales per hour, units per transaction and dollars per transaction to ensure productivity, to recognize top performers and to identify potential training opportunities. We endeavor to design incentive programs for store associates that promote a competitive, yet fun, culture that is consistent with our image.

We provide our managers with the knowledge and tools to succeed through comprehensive training programs, focusing on both operational expertise and supervisory skills. Our training programs and workshops are offered at the store, district and regional levels, allowing managers from multiple locations to interact with each other and exchange ideas to better operate stores. Store associates receive training from their managers to improve their product expertise and selling skills.

E-Commerce

Our e-commerce platform was established in 2004 and has grown significantly since inception, generating total sales of $76 million during fiscal 2017, or 13.1% of our total net sales. In fiscal 2017, we commenced implementation of a new platform for our e-commerce website. Our online business is served by a dedicated e-commerce fulfillment center in Irvine, California that can accommodate significant additional growth. In fiscal 2018, we plan on upgrading our mobile application to provide an enhanced customer experience. We believe our digital platform is an extension of our brand and retail stores, providing our customers a seamless shopping experience. We believe that our target customer regularly shops online through various digital channels in addition to visiting stores. Our website serves both as a sales channel and a marketing tool to our extended customer base, including those customers in markets where we do not currently have stores. In both fiscal 2017 and 2016, we sold merchandise to customers in all 50 states even though we have brick-and-mortar stores in only 32 states. We also believe our fully integrated digital platform reinforces the Tillys brand image and serves as an effective advertising vehicle for our retail stores. Our digital platform provides the same assortment available in our brick-and-mortar stores, supplemented by additional online-only styles. Similar to the merchandising approach in our stores, we frequently change the look of our website to highlight new brands and products and to encourage frequent visits. We utilize multiple tools to drive traffic online, including our catalog, newspaper, postcards, marketing materials in our retail stores, search engine marketing, internet ad placement, shopping site partnerships, third-party affiliations, email marketing, digital marketing and direct mail. In addition, we utilize the website to offer current information on our upcoming events, promotions and store locations.

Marketing and Advertising

Our marketing approach is designed to create an authentic connection with our customers by consistently generating excitement for our brand and the connected, active lifestyle we represent. We utilize a multi-pronged marketing strategy to connect with our customers and drive traffic to our stores and online platform, comprised of the following:

- Catalog, Newspaper Ads, Postcards. We view our catalog, newspaper ads and postcards in print format and our digital-format catalog primarily as sales and marketing tools to drive online and store traffic from both existing and new customers. We also believe our marketing materials reinforce the Tillys brand and showcases our comprehensive selection of products in settings designed to reflect our brand’s lifestyle image. We send these marketing materials, which include coupons that can be redeemed at stores or online, to the customers in our database several times a year, primarily around key shopping periods such as spring break, back-to-school, and the winter holidays.
- Brand Partnerships. We partner and collaborate with our vendors for exclusive events such as autograph signings, in-store performances, contests, demos, giveaways, shopping sprees and VIP trips. We organize a variety of events, many involving musicians, celebrities and athletes in the entertainment, music and action sports industries. Through brand partnerships such as these, we are able to connect with and engage our customers in an exciting, authentic experience.
- Social Media. We believe our core customers rely heavily on the opinions of their peers, often expressed through social media. Therefore, we use our website blog, as well as Facebook, Instagram, Twitter and Snapchat posts, as a viral marketing platform to communicate directly with our customers while also allowing customers to interact with one another and provide feedback on our events and products.
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- Loyalty Program. During fiscal 2016, we launched an improved and rebranded customer loyalty program designed to interact with our customers in a more direct and targeted manner, and to provide more insight into their shopping behaviors and preferences. This program offers more frequent and compelling rewards to our most loyal customers than our previous program.
- Community Outreach. Through our "We Care Program" and in partnership with our vendors, we support and participate in various academic, art, and athletic programs at local schools and other organizations in communities surrounding our stores. We also support Tilly's Life Center, founded by our co-founder, Tilly Levine, which provides underprivileged youth a healthy and caring environment to help create a well-defined sense of self, cultivate community mindedness and release negative emotional stress.

- Email Marketing. We utilize email marketing to build awareness, drive traffic to our stores and online platform and to promote local in-store promotions and events. We periodically send emails to the customers in our proprietary database to introduce new brands and products, offer promotions on select merchandise, highlight key events and announce new store openings.

Distribution

We distribute all of our store merchandise through a 126,000 square foot distribution facility co-located with our headquarters in Irvine, California. Our lease expires in December 2027. Extensive investments have been made to the distribution-center infrastructure, focused around systems automation, material-handling equipment, radio frequency technologies, and automated sorters in order to enhance our processing speed and long term scalability in support of our planned growth.

We also operate a dedicated e-commerce fulfillment center in Irvine, California to handle all e-commerce orders in a highly automated environment that leverages material handling equipment, automated systems and other technologies consistent with our current distribution facility. This investment supports our future e-commerce growth initiatives.

We ship merchandise to our stores multiple times per week, providing them with a steady flow of both new and replenishment products. Merchandise is shipped in a floor-ready format (carrying price tickets, sensor tags and with hangers where appropriate) which allows store employees to spend less time processing the merchandise and more time with our customers. We use our own fleet of trucks to ship merchandise to our Southern California stores and third-party distributors to ship merchandise to stores outside of our local area.

We believe our distribution and fulfillment infrastructure can support significant growth of our e-commerce platform and additional stores with minimal incremental capital investment.

Management Information Systems

Our management information systems provide a full range of business process support and information to our store, merchandising, financial, real estate and other business teams. We selected, customized and integrated our information systems to enable and support our dynamic merchandise model. We believe our systems provide us with improved operational efficiencies, scalability, management control and timely reporting that allow us to identify and quickly respond to changes in our business. We believe that our information systems are scalable, flexible and have the capacity to accommodate our current growth plans.

During the fall of fiscal 2017, we began implementation of our new point-of-sale, order management, and customer relationship management systems through an end-to-end, cloud-based suite of technology additions that will improve the customer experience wherever, whenever and however our customers engage with us. We believe that these improvements will enhance our real-time inventory visibility and order management, facilitate seamless omni-channel execution integrated across mobile devices and stores, and true customer relations management capabilities. We believe this newly implemented technology will improve customer engagement and increase sales opportunities. Also during the fall of fiscal 2017, we re-platformed our website to a cloud-based, more cost effective solution and have plans to further upgrade our mobile application in advance of the fiscal 2018 holiday season. We believe the re-platforming of our website will improve functionality and reporting capabilities, reduce internal operating costs and effort for updates, and improve redundancy to better guard against system downtime. Both the new website platform and enhanced mobile application will be designed to function seamlessly with our new point-of-sale solution to provide an enhanced customer engagement.

Competition

The teenage and young adult retail apparel, accessories and footwear industry is highly competitive. We compete with other retailers for customers, store locations, store associates and management personnel. We currently compete with other teenage-focused retailers such as, but not limited to, Abercrombie & Fitch Co., Aeropostale, Inc., American Eagle Outfitters, Inc., The Buckle, Inc., Forever 21, Inc., Hot Topic, Inc., Pacific Sunwear of California, Inc., Urban Outfitters, Inc., and Zumiez, Inc. In addition, we compete with independent specialty shops, department stores, off-price retailers, online marketplaces such as Amazon, stores and websites operated by our third-party brands and direct marketers that sell similar lines of merchandise and target customers through catalogs and e-commerce. Further, we may face new competitors and increased competition from existing competitors as we expand into new markets and increase our presence in existing markets. Given the extensive number and types of retailers with which Tillys competes for customers, we believe that our target market is highly fragmented and we do not believe we have a significant share of this market.

Competition in our sector is based, among other things, upon merchandise offerings, store location, price and the ability to identify with the customer. We believe that we compete favorably with many of our competitors based on our differentiated merchandising strategy, store environment, flexible real estate strategy and company culture. However, many of our competitors are larger, have significantly more stores, and have substantially greater financial, marketing and other resources than we do. Moreover, we recognize that we do not possess exclusive rights to many of the elements that comprise our in-store experience and product offerings. Our competitors can emulate facets of our business strategy and in-store experience, which could result in a reduction of any competitive advantage or special appeal that we might possess. See Item 1A. “Risk Factors—Risks Related to Our Business. We face intense competition in our industry and we may not be able to compete effectively.”

Trademarks

“Ambitious”, “Blue Crown”, “Division 7”, “Eldon”, “Full Tilt”, “Full Tilt Sport”, “If it’s not here...it’s not happening”, “Infam
“RSQ”, “#RSQME”,“Tilly's”, “Vindicated”, "Destined" ,“Tilly’s Clothing & Shoes”, ”Full Tilt Swim”, “Girl in Motion”, “The
Hookup”, "Vaporize”, “Ivy + Main”, "Sky and Sparrow", and "White Fawn" and logos related to some of these names, are among our trademarks registered with the United States Patent and Trademark Office. We regard our trademarks as valuable and intend to maintain such marks and any related registrations. We are not aware of any claims of infringement or other challenges to our right to use our marks in the United States. We vigorously protect our trademarks.

Employees

As of February 3, 2018, we employed approximately 1,400 full-time and approximately 3,300 part-time employees, of which approximately 400 were employed at our corporate office and distribution facility and approximately 4,300 were employed at our store locations. However, the number of total employees, especially part-time employees, fluctuates depending upon our seasonal needs and, in fiscal year 2017, varied between approximately 4,700 and 7,100 employees. None of our employees are represented by a labor union and we consider our relationship with our employees to be good.

Government Regulation

We are subject to labor and employment laws, laws governing advertising and promotions, privacy laws, safety regulations, consumer protection regulations and other laws that regulate retailers and govern the promotion and sale of merchandise and the operation of stores and warehouse facilities. We monitor changes in these laws and believe that we are in material compliance with applicable laws.

Insurance

We use insurance for a number of risk management activities, including workers’ compensation, general liability, automobile liability and employee-related health care benefits, a portion of which is paid by the employees. We evaluate our insurance requirements on an ongoing basis to maintain adequate levels of coverage.

Seasonality

Due to the seasonal nature of the retail industry, we have historically experienced and expect to continue to experience fluctuations in our revenues and net income. Net revenues are typically smallest in the first quarter of a given fiscal year followed by sequentially increased net revenues in each succeeding quarter within a fiscal year. Our net sales fluctuate significantly in relation to various holidays and other peak shopping periods, including but not limited to the Thanksgiving and year-end holiday season, the back-to-school season, spring break periods, and other holidays. If, for any reason, our revenues were below seasonal norms or expectations during these quarters, particularly during peak selling periods, our annual results of operations could be adversely affected. The level of our working capital reflects the seasonality of our business. We expect inventory levels, along with an increase in accounts payable and accrued expenses, generally to reach their highest levels in anticipation of the increased revenues during these periods.

Additional Information

We make available free of charge on our internet website, www.tillys.com, copies of our Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and all amendments to these reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended, or the Exchange Act, as soon as reasonably practicable after filing such material electronically with, or otherwise furnishing it to, the Securities and Exchange Commission, or the SEC. The public may also read and copy any materials that we have filed with the SEC at the SEC's Public Reference Room at 100 F Street, NE, Washington, D.C. 20549. In addition, these materials may be obtained at the web site maintained by the SEC at www.sec.gov. The reference to our website address does not constitute incorporation by reference of the information contained on the website, and the information contained on the website is not part of this document.

Item 1A. Risk Factors

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

Risks Related to Our Business

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

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

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

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

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

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

We depend upon consumers feeling confident to spend discretionary income on our product offering to drive our sales. Consumer spending may be adversely impacted by economic conditions such as consumer confidence in future economic conditions, interest and tax rates, employment levels, salary and wage levels, general business conditions, the availability of consumer credit and the level of housing, energy and food costs. These risks may be exacerbated for retailers like us who focus on specialty apparel and accessories. Our financial performance is particularly susceptible to economic and other conditions in regions or states where we have a significant number of stores, such as the southwestern and northeastern United States and Florida. If periods of decreased consumer spending persist, our sales could decrease and our financial condition and results of operations could be adversely affected.

Our continued growth depends upon our ability to successfully open a significant number of new stores and improve the performance of our existing stores and our e-commerce platform.

We have grown our store count rapidly in recent years and that has contributed to our growth in revenue. However, in fiscal 2017 and 2016 we slowed the pace of new store openings to focus our efforts on improving the performance of our existing stores. During fiscal 2018, we plan on opening up to 15 new stores and three new RSQ pop-up stores. Despite this plan, we may not be able to grow our revenue as we have in years past, or at all. In addition, our e-commerce platform which was established in 2004, has grown significantly since inception, generating total sales of $76 million during fiscal 2017, or 13.1% of our total net sales, which has also contributed to revenue growth. However, the e-commerce retail market continues to rapidly evolve, and there can be no assurances that we can continue to grow our e-commerce revenue. The failure to improve the performance of existing stores and our e-commerce platform could have a material adverse effect on our financial condition and results of operations.

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

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

We may not be able to implement our new business strategies, including the implementation of our new suite of technology solutions, on the timelines we anticipate, in a cost-effective manner, or at all.

In fiscal 2017, we implemented new point-of-sale, order management, and customer relations management systems and re-platformed our website. In fiscal 2018, we plan on updating our mobile application so that they function seamlessly and provide enhanced customer engagement. However, these upgrades may not be completed in the expected timeframe or may result in unanticipated costs, delays or declines in revenue. We may decide not to complete these projects if it becomes apparent that they are no longer feasible. Even if implemented, we cannot assure these upgrades will meet our current and future business needs or that they will operate as designed. Implementing new systems involves risks inherent in the conversion to a new technology platform including loss of information, and there is no assurance that the implementation of these upgrades will not result in disruptions to our business. If the implementation of our new systems are not executed efficiently and effectively, our business and our operating results could be adversely affected.

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

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

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

Because of a traditionally higher level of sales during the back-to-school and winter holiday shopping seasons, our sales are typically higher in the third and fourth fiscal quarters than they are in the first and second fiscal quarters.

Accordingly, the results of a single fiscal quarter, particularly the third and fourth fiscal quarters, should not be relied on as an indication of our annual results or future performance. In addition, any factors that harm our third and fourth fiscal quarter operating results could have a disproportionate effect on our results of operations for the entire fiscal year.

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

We primarily rely on cash flows generated from existing stores to fund our current operations and our growth plans. An increase in our net cash outflow for new stores or remodels of existing stores could adversely affect our operations by reducing the amount of cash available to address other aspects of our business.

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

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

We have historically depended on the location of our stores to generate a large amount of traffic for our stores. We try to select well-known and popular malls, power centers, neighborhood and lifestyle centers, outlet centers and street-front locations, usually near prominent retailers, to generate traffic to our stores. Traffic at these retail centers, and consequently our stores, could be adversely affected by economic downturns nationally or regionally, competition from Internet retailers, changes in consumer demographics, the closing or decrease in popularity of other retailers in the retail centers in which our stores are located, our inability to obtain or maintain prominent store locations within retail centers or the selection by prominent retailers and businesses of other locations. Over the last few years, we have experienced periodic declines in traffic to our stores as consumer purchasing behaviors shifted toward online purchases and we may experience similar further declines in the future. A reduction in traffic would likely lead to a decrease in our sales, and, if similar reductions in traffic occur at a number of our stores, this could have a material adverse effect on our financial condition and results of operations.

Our ability to successfully open and operate new stores is subject to a variety of risks and uncertainties.

As we continue to open additional locations, our ability to successfully open and operate new stores is subject to a variety of risks and uncertainties, such as:

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

Additionally, some of our new stores may open in locations close enough to our existing stores that a segment of customers will stop shopping at our existing locations and prefer to shop at the new locations, and therefore sales and profitability at those existing stores may decline.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

We lease all of our retail store locations as well as our corporate headquarters, warehouses, distribution and e-commerce fulfillment centers. We do not own any real estate. Leases for our stores are typically for terms of ten years and many can be extended in five-year increments. Many of our leases have early cancellation clauses which permit us to terminate the lease if certain sales thresholds are not met in certain periods of time. Our costs under these leases are a significant amount of our expenses and are growing rapidly as we expand the number of locations and existing locations experience expense increases. We are required to pay additional rent under many of our lease agreements based upon achieving certain sales plateaus for each store location. In addition, we must make significant payments for common area maintenance and real estate taxes. Many of our lease agreements also contain provisions which increase the rent payments on a set time schedule, causing the cash rent paid for a location to escalate over the term of the lease. In addition, rent costs could escalate when multi-year leases are renewed at the expiration of their lease term. These costs are significant, recurring and increasing, which places a consistent strain on our cash flows.
We depend on cash flows from operations to pay our lease expenses and to fulfill our other cash needs. If our business does not generate sufficient cash flows from operating activities, and sufficient funds are not otherwise available to us from borrowings under our available revolving credit facility or from other sources, we may not be able to service our operating lease expenses, grow our business, respond to competitive challenges or to fund our other liquidity and capital needs, which would harm our business.
Additional sites that we lease are likely to be subject to similar long-term leases. If an existing or future store is not profitable, and we decide to close it, we may nonetheless be committed to perform our obligations under the applicable lease including, among other things, paying the base rent for the balance of the lease term. In addition, as our leases expire, we may fail to negotiate renewals, either on commercially acceptable terms or at all, which could cause us to close stores in desirable locations. If we are unable to enter into new leases or renew existing leases on terms acceptable to us or be released from our obligations under leases for stores that we close, our business, profitability and results of operations may be harmed.
We rely on third parties to deliver merchandise to our stores located outside of southern California and therefore our business could be negatively impacted by disruptions in the operations of these third-party providers.
We rely on third parties to ship our merchandise from our distribution center in Irvine, California to our stores located across the United States, as well as to ship e-commerce sales packages directly to our customers. Relying on these third-party delivery services puts us at risk from disruptions in their operations, such as employee strikes, inclement weather and their ability to meet our shipping demands. If we are forced to use other delivery services, our costs could increase and we may not be able to meet shipment deadlines. Moreover, we may not be able to obtain delivery terms as favorable as those received from the transportation providers we currently use, which would further increase our costs. These circumstances may negatively impact our financial condition and results of operations.
We rely on print and online marketing services.
We use the U.S. Postal Service to mail printed marketing materials several times each year to inform our customers about our products, acquire new customers, drive customers into our stores, and promote our website and stores. As a result, postal rate increases and paper and printing costs affect the cost of our mailings. We also use third-party online services to market our website and stores and to distribute promotions to attract new customers and encourage existing customers to purchase from us. Any significant or unanticipated increase in postage, reduction in postal service, or slow-down in postal delivery, increases in paper and printing costs, increases in the cost of our online marketing services or any service interruption or failure on the part of such service providers could impair our ability to deliver printed marketing materials or our online marketing in a timely or economically efficient manner. This could also adversely impact our sales and earnings if we are unable to pass such increases on to our customers or are unable to implement more efficient printing, mailing, delivery and order fulfillment systems or, in the case of our online marketing, to find alternative providers in a timely manner and on terms that are not significantly more costly to us.
If our management information systems fail to operate or are unable to support our growth, our operations could be disrupted.
We rely upon our management information systems in almost every aspect of our daily business operations. For example, our management information systems serve an integral part in enabling us to order merchandise, process merchandise at our distribution center and retail stores, perform and track sales transactions, manage personnel, pay

vendors and employees, operate our e-commerce platform and report financial and accounting information to management. In addition, we rely on our management information systems to enable us to leverage our costs as we grow. If our management information systems fail to operate or are unable to support our growth, our store operations and e-commerce platform could be severely disrupted, and we could be required to make significant additional expenditures to remediate any such failure.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

We may be subject to unionization, work stoppages, slowdowns or increased labor costs.

Currently, none of our employees are represented by a union. However, our employees have the right under the National Labor Relations Act to form or affiliate with a union. If some or all of our workforce were to become unionized and the terms of the collective bargaining agreement were significantly different from our current compensation arrangements, it could increase our costs and adversely impact our profitability. Moreover, participation in labor unions could put us at increased risk of labor strikes and disruption of our operations.

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

We are subject to numerous regulations, including labor and employment, customs, truth-in-advertising, consumer protection and zoning and occupancy laws and ordinances that regulate retailers generally and/or govern the importation, promotion and sale of merchandise and the operation of stores and warehouse facilities. If these regulations were violated by our management, employees or vendors, the costs of certain goods could increase, or we could experience delays in shipments of our goods, be subject to fines or penalties or suffer reputational harm, which could reduce demand for our merchandise and hurt our business and results of operations. Similarly, changes in laws could make operating our business more expensive or require us to change the way we do business. For example, changes in laws related to employee health care, hours, wages, job classification and benefits could significantly increase operating costs and adversely impact our results of operations. Furthermore, changes in product safety or other consumer protection laws could lead to increased costs for certain merchandise, or additional labor costs associated with readying merchandise for sale. It may be difficult for us to foresee regulatory changes impacting our business and our actions needed to respond to changes in the law could be costly and may negatively impact our operations.

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

As a result of being a publicly traded company, we are obligated to file periodic reports with the SEC under the Exchange Act. We are also subject to other reporting and corporate governance requirements, including certain requirements of the New York Stock Exchange, or NYSE, Financial Industry Regulatory Authority, or FINRA, and certain provisions of the Sarbanes-Oxley Act of 2002, or SOX, and the regulations promulgated thereunder, which impose significant compliance obligations on us. SOX, as well as rules subsequently implemented by the SEC, NYSE and FINRA, have imposed increased regulation and disclosure and have required enhanced corporate governance practices of public companies. Our efforts to comply with evolving laws, regulations and standards result in increased administrative expenses and a diversion of management’s time and attention from revenue-generating activities. In addition, if we fail to implement or maintain the requirements with respect to our internal accounting and audit functions, our ability to continue to report our operating results on a timely and accurate basis could be impaired and we could be subject to sanctions or investigation by regulatory authorities, such as the SEC, NYSE or FINRA. Any such action could harm our reputation and the confidence of investors and customers in our company and could materially adversely affect our business.

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

Our public company reporting obligations and our anticipated growth will likely strain our financial and management systems, internal controls and our employees. In addition, pursuant to Section 404 of SOX, we are required to provide annually an assessment of the effectiveness of our internal controls over financial reporting and our independent registered public accounting firm will be required to provide an attestation on our assessment of our internal controls over financial reporting. The process required to comply with Section 404 of SOX is time consuming and costly. If during this process we identify one or more material weaknesses in our internal controls, it is possible that our management may not be able to certify that our internal controls are effective by the certification deadline. Moreover, if we identify any material weaknesses or significant deficiencies in our internal controls we will have to implement appropriate changes to these controls, which may require specific compliance training for our directors, officers and employees, require the hiring of additional finance, accounting, legal and other personnel, entail substantial costs to modify our existing accounting systems and take a significant period of time to complete. Such changes may not, however, be effective in maintaining the adequacy of our internal controls, and any failure to maintain that adequacy, or consequent inability to produce accurate financial statements on a timely basis, could increase our operating costs and could materially impair our ability to operate our business. Effective internal controls are necessary for us to produce reliable financial reports and are important to prevent fraud. As a result, our failure to satisfy the requirements of Section 404 on a timely basis could result in us being subject to regulatory action and a loss of investor confidence in the reliability of our financial statements, both of which in turn could cause the market value of our Class A common stock to decline.

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

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

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

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

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

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

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

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

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

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

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

Our consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States of America, or GAAP. New accounting rules or regulations and changes to existing accounting rules or regulations have occurred and may occur in the future. Future changes to accounting rules or regulations, such as changes as a requirement to convert to international financial reporting standards, could negatively affect our results of operations and financial condition through increased cost of compliance.

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

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

We may experience fluctuations in our tax obligations and effective tax rate.

We are subject to income taxes in federal and applicable state and local tax jurisdictions in the U.S. We record tax expense based on our estimates of current and future payments. At any time, many tax years are subject to audit by various taxing jurisdictions. The results of these audits and negotiations with taxing authorities may impact the ultimate settlement of these tax positions. As a result, there could be ongoing variability in our tax rates as taxable events occur and exposures are re-evaluated. Further, our effective tax rate in any financial statement period may be materially affected by changes in the mix and level of earnings.

On December 22, 2017, the President signed the Tax Cuts and Jobs Act (the ”Tax Act“) into law. The Tax Act has significantly changed the U.S. federal income taxation of U.S. corporations, including by reducing the U.S. corporate income tax rate, limiting interest deductions, permitting immediate expensing of certain capital expenditures, revising the rules governing net operating losses and the rules governing foreign tax credits, and introducing new anti-base erosion provisions. Many of these changes are effective immediately, without any transition periods or grandfathering for existing transactions. The Tax Act is unclear in many respects and could be subject to potential amendments and technical corrections, as well as interpretations and implementing regulations by the Treasury and Internal Revenue Service, any of which could lessen or increase certain adverse impacts of the Tax Act. In addition, it is unclear how these U.S. federal income tax changes will affect state and local taxation, which often uses federal taxable income as a starting point for computing state and local tax liabilities.

While we have analyzed and interpreted the anticipated impacts of the Tax Act on us on a preliminary basis, including recognizing a reduction in deferred tax asset value during fiscal year 2017, which resulted in a corresponding charge to income tax expense for the year, the financial statement impacts of the Tax Act on us may be subject to further adjustment in subsequent periods throughout 2018 in accordance with recent interpretive guidance issued by the SEC. Further, there may be other material adverse effects resulting from the Tax Act that we have not yet identified.

While some of the changes made by the Tax Act may adversely affect the Company in one or more reporting periods and prospectively, other changes may be beneficial on a going forward basis. We continue to work with our tax advisors to determine the full impact that the Tax Act as a whole will have on us. We urge our investors to consult with their legal and tax advisors with respect to the Tax Act.

Risks Related to Ownership of Our Class A Common Stock

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

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

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

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

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

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

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

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

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

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

The price of our Class A common stock has been, and may continue to be volatile and may decline in value.

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

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

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

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

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

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

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

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

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

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

While we have paid dividends in February of 2018 and 2017 there can be no assurance that we will pay dividends in the future, which may make our Class A common stock less desirable to investors and decrease its value.

In February of 2018 and 2017, we paid special cash dividends of $1.00 per share and $0.70 per share, respectively, to all holders of record of issued and outstanding shares of our common stock. However, there can be no assurance that we will pay additional cash dividends on our common stock in the future. We currently intend to retain all of our earnings to finance our operations and growth, and do not anticipate paying any additional cash dividends on our common stock at this time. Therefore, capital appreciation, if any, of our Class A common stock could be the sole source of gain for our Class A common stockholders for the foreseeable future.

Item 1B. Unresolved Staff Comments

None.

Item 2. Properties

We lease approximately 172,000 square feet for our corporate headquarters and retail support and distribution center located at 10 Whatney and 12 Whatney, Irvine, California. Our lease began on January 1, 2003 and terminates on December 31, 2027.

We lease approximately 26,000 square feet of office and warehouse space located at 11 Whatney, Irvine, California. The lease began on September 2, 2011 and terminates on June 30, 2022.

We lease approximately 81,000 square feet for our e-commerce fulfillment center located at 17 Pasteur, Irvine, California. The lease began on November 1, 2011 and terminates on October 31, 2021.

All of our 219 stores, encompassing a total of approximately 1.7 million total square feet as of February 3, 2018, are occupied under operating leases. The store leases generally have a base lease term of 10 years and many have renewal option periods, and we are generally responsible for payment of property taxes and utilities, common area maintenance and mall marketing fees.

We consider all of our properties adequate for our present and anticipated future needs.

Item 3. Legal Proceedings

From time to time, we may become involved in lawsuits and other claims arising from our ordinary course of business. We have established loss provisions of approximately $7.5 million for matters in which losses are probable and can be reasonably estimated. For some matters, we are currently unable to predict the ultimate outcome, determine whether a liability has been incurred or make an estimate of the reasonably possible liability that could result from an unfavorable outcome because of the uncertainties related to the incurrence, amount and range of loss on any pending litigation or claim. Because of the unpredictable nature of these matters, we cannot provide any assurances regarding the outcome of any litigation or claim to which we are a party or that the ultimate outcome of any of the matters threatened or pending against us, including those disclosed below, will not have a material adverse effect on our financial condition, results of operations or cash flows. See Item 1A "Risk Factors- Risks Related to Our Business- Litigation costs and the outcome of litigation could have a material adverse effect on our business" included in this report.

Juan Carlos Gonzales, on behalf of himself and all others similarly situated, v. Tilly's Inc. et al, Superior Court of California, County of Orange, Case No. 30-2017-00948710-CU-OE-CXC. In October 2017, the plaintiff filed a putative class action against us, alleging various violations of California's wage and hour laws. The complaint seeks class certification, unspecified damages, unpaid wages, penalties, restitution, interest, and attorneys' fees and costs. In December 2017, we filed an answer to the complaint, denying all of the claims and asserting various defenses. Subsequently, we requested the plaintiff to dismiss the class action claims based on an existing waiver in an arbitration agreement which plaintiff signed with our co-defendant, BaronHR, the staffing company that employed plaintiff to work at the Company. We intend to defend this case vigorously.

Lauren Minniti, on behalf of herself and all others similarly situated, v. Tilly's, Inc., United States District Court, Southern District of Florida, Case No. 0:17-cv-60237-FAM. On January 30, 2017, the plaintiff filed a putative class action lawsuit against us, alleging violations of the Telephone Consumer Protection Act of 1991 (the "TCPA"). Specifically, the complaint asserts a violation of the TCPA for allegedly sending unsolicited automated messages to the cellular telephones of the plaintiff and others. The complaint seeks class certification and damages of $500 per violation plus treble damages under the TCPA. In March 2017, we filed our initial response to this matter with the court. In June 2017, the parties attended a mediation. In July 2017, the parties reached an agreement in principle to settle this matter, subject to court approval and the execution of a final settlement agreement. In March 2018, the parties executed a settlement agreement, subject to court approval.

Skylar Ward, on behalf of herself and all others similarly situated, v. Tilly's, Inc., Superior Court of California, County of Los Angeles, Case No. BC595405. In September 2015, the plaintiff filed a putative class action lawsuit against us alleging, among other things, various violations of California's wage and hour laws. The complaint sought class certification, unspecified damages, unpaid wages, penalties, restitution, and attorneys' fees. In June 2016, the court granted our demurrer to the plaintiff's complaint on the grounds that the plaintiff failed to state a cause of action against Tilly's and dismissed the complaint. Specifically, the court agreed with us that the plaintiff's cause of action for reporting-time pay fails as a matter of law as the plaintiff and other putative class members did not "report for work" with respect to certain shifts on which the plaintiff's claims are based. In November 2016, the court entered a written order sustaining our demurrer to the plaintiff's complaint and dismissing all of plaintiff’s causes of action with prejudice. In January 2017, the plaintiff filed an appeal of the order to the California Court of Appeal. In October 2017, the plaintiff filed her opening appellate brief, and our responding appellate brief was filed in December 2017. Plaintiff's reply appellate brief is currently due to be filed in April 2018. We have defended this case vigorously and will continue to do so.

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. BC548252. In June 2014, the plaintiff filed a putative class action and representative Private Attorney General Act of 2004 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 sought class certification, penalties, restitution,
injunctive relief and attorneys’ fees and costs. The plaintiff filed a first amended complaint in December 2014. We answered the complaint in January 2015, denying all allegations. We engaged in mediation in May 2016, and the parties reached a resolution that was presented to the court for preliminary approval in September 2016. The court preliminarily approved the settlement in October 2016, and notice of the settlement was issued to class members. Upon completion of the claims process, the court approved the final settlement in February 2017. We concluded this matter with the payment of the final settlement in April 2017. The final settlement amount was not materially different from the amount previously accrued when a loss provision was established.

On June 10, 2015, we and one of our vendors entered into a settlement arrangement with a plaintiff who filed a copyright infringement lawsuit against the vendor and us related to certain vendor products we sell. The settlement requires that the vendor pay $2.0 million to the plaintiff over three years and we agreed to guarantee such payments in exchange for a security interest in the vendor's intellectual property. As of February 3, 2018, due to updated facts and circumstances, we have accrued for the remaining maximum exposure loss of $1.4 million relating to this matter. We will utilize all available rights of offset to reduce our loss, including the enforcement of the security interest we have in the vendor's intellectual property.

Item 4. Mine Safety Disclosures

Not applicable.

PART II

Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

The following table sets forth the high and low sales prices of our Class A common stock, as reported by the NYSE under the symbol "TLYS" for the quarters indicated. On March 28, 2018, the closing price of our Class A common stock was $11.33.

	High	Low
Fiscal 2017:		
Fourth Quarter	$16.57	$11.41
Third Quarter	$12.87	$8.42
Second Quarter	$11.43	$8.43
First Quarter	$13.70	$8.02
Fiscal 2016:		
Fourth Quarter	$15.29	$8.74
Third Quarter	$10.86	$5.53
Second Quarter	$6.69	$5.49
First Quarter	$8.72	$6.18

As of March 28, 2018, we had approximately 12 stockholders of record, six of whom were holders of our Class A common stock and six of whom were holders of our Class B common stock. The number of stockholders of record is based upon the actual number of stockholders registered at such date and does not include holders of shares in "street names" or persons, partnerships, associates, corporations or other entities identified in security position listings maintained by depositories.

Dividends

On January 24, 2018, we declared a special cash dividend of $1.00 per share to all holders of record of issued and outstanding shares of both Class A and Class B common stock as of the close of business on February 9, 2018, with payment of $29.1 million made on February 20, 2018.

On January 31, 2017, we declared a special cash dividend of $0.70 per share to all holders of record of issued and outstanding shares of both Class A and Class B common stock as of the close of business on February 15, 2017, with payment of $20.1 million made on February 24, 2017.

We do not currently anticipate declaring any additional dividends, but may do so again in the future.

Securities Authorized for Issuance under Equity Compensation Plans

The information required by this Item is incorporated herein by reference to our Proxy Statement for the 2018 Annual Meeting of Stockholders, which will be filed with the SEC no later than 120 days after the end of the fiscal year ended February 3, 2018 (the "2018 Proxy Statement").

Stock Performance Graph

The following graph compares the cumulative stockholder return on our Class A common stock for the five years ended February 3, 2018 to the cumulative return of (i) the S&P Midcap 400 Index and (ii) the S&P 400 Apparel Retail Index over the same period. This graph assumes an initial investment of $100 on February 2, 2013 in our Class A common stock, the S&P Midcap 400 Index and the S&P 400 Apparel Retail Index and assumes the reinvestment of dividends, if any.

Comparison of 5-Year Cumulative Total Return as of February 3, 2018
Among Tilly's, Inc., the S&P Midcap 400 Index and the S&P 400 Apparel Retail Index
Recent Sales of Unregistered Securities
We did not sell any unregistered equity securities or purchase any of our securities during the fiscal year ended February 3, 2018.
Item 6. Selected Financial Data
The following tables present selected consolidated financial and other data as of and for the periods indicated. The selected consolidated statement of income data for the fiscal year ended February 3, 2018, January 28, 2017 and January 30, 2016 and selected balance sheet data as of February 3, 2018 and January 28, 2017 are derived from our audited consolidated financial statements included in Part II, Item 8, "Financial Statements and Supplementary Data" of this Annual Report on Form 10-K. The selected consolidated statement of income data for the fiscal years ended January 31, 2015 and February 1, 2014 and the selected consolidated balance sheet data as of January 30, 2016, January 31, 2015 and February 1, 2014 are derived from our audited consolidated financial statements that have not been included elsewhere in this report. The historical results presented below are not necessarily indicative of the results to be expected for any future period. You should read this selected consolidated financial data in conjunction with the consolidated financial statements and accompanying notes and the information under “Management’s Discussion and Analysis of Financial Condition and Results of Operations” appearing elsewhere in this report.

	Fiscal Year Ended (1)				
	February 3, 2018	January 28, 2017	January 30, 2016	January 31, 2015	February 1, 2014
	(in thousands, except per share data)				
Consolidated Statements of Income Data:					
Net sales	$576,899	$568,952	$550,991	$518,294	$495,837
Cost of goods sold (2)	401,529	400,493	383,745	362,762	345,015
Gross profit	175,370	168,459	167,246	155,532	150,822
Selling, general and administrative expenses	151,384	149,129	149,150	132,343	121,085
Operating income	23,986	19,330	18,096	23,189	29,737
Interest income (expense), net	1,223	418	52	(14)	(9)
Income before income taxes	25,209	19,748	18,148	23,175	29,728
Income tax expense	10,509	8,338	10,607	9,100	11,591
Net income	$14,700	$11,410	$7,541	$14,075	$18,137
Basic earnings per share of Class A and Class B common stock	$0.51	$0.40	$0.27	$0.50	$0.65
Diluted earnings per share of Class A and Class B common stock	$0.51	$0.40	$0.27	$0.50	$0.65
Weighted average basic shares outstanding	28,804	28,496	28,332	28,013	27,822
Weighted average diluted shares outstanding	29,074	28,529	28,402	28,078	28,116

	Fiscal Year Ended				
	February 3, 2018	January 28, 2017	January 30, 2016	January 31, 2015	February 1, 2014
Operating Data (unaudited):					
Stores operating at beginning of period	223	224	212	195	168
Stores opened during the period	2	3	15	19	28
Stores closed during the period	6	4	3	2	1
Stores operating at end of period	219	223	224	212	195
Comparable store sales change (3)	1.0%	0.5%	1.2%	(2.8)%	(1.9)%
Total square feet at end of period	1,668,008	1,703,144	1,704,031	1,622,156	1,513,138
Average square footage per store at end of period	7,616	7,637	7,607	7,652	7,760
Average net sales per brick-and-mortar store (in thousands) (4)	$2,258	$2,188	$2,219	$2,250	$2,396
Average net store sales per square foot (4)	$296	$287	$290	$292	$307
Capital expenditures (in thousands)	$13,753	$17,047	$23,100	$23,636	$42,701

	As of				
	February 3, 2018	January 28, 2017	January 30, 2016	January 31, 2015	February 1, 2014
	(in thousands)				
Consolidated Balance Sheet Data:					
Cash, cash equivalents and marketable securities	$135,952	$133,917	$100,952	$84,746	$60,355
Working capital	107,423	129,819	110,965	94,394	77,331
Total assets	290,111	290,506	270,751	257,551	232,407
Total capital lease obligation (5)	—	835	1,693	2,500	3,258
Stockholders' equity	$160,425	$189,220	$173,213	$158,686	$140,923

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(1) The fiscal year ended February 3, 2018 included 53 weeks. The fiscal years ended January 28, 2017, January 30, 2016, January 31, 2015 and February 1, 2014 each included 52 weeks.

(2) Includes buying, distribution and occupancy costs.

(3) Comparable store sales are net sales from stores that have 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 platform but exclude gift card breakage income, deferred revenue from the loyalty program and e-commerce shipping and handling fee revenue. The comparable store sales change for the period ended February 3, 2018 includes the 53rd week in fiscal year 2017.

(4) The number of stores and the amount of square footage reflect the number of days during the period that new stores were open. E-commerce sales, e-commerce shipping revenue, and gift card breakage income are excluded from our sales in deriving net sales per store.

(5) Comprised solely of a capital lease for our corporate headquarters and distribution center.

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

You should read the following discussion in conjunction with the consolidated financial statements and the accompanying notes and the information contained in other sections of this report, particularly under the headings "Risk Factors", "Selected Consolidated Financial Data" and "Business". This discussion and analysis is based on the beliefs of our management, as well as assumptions made by, and information currently available to, our management. The statements in this discussion and analysis concerning expectations regarding our future performance, liquidity and capital resources, as well as other non-historical statements in this discussion and analysis, are forward-looking statements. See "Forward-Looking Statements". These forward-looking statements are subject to numerous risks and uncertainties, including those described under "Risk Factors". Our actual results could differ materially from those suggested or implied by any forward-looking statements.

We operate on a fiscal calendar widely used by the retail industry that results in a given fiscal year consisting of a 52- or 53-week period ending on the Saturday closest to January 31 of the following year. References to "fiscal year 2017" or "fiscal 2017" refer to the fiscal year ended February 3, 2018, references to "fiscal year 2016" or "fiscal 2016" refer to the fiscal year ended January 28, 2017 and references to 'fiscal year 2015" or "fiscal 2015" refer to the fiscal year ended January 30, 2016. Fiscal year 2017 consisted of a 53-week period. Fiscal years 2016 and 2015 each consisted of a 52-week period.

Overview

Tillys is a leading destination specialty retailer of casual apparel, footwear and accessories for young men, young women, boys and girls. We believe we bring together an unparalleled selection of iconic global, emerging and proprietary brands rooted in an active and outdoor lifestyle. The Tillys concept began in 1982 when our co-founders, Hezy Shaked and Tilly Levine, opened our first store in Orange County, California. As of February 3, 2018, we operated 219 stores in 32 states, averaging approximately 7,600 square feet. We also sell our products through our e-commerce website, www.tillys.com.

Known or Anticipated Trends

The retail industry has experienced a general downward trend in customer traffic to physical stores for an extended period of time. Conversely, online shopping has generally increased and resulted in sustained online sales growth. We believe these market trends will continue, despite the improvement in store traffic that we experienced during fiscal 2017. There can be no guarantee that our recent improvement in store traffic will continue given the broader industry trends. We will continue to focus our efforts on improving our existing stores, and expanding our online/digital capabilities through omni-channel initiatives designed to provide a seamless shopping experience for our customers, whether in-store or online.

During fiscal 2018, we plan to open up to 15 new stores and three RSQ-branded "pop-up" stores. We will leverage existing markets where we believe our brand recognition can be enhanced with new stores that are planned to drive additional improvement to our operating income.

As a result of the Tax Act, which was signed into law in December 2017, we expect our effective income tax rate to be reduced to approximately 27% for fiscal 2018.

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 platform, 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

Comparable store sales is a measure that indicates the change in year-over-year comparable store sales, which allows us to evaluate how our store base is performing. Numerous factors affect our comparable store sales, including:

- overall economic trends;
- our ability to attract traffic to our stores and online platform;
- our ability to identify and respond effectively to consumer preferences and fashion trends;
- competition;
- the timing of our releases of new and seasonal styles;
- changes in our product mix;
- pricing;
- the level of customer service that we provide in stores;
- our ability to source and distribute products efficiently;
- calendar shifts of holiday or seasonal periods;
- the number and timing of store openings and the relative proportion of new stores to mature stores; and
- the timing and success of promotional and advertising efforts.

Comparable store sales are sales from our e-commerce platform and stores open at least 12 full fiscal months as of the end of the current reporting period. A remodeled, relocated or refreshed store is included in comparable store sales, both during and after construction, if the square footage of the store was not changed by more than 20% and the store was not closed for more than five days in any fiscal month. We include sales from our e-commerce platform as part of comparable store sales as we manage and analyze our business on a single omni-channel and have substantially integrated our investments and operations for our stores and e-commerce platform to give our customers seamless access and increased ease of shopping. Comparable store sales exclude gift card breakage income and e-commerce shipping and handling fee revenue. Some of our competitors and other retailers may calculate comparable or "same store" sales differently than we do. As a result, data in this report regarding our comparable store sales may not be comparable to similar data made available by other retailers.

Gross Profit

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

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

Gross profit is also impacted by shifts in the proportion of sales of proprietary branded products compared to third-party branded products, as well as by sales mix shifts within and between brands and between major product departments such as young men's and women's 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 receiving and processing costs and store supplies costs. General and administrative expenses include the payroll and support costs of corporate functions such as executive management, legal, accounting, information systems, human resources, impairment charges 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.

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 results of operations for the periods indicated, both in dollars and as a percentage of our net sales:

	Fiscal Year Ended		
	February 3, 2018	January 28, 2017	January 30, 2016
	(in thousands)		
Statements of Income Data:			
Net sales	$576,899	$568,952	$550,991
Cost of goods sold	401,529	400,493	383,745
Gross profit	175,370	168,459	167,246
Selling, general and administrative expenses	151,384	149,129	149,150
Operating income	23,986	19,330	18,096
Other income, net	1,223	418	52
Income before income taxes	25,209	19,748	18,148
Income tax expense	10,509	8,338	10,607
Net income	$14,700	$11,410	$7,541
Percentage of Net Sales:			
Net sales	100.0 %	100.0 %	100.0 %
Cost of goods sold	69.6 %	70.4 %	69.6 %
Gross profit	30.4 %	29.6 %	30.4 %
Selling, general and administrative expenses	26.2 %	26.2 %	27.1 %
Operating income	4.2 %	3.4 %	3.3 %
Interest income, net	0.2 %	0.1 %	— %
Income before income taxes	4.4 %	3.5 %	3.3 %
Income tax expense	1.9 %	1.5 %	1.9 %
Net income	2.5 %	2.0 %	1.4 %

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

	Fiscal Year Ended		
	February 3, 2018	January 28, 2017	January 30, 2016
Store Operating Data:			
Stores operating at end of period	219	223	224
Comparable store sales change (1)	1.0 %	0.5 %	1.2 %
Total square feet at end of period (in thousands)	1,668	1,703	1,704
Average net sales per brick-and-mortar store (in thousands) (2)	$2,258	$2,188	$2,219
Average net sales per square foot (2)	$296	$287	$290
E-commerce revenues (in thousands) (3)	$75,846	$76,380	$68,978
E-commerce revenues as a percentage of net sales	13.1 %	13.4 %	12.5 %

(1) Comparable store sales are net sales from stores that have 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 platform but exclude gift card breakage income, deferred revenue from the loyalty program and e-commerce shipping and handling fee revenue.

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

Fiscal Year 2017 Compared to Fiscal Year 2016

Net Sales

Net sales were $576.9 million in fiscal 2017 compared to $569.0 million in fiscal 2016, an increase of $7.9 million, or 1.4%. The components of our net sales increase were as follows:

$ millions	Attributable to
$5.8	Increase in comparable store sales of 1.0%
2.1	Increase in non-comparable store sales
$7.9	Total

Our comparable store sales increased 1.0%, driven by a 1.6% increase in store sales, partially offset a 2.5% decrease in e-commerce sales. Our comparable store sales growth was characterized by high single-digit percentage growth in our Mens department and low single-digit percentage growth in our Boys department. This growth was partially offset by low single-digit percentage decreases in our Girls, Womens, Accessories and Footwear departments. E-commerce revenues represented 13.1% of our total net sales, or $75.8 million, in fiscal 2017 as compared to 13.4%, or $76.4 million, in fiscal 2016. E-commerce sales declined due to certain transitional issues we experienced during the fourth quarter associated with the implementation of our new omni-channel order management system. We expect these transitional issues will be substantially corrected near the end of the first quarter or early in the second quarter of fiscal 2018.

Gross Profit

Gross profit was $175.4 million in fiscal 2017 compared to $168.5 million in fiscal 2016, an increase of $6.9 million, or 4.1%, primarily due to the increase in net sales. Gross margin, or gross profit as a percentage of net sales, was 30.4% during fiscal 2017 compared to 29.6% during fiscal 2016. This 0.8% increase in gross margin was primarily attributable to a decline in buying, distribution and occupancy costs. Product margins were flat.

Selling, General and Administrative Expenses ("SG&A")

SG&A was $151.4 million in fiscal 2017 compared to $149.1 million in fiscal 2016. As a percentage of net sales, SG&A was flat at 26.2% for both fiscal 2017 and fiscal 2016. The components of the changes in SG&A, both in terms of percentage of net sales and total dollars, were as follows:

%	$ millions	Attributable to
0.8%	$4.4	Net increase in year over year legal provisions
0.5%	2.8	Increase in expenses associated with several information technology system implementations
0.1%	2.0	Increase in store payroll and benefits primarily due to minimum wage increases
(0.6)%	(3.4)	Decrease in marketing spend
(0.2)%	(1.5)	Decrease in non-cash store asset impairment charges
(0.2)%	(0.8)	Decrease in corporate payroll and benefits
(0.4)%	(1.2)	Decrease in all other SG&A expenses
—%	$2.3	Total

Operating Income

Operating income was $24.0 million in fiscal 2017 compared to $19.3 million for fiscal 2016, an increase of $4.7 million, or 24.1%. As a percentage of net sales, operating income was 4.2% for fiscal 2017 compared to 3.4% for fiscal 2016. The increase in operating income was primarily attributable to the increase in comparable store sales and reductions in buying, distribution and occupancy costs.

Income Tax Expense

Income taxes were $10.5 million for fiscal 2017 compared to $8.3 million for fiscal 2016. Our effective tax rates were 41.7% for fiscal 2017 and 42.2% for fiscal 2016. Fiscal 2017 income tax expense includes a net charge of $0.2 million due to the impact of the Tax Cuts and Job Act (the "Act") signed into law during December 2017.

Net Income and Earnings Per Share

Net income was $14.7 million for fiscal 2017 compared to $11.4 million for fiscal 2016, an increase of $3.3 million, or 28.9%. Diluted earnings per share was $0.51 for fiscal 2017 compared to $0.40 for fiscal 2016.

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Fiscal Year 2016 Compared to Fiscal Year 2015

Net Sales

Net sales were $569.0 million in fiscal 2016 compared to $551.0 million in fiscal 2015, an increase of $18.0 million, or 3.3%. The components of our net sales increase were as follows:

$ millions	Attributable to
$15.4	Increase in non-comparable store sales
2.6	Increase in comparable store sales of 0.5%
$18.0	Total

Comparable store sales increased 0.5%, driven by e-commerce growth of 11.1% which offset a 1.0% decrease in sales from our physical stores. E-commerce revenues represented 13.4% of our total net sales, or $76.4 million, in fiscal 2016 as compared to 12.5%, or $69.0 million, in fiscal 2015. We experienced a shift in our customers' shopping behaviors, which resulted in an increase in online shopping that largely offset declining traffic trends in our physical stores. Our comparable store sales were driven by higher comparable sales increases in mens, boys and footwear, offset by decreases in women, accessories, and girls.

Gross Profit

Gross profit was $168.5 million in fiscal 2016 compared to $167.2 million in fiscal 2015, an increase of $1.3 million, or 0.8%, primarily due to the increase in net sales. Gross margin, or gross profit as a percentage of net sales, was 29.6% and 30.4% during fiscal 2016 and fiscal 2015, respectively. The 0.8% decrease in gross margin was primarily attributable to a decline in product margins as a result of increased markdowns.

Selling, General and Administrative Expenses ("SG&A")

SG&A expenses were $149.1 million in fiscal 2016 compared to $149.2 million in fiscal 2015, a slight decrease from fiscal 2015. As a percentage of net sales, SG&A expenses were 26.2% and 27.1% during fiscal 2016 and fiscal 2015, respectively. The components of the SG&A expense decrease, both in terms of percentage of net sales and total dollars, were as follows:

%	$ millions	Attributable to
(0.9)%	$(4.3)	Decrease due to more efficient marketing expenses
(0.5)%	(2.1)	Decrease in corporate payroll and benefits primarily due to prior year's severance obligations and lower stock based compensation as compared to fiscal 2015
0.1%	2.8	Increase in store payroll and benefits primarily due to minimum wage increases
0.4%	2.6	Increase in computer maintenance expenses and bank chargebacks
—%	0.9	Increase in all other SG&A expenses
(0.9)%	$(0.1)	Total

Operating Income

Operating income was $19.3 million in fiscal 2016 compared to $18.1 million for fiscal 2015, an increase of $1.2 million, or 6.6%. As a percentage of net sales, operating income was 3.4% and 3.3% for fiscal 2016 and fiscal 2015, respectively. The increase in operating income was primarily attributable to the increase in gross profit as discussed above.

Income Tax Expense

Income taxes were $8.3 million and $10.6 million for fiscal 2016 and fiscal 2015, respectively. Our effective tax rates were 42.2% and 58.4% for fiscal 2016 and fiscal 2015, respectively. The decrease in our effective tax rate for fiscal 2016 was primarily due a reduction in the discrete items related to the expiration of stock options.

Net Income and Earnings Per Share

Net income was $11.4 million for fiscal 2016 compared to $7.5 million for fiscal 2015, an increase of $3.9 million, or 52.0%. Diluted earnings per share was $0.40 for fiscal 2016 compared to $0.27 for fiscal 2015.

Liquidity and Capital Resources

Our business relies on cash flows from operating activities as well as cash on hand as our primary sources of liquidity. We currently expect to finance company operations, store growth and remodels with existing cash on hand, marketable securities and cash flows from operations.

In addition to cash and cash equivalents and marketable securities, the most significant components of our working capital are merchandise inventories, accounts payable and accrued expenses. We believe that cash flows from operating activities 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 from the issuance of this Annual Report. If cash flows from operations are not sufficient or available 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 stockholders.

Working capital at February 3, 2018, was $107.4 million compared to $129.8 million at January 28, 2017, a decrease of $22.4 million. The changes in our working capital during fiscal 2017 were as follows:

$ millions	Description
$129.8	Working capital at January 28, 2017
(29.1)	Increase in dividends payable, paid in February 2018
(4.3)	Increase in legal loss contingencies
3.5	Decrease in sales and use taxes payable
2.0	Increase in cash, cash equivalents and marketable securities
1.4	Increase in merchandise inventories, net of merchandise payables
1.1	Decrease in accrued compensation and benefits
3.0	Net increase from changes in all other assets and liabilities
$107.4	Working capital at February 3, 2018

Cash Flow Analysis

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

	Fiscal Year Ended		
	February 3, 2018	January 28, 2017	January 30, 2016
	(in thousands)		
Net cash provided by operating activities	$32,708	$ 48,509	$ 36,945
Net cash used in investing activities	(40,878)	(21,658)	(37,966)
Net cash (used in) provided by financing activities	(17,622)	1,123	2,252

Net Cash Provided by Operating Activities

Operating activities consist primarily of net income adjusted for non-cash items that include depreciation, asset impairment write-downs, deferred income taxes and share-based compensation expense, plus the effect on cash of changes during the year in our assets and liabilities.

Net cash provided by operating activities decreased in fiscal 2017 as compared to fiscal 2016 primarily due to a decrease in cash generated from working capital mainly due to the timing of inventory purchases, an increase in accrued legal loss contingencies, and timing of payments to vendors, partially offset by a decrease in deferred tax assets due to the impact of the Tax Act.

Net cash provided by operating activities increased in fiscal 2016 as compared to fiscal 2015 primarily due to higher operating income and an increase in cash generated from working capital mainly due to the timing of payments to vendors and decreases in inventories and receivables, partially offset by a decrease in deferred rent.

Net Cash Used in Investing Activities

Investing activities consist 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, expansion into the new e-commerce fulfillment center, assets at our corporate headquarters and the addition or replacement of company vehicles. Investing activities also consist of the purchase and sale of marketable securities.

Net cash used in investing activities was $40.9 million in fiscal 2017. Capital expenditures totaled $13.8 million, primarily related to new and remodeled stores and other improvements in our existing stores and information technology systems. We purchased $152.4 million of marketable securities and received proceeds of $125.3 million from marketable securities during fiscal 2017.

Net cash used in investing activities was $21.7 million in fiscal 2016. Capital expenditures totaled $17.0 million, primarily related to new and remodeled stores and other improvements in our existing stores and information technology systems. We purchased $99.7 million of marketable securities and received proceeds of $95.0 million from marketable securities during fiscal 2016.

Net cash used in investing activities was $38.0 million in fiscal 2015. Capital expenditures totaled $23.1 million, primarily related to new and remodeled stores and other improvements in our information technology systems, distribution centers, and corporate offices. We purchased $74.9 million of marketable securities and received proceeds of $60.0 million from the maturities of marketable securities during fiscal 2015.

Capital expenditures during fiscal 2018 are expected to be approximately $20 million, primarily for construction of up to 15 new stores and three RSQ-branded "pop-up" stores and continuing information technology investments. These expenditures are expected to be funded from cash provided by operations.

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, cash dividends paid and employee taxes paid in result of the net settlement of issued restricted stock.

Net cash used in financing activities was $17.6 million in fiscal 2017. This included $20.1 million of cash dividends paid, $0.8 million in payments towards our capital lease obligation, partially offset by $3.4 million of proceeds from the exercise of stock options from share-based compensation.

Net cash provided by financing activities was $1.1 million in fiscal 2016. This included $2.0 million of proceeds from the exercise of stock options from share-based compensation and taxes paid in lieu of shares issued for stock-based compensation, partially offset by $0.9 million in payments towards our capital lease obligation.

Net cash provided by financing activities was $2.3 million in fiscal 2015. This included $3.1 million of proceeds from the exercise of stock options, partially offset by $0.8 million in payments towards our capital lease obligation during fiscal 2015.

Line of Credit

Our amended and restated credit agreement with Wells Fargo Bank, N.A. ("Bank") provides for a $25.0 million revolving line of credit with a maturity date of January 26, 2020. The interest rate charged on borrowings is selected at our discretion at the time of draw between the London Interbank Offered Rate, plus 0.75%, or at the Bank’s prime rate. The agreement allows for the declaration and payment of dividends or distributions to stockholders, subject to certain limitations. On February 20, 2018 and February 24, 2017, we paid a special dividend of $1.00 per share and $0.70 per share, respectively. Refer to "Note 18: Shareholders' Equity", for further information. The line of credit is secured by substantially all of our assets. As a sub-feature under the revolving line of credit, the Bank may also issue stand-by and/or commercial letters of credit up to $15.0 million.

We are required to maintain certain financial and non-financial covenants in accordance with the line of credit. The financial covenants require certain levels of leverage and profitability, such as (i) income before income taxes not to be less than $1 million (measured at the end of each fiscal quarter), (ii) a maximum ratio of 4.00 to 1.00 as of each quarter end for “Funded Debt to EBITDAR”, defined as the sum of total debt, capital leases and annual rent expense multiplied by 6 divided by the sum of net income, interest expense, taxes, depreciation, amortization and annual rent expense, and (iii) requires minimum eligible inventory of $50 million as of the end of each quarter. In addition, maximum investment in fixed assets in any fiscal year of $50 million.

In September 2016, we established a $750,000 standby letter of credit as security against insurance claims as required by our worker's compensation insurance policy. As of February 3, 2018, there has been no activity under this letter of credit.

As of February 3, 2018, we had no outstanding borrowings under the credit facility.

Contractual Obligations

We enter into long-term contractual obligations and commitments in the normal course of business, primarily noncancellable capital and operating leases.

We lease approximately 172,000 square feet for our corporate headquarters and distribution center from a company that is owned by the co-founders of Tillys. These buildings are located at 10 and 12 Whatney, Irvine, California. The lease is accounted for as an operating lease and expires on December 31, 2027.

We lease approximately 26,000 square feet of office and warehouse space with a company that is owned by one of the co-founders of Tillys. This building is located at 11 Whatney, Irvine, California. The lease is accounted for as an operating lease and expires on June 30, 2022.

We lease approximately 81,000 square feet for our e-commerce distribution center from a company that is owned by one of the co-founders of Tillys. This building is located at 17 Pasteur, Irvine, California. The lease is accounted for as an operating lease and expires on October 31, 2021.

Our leases are generally non-cancellable operating leases expiring at various dates through fiscal year 2027. Certain leases provide for additional rent based on a percentage of sales and annual rent increases based upon the Consumer Price Index. In addition, many of our store leases contain certain co-tenancy provisions that permit us to pay rent based on a pre-determined percentage of sales when the occupancy of the retail center falls below minimums established in such lease.

As of February 3, 2018, our contractual cash obligations over the next several years are as follows:

	Payments Due by Period				
	Total	Less Than 1 Year	1-3 Years	3-5 Years	More Than 5 Years
	(in thousands)				
Operating Lease Obligations (1)	$366,819	$ 69,029	$120,498	$ 93,692	$ 83,600
Purchase Obligations (2)	8,264	2,648	4,080	1,536	—
Total	$375,083	$ 71,677	$124,578	$ 95,228	$ 83,600

(1) Operating leases include minimum lease commitments, including fixed common area maintenance charges, if any, for our stores, and our corporate headquarters and distribution center and warehouse leases. Our store leases generally have initial lease terms of 10 years and many also include renewal options on substantially the same terms and conditions as the original lease.

(2) Purchase obligations consist primarily of software maintenance commitments.

Off-Balance Sheet Arrangements

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

Critical Accounting Policies and Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States 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.

We believe the application of our accounting policies, and the estimates inherently required therein, are reasonable. Our accounting policies and estimates are reevaluated on an ongoing basis and adjustments are made when facts and circumstances dictate a change.

The policies and estimates discussed below involve the selection or application of alternative accounting policies that are material to our consolidated financial statements. With respect to critical accounting policies, even a relatively minor variance between actual and expected experience can potentially have a materially favorable or unfavorable impact on subsequent results of operations. However, our historical results for the periods presented in the consolidated financial statements have not been materially impacted by such variances. Our accounting policies are more fully described in "Note 2: Summary of Significant Accounting Policies" in the notes to our consolidated financial statements. Management has discussed the development and selection of these critical accounting policies and estimates with our Board of Directors.

We have certain accounting policies that require more significant management judgment and estimates than others. These include our accounting policies with respect to revenue recognition, loyalty program, merchandise inventories, long-lived assets, share-based compensation and accounting for income taxes, which are more fully described below.

Revenue Recognition

Revenue is recognized for store sales when the customer receives and pays for the merchandise at the register, net of estimated returns. Taxes collected from our customers are recorded on a net basis. For e-commerce sales, we recognize revenue, net of sales taxes and estimated sales returns, and the related cost of goods sold at the time the merchandise is received by the customer. We defer e-commerce revenue that is in-transit to the customer. Customers typically receive goods within four days of shipment. Amounts related to shipping and handling that are billed to customers are reflected in net sales, and the related costs are reflected in cost of goods sold in the Consolidated Statements of Income.

Loyalty Program

We have a customer loyalty program wherein customers accumulate points based on purchase activity. Once a loyalty member achieves a certain point level, the member earns awards that may be redeemed for merchandise. Unredeemed awards and accumulated partial points are accrued as deferred revenue and awards redeemed by the member for merchandise are recorded as an increase to net sales. We expire unredeemed awards after 45 days from date of issuance and accumulated partial points 365 days after the last purchase activity. When a customer redeems an earned reward, we recognize revenue for the redeemed product and reduce the related loyalty program liability.

Merchandise Inventories

Merchandise inventories are stated at the lower of cost or net realizable value, which generally is the merchandise selling price. Cost is calculated using the retail inventory method. Under the retail inventory method, inventory is stated at its current retail selling value and then is converted to a cost basis by applying a cost-to-retail ratio based on beginning inventory and the fiscal year purchase activity. The retail inventory method inherently requires management judgments and estimates, such as the amount and timing of markdowns needed in order to sell through slow-moving inventories.

Markdowns are recorded when the sales value of the inventory has diminished. Factors considered in the determination of markdowns include current and anticipated demand, customer preferences, age of the merchandise and fashion trends. When a decision is made to mark down merchandise, the resulting gross margin reduction is recognized in the period in which the markdown is recorded. During each accounting period we record adjustments to our inventories, which are reflected in cost of goods sold, if the cost of specific inventory items on hand exceeds the amount we expect to realize from the ultimate sale or disposal of the inventory. This adjustment calculation requires us to make assumptions and estimates, which are based on factors such as merchandise seasonality, historical trends and inventory levels, including estimated sell-through rates of remaining units.

To the extent that management’s estimates differ from actual results, additional markdowns may be required that could reduce our gross margin, operating income and the carrying value of inventories. Our success is largely dependent upon our ability to anticipate the changing fashion tastes of our customers and to respond to those changing tastes in a timely manner. If we fail to anticipate, identify or react appropriately to changing styles, trends or brand preferences of our customers, we may experience lower sales, excessive inventories and more frequent and extensive markdowns, which would adversely affect our operating results.

We also record an inventory shrinkage reserve calculated as a percentage of net sales for estimated merchandise losses for the period between the last physical inventory count and the balance sheet date. These estimates are based on historical percentages and can be affected by changes in merchandise mix and changes in shrinkage trends. We perform physical inventory counts at least once per year for the entire chain of stores and our distribution center and adjust the inventory shrinkage reserve accordingly. If actual physical inventory losses differ significantly from the estimate, our results of operations could be adversely impacted. The inventory shrinkage reserve reduces the value of total inventory and is a component of inventories on the Consolidated Balance Sheets. The inventory shrinkage reserve at February 3, 2018 and January 28, 2017 was not material.

Long-Lived Assets

We evaluate the carrying value of our long-lived assets, consisting largely of leasehold improvements, furniture and fixtures and equipment at store, distribution center and corporate office locations, for impairment whenever events or changes in circumstances indicate that the carrying value of such assets may not be recoverable. Factors that are considered important that could result in the necessity to perform an impairment review include a current-period operating or cash flow loss combined with a history of operating or cash flow losses and a forecast that indicates continuing losses or insufficient income associated with the realization of a long-lived asset or asset group. Other factors include a significant change in the manner of the use of the asset or a significant negative industry or economic trend. This evaluation is performed based on estimated undiscounted future cash flows from operating activities compared with the carrying value of the related assets. If the undiscounted future cash flows are less than the carrying value, an impairment loss is recognized, measured by the difference between the carrying value and the estimated fair value of the assets, based on discounted cash flows using our weighted-average cost of capital, with such estimated fair values determined using the best information available. Quarterly, we assess whether events or changes in circumstances have occurred that potentially indicate the carrying value of long-lived assets may not be recoverable. The estimation of future cash flows from operating activities requires significant estimates of factors that include future sales and gross margin performance. Factors used in the valuation of long-lived assets with finite lives include, but are not limited to, discount rates, management’s plans for future operations, recent operating results and projected future cash flows. If our net sales or gross profit performance or other estimated operating results are not achieved at or above our forecasted level, or inflation exceeds our forecast and we are unable to recover such costs through price increases, the carrying value of certain of our retail stores may prove to be unrecoverable and we may incur additional

impairment charges in the future.
Share-based Compensation
We account for share-based compensation in accordance with the provisions of ASC Topic 718, Compensation-Stock Compensation, or ASC 718, which establishes accounting for equity instruments exchanged for employee services. Under the provisions of this statement, share-based compensation expense is measured at the grant date, based on the calculated fair value of the award, and is recognized as an expense on a straight-line basis over the employee’s requisite service period (generally the vesting period of the equity grant). Changes in these inputs and assumptions can materially affect the measurement of the estimated fair value of our share-based compensation expense.

Determining the fair value of share-based awards at the grant date requires judgment. We use the Black-Scholes option-pricing model to determine the fair value of stock options. The determination of the grant date fair value of options using an option-pricing model is affected by a number of assumptions, such as the fair value of the common stock, our expected stock price volatility over the expected term of the options, stock option exercise and cancellation behaviors, risk-free interest rates, and expected dividends, which we estimate as follows:

- Fair Value of Our Common Stock. We use the closing price of our Class A common stock on the date of grant.
- Expected Term. We have limited historical information regarding expected option term. Accordingly, we determined the expected stock option term of the awards using the latest historical data available from comparable public companies and our expectation of exercise behavior.
- Volatility. Our stock volatility for each grant is measured using the weighted average of historical daily price changes of our common stock over the most recent period equal to the expected option term of the awards.
- Risk-Free Rate. The risk-free interest rate is based on the yields of United States Treasury securities with maturities similar to the expected term of the stock options for each stock option group.
- Dividend Yield. On January 31, 2017 and January 24, 2018, we declared special cash dividends of $0.70 and $1.00 per share, respectively, to all holders of record of issued and outstanding shares Class A common stock and Class B common stock as of the close of business on February 15, 2017 and February 9, 2018, respectively. Except as described above, Tilly's, Inc. has never declared or paid any cash dividends and does not plan to pay additional cash dividends in the foreseeable future. Consequently, we used an expected dividend yield of zero.

If any of the assumptions used in the Black-Scholes model change significantly, share-based compensation expense for future awards may differ materially compared with the expense for awards granted previously.

Accounting for Income Taxes

We account for income taxes and the related accounts using the asset and liability method in accordance with FASB ASC Topic 740, Income Taxes, or ASC 740. Under this method, we accrue income taxes payable or refundable and recognize deferred tax assets and liabilities based on differences between GAAP and tax bases of assets and liabilities. We measure deferred tax assets and liabilities using enacted tax rates in effect for the years in which the differences are expected to reverse, and recognize the effect of a change in enacted rates in the period of enactment.

We record net deferred tax assets to the extent we believe these assets will more likely than not be realized. In making such determination, we consider all available positive and negative evidence, including future reversals of existing taxable temporary differences, projected future taxable income, tax planning strategies and recent financial operations.

We establish assets and liabilities for uncertain positions taken or expected to be taken in income tax returns, using a more-likely-than-not recognition threshold. We include in income tax expense any interest and penalties related to uncertain tax positions.

We have included the estimated impact of the Tax Act in our financial results for the period ended February 3, 2018. The Securities and Exchange Commission ("SEC") has issued interpretive guidance under Staff Accounting Bulletin No. 118 ("SAB 118") that allows for a measurement period up to one year after the enactment date of the Tax Act to finalize the recording of the related tax impacts. Our accounting for the income tax effects of the new tax legislation, based on available guidance and interpretation, is included in our provision amount and we do not anticipate material adjustments to such accounting in future periods. Refer to Note 14 to the Consolidated Financial Statements for additional information.

New Accounting Standards Not Yet Adopted

In May 2014, the FASB issued ASU No. 2014-09, Revenue from Contracts with Customers (“ASU 2014-09”), along with amendments issued in 2015 and 2016, which amends the existing accounting standards for revenue recognition. ASU 2014-09 outlines principles that govern revenue recognition at an amount an entity expects to be entitled when products are transferred to customers. ASU 2014-09, which will become effective for us in the first quarter of fiscal 2018, may be applied retrospectively for each period presented (the "full retrospective method") or retrospectively with the cumulative effect recognized in the opening retained earnings balance in fiscal year 2018 (the "modified retrospective method"). We are adopting the standard using the modified retrospective method. We have determined that the adoption will change the timing of recognition of gift card breakage income, which is currently recognized when the probability of the redemption is remote and recorded in net sales. The new guidance will require recognition of gift card breakage income proportionately in net sales as redemptions occur. Additionally, we have determined that revenue for merchandise shipped to the customer from a distribution center or store will be recognized at the shipping point rather than upon receipt by the customer. Lastly, under the new guidance, we will recognize allowances for estimated sales returns on a gross basis rather than net basis on the consolidated balance sheets. The new guidance also requires enhanced disclosures, such as disaggregation of revenues and revenue recognition policies that require significant judgment and identification of performance obligations to customers. We have determined that the new standard will result in a net cumulative effect adjustment to increase beginning retained earnings by approximately $1.4 million. We currently do not expect the adoption of this update to have a material effect on our consolidated financial statements.

In February 2016, the FASB issued ASU No. 2016-02, Leases (Topic 842). The new standard requires lessees to apply a dual approach, classifying leases as either finance or operating leases based on the principle of whether or not the lease is effectively a financed purchase by the lessee. This classification will determine whether lease expense is recognized based on an effective interest method or on a straight-line basis over the term of the lease. A lessee is also required to record a right-of-use asset and a lease liability for all leases with a term of greater than 12 months regardless of their classification. Leases with a term of 12 months or less will be accounted for similar to existing guidance for operating leases. ASU 2016-02, which will become effective for us in the first quarter of fiscal 2019, with early adoption permitted, must be adopted using the modified retrospective method. The new standard is expected to impact our consolidated financial statements as we conduct all of our retail sales and corporate operations in leased facilities. We are in the process of evaluating the impact of adopting the new standard on our consolidated financial statements.

Accounting Standard Adopted in Fiscal 2017

On January 29, 2017, we adopted FASB ASU No. 2016-09, Improvements to Employee Share-Based Payment Accounting, which simplifies the accounting and reporting for share-based compensation, including the accounting for income taxes, forfeitures and statutory tax withholding requirements, as well as the classification in the statement of cash flows. We elected to account for forfeitures as they occur, rather than estimate expected forfeitures. The adoption of ASU 2016-09 resulted in a cumulative-effect adjustment of $0.2 million decrease to retained earnings and a $0.2 million increase to additional paid-in-capital as of January 29, 2017, related to the recognition of previously estimated expected forfeitures using the modified retrospective method. We adopted the cash flow presentation which requires excess tax benefits to be presented as an operating activity rather than a financing activity. The adoption of this update did not have an effect on our consolidated results of operations.

Item 7A. Quantitative and Qualitative Disclosures About Market Risks

Interest Rate Risk

We are subject to interest rate risk in connection with borrowings, if any, under our line of credit, which bears interest at variable rates. As of February 3, 2018 and January 28, 2017, we had no outstanding borrowings under our credit facility.

Impact of Inflation

Our results of operations and financial condition are presented based on historical cost. While it is difficult to accurately measure the impact of inflation due to the imprecise nature of the estimates required, we believe the effects of inflation, if any, on our results of operations and financial condition have been immaterial.

Foreign Exchange Rate Risk

We currently source all merchandise through domestic vendors. We source certain fixtures and materials from various suppliers in other countries. All purchases are denominated in U.S. dollars, and therefore we do not hedge using any derivative instruments. Historically, we have not been impacted by changes in exchange rates.

Item 8. Financial Statements and Supplementary Data
Tilly's, Inc.
Index to Consolidated Financial Statements

Report of Independent Registered Public Accounting Firm
Shareholders and Board of Directors
Tilly’s, Inc.
Irvine, California

Opinion on the Consolidated Financial Statements

We have audited the accompanying consolidated balance sheets of Tilly’s, Inc. (the “Company”) as of February 3, 2018 and January 28, 2017, the related consolidated statements of income, comprehensive income, stockholders’ equity, and cash flows for each of the three years in the period ended February 3, 2018, and the related notes (collectively referred to as the “consolidated financial statements”). In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of the Company at February 3, 2018 and January 28, 2017, and the results of their operations and their cash flows for each of the three years in the period ended February 3, 2018, in conformity with accounting principles generally accepted in the United States of America.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) (“PCAOB”), the Company's internal control over financial reporting as of February 3, 2018, based on criteria established in Internal Control - Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission (“COSO”) and our report dated March 30, 2018 expressed an unqualified opinion thereon.

Changes in Accounting Method Related to Share-Based Payments

As discussed in Note 2 to the consolidated financial statements, the Company has changed its method of accounting for employee shared-based compensation in fiscal 2017 due to the adoption of Accounting Standards Update 2016-09.

Basis for Opinion

These consolidated financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on the Company’s consolidated financial statements based on our audits. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement, whether due to error or fraud.

Our audits included performing procedures to assess the risks of material misstatement of the consolidated financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the consolidated financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements. We believe that our audits provide a reasonable basis for our opinion.

/s/ BDO USA, LLP
We have served as the Company's auditor since 2015.
Costa Mesa, California
March 30, 2018

Tilly's, Inc.
Consolidated Balance Sheets
(In thousands, except per share data)

	February 3, 2018	January 28, 2017
ASSETS		
Current assets:		
Cash and cash equivalents	$53,202	$78,994
Marketable securities	82,750	54,923
Receivables	4,352	3,989
Merchandise inventories	53,216	47,768
Prepaid expenses and other current assets	9,534	9,541
Total current assets	203,054	195,215
Property and equipment, net	83,321	89,219
Other assets	3,736	6,072
Total assets	$290,111	$290,506
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$21,615	$17,584
Accrued expenses	22,731	23,872
Deferred revenue	10,879	10,203
Accrued compensation and benefits	6,119	7,259
Dividends payable	29,067	—
Current portion of deferred rent	5,220	5,643
Current portion of capital lease obligation (Note 9)	—	835
Total current liabilities	95,631	65,396
Long-term portion of deferred rent	31,340	35,890
Other	2,715	—
Total long-term liabilities	34,055	35,890
Total liabilities	129,686	101,286
Commitments and contingencies (Note 10)		
Stockholders' equity:		
Common stock (Class A), $0.001 par value; 100,000 shares authorized; 14,927 and 13,434 shares issued and outstanding, respectively	15	14
Common stock (Class B), $0.001 par value; 35,000 shares authorized; 14,188 and 15,329 shares issued and outstanding, respectively	14	15
Preferred stock, $0.001 par value; 10,000 shares authorized, no shares issued or outstanding	—	—
Additional paid-in capital	143,984	138,102
Retained earnings	16,398	51,023
Accumulated other comprehensive income	14	66
Total stockholders' equity	160,425	189,220
Total liabilities and stockholders' equity	$290,111	$290,506

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

Tilly's, Inc.
Consolidated Statements of Income
(In thousands, except per share data)

	Fiscal Year Ended February 3, 2018	January 28, 2017	January 30, 2016
Net sales	$ 576,899	$ 568,952	$ 550,991
Cost of goods sold (includes buying, distribution, and occupancy costs)	401,529	400,493	383,745
Gross profit	175,370	168,459	167,246
Selling, general and administrative expenses	151,384	149,129	149,150
Operating income	23,986	19,330	18,096
Other income, net	1,223	418	52
Income before income taxes	25,209	19,748	18,148
Income tax expense	10,509	8,338	10,607
Net income	$ 14,700	$ 11,410	$ 7,541
Basic earnings per share of Class A and Class B common stock	$ 0.51	$ 0.40	$ 0.27
Diluted earnings per share of Class A and Class B common stock	$ 0.51	$ 0.40	$ 0.27
Weighted average basic shares outstanding	28,804	28,496	28,332
Weighted average diluted shares outstanding	29,074	28,529	28,402

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

Tilly’s, Inc.
Consolidated Statements of Comprehensive Income
(In thousands)

	For the Fiscal Years Ended		
	February 3, 2018	January 28, 2017	January 30, 2016
Net income	$14,700	$11,410	$ 7,541
Other comprehensive income, net of tax:			
Net change in unrealized gains on available-for-sale securities	(52)	44	1
Other comprehensive income, net of tax	(52)	44	1
Comprehensive income	$14,648	$11,454	$ 7,542

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

Tilly's, Inc.
Consolidated Statements of Stockholders' Equity
(In thousands)

	Number of Shares Common Stock (Class A)	Common Stock (Class B)	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Income	Total Stockholders' Equity
Balance at January 31, 2015	11,546	16,544	$ 28	$ 126,565	$ 32,072	$ 21	$ 158,686
Net income	—	—	—	—	7,541	—	7,541
Shares converted by founders	375	(375)	—	—	—	—	—
Stock-based compensation expense	—	—	—	3,926	—	—	3,926
Restricted stock	48	—	—	—	—	—	—
Exercise of stock options	336	—	—	3,094	—	—	3,094
Net change in unrealized gain on available-for-sale securities	—	—	—	—	—	1	1
Balance at January 30, 2016	12,305	16,169	28	133,550	39,613	22	173,213
Net income	—	—	—	—	11,410	—	11,410
Shares converted by founders	840	(840)	—	—	—	—	—
Stock-based compensation expense	—	—	—	2,572	—	—	2,572
Restricted stock	74	—	—	—	—	—	—
Exercise of stock options	215	—	1	2,079	—	—	2,080
Taxes paid in lieu of shares issued for stock based compensation	—	—	—	(99)	—	—	(99)
Net change in unrealized gain on available-for-sale securities	—	—	—	—	—	44	44
Balance at January 28, 2017	13,434	15,329	29	138,102	51,023	66	189,220
Cumulative-effect adjustment from adoption of ASU 2016-09	—	—	—	178	(178)	—	—
Net income	—	—	—	—	14,700	—	14,700
Dividends declared	—	—	—	—	(29,067)	—	(29,067)
Dividends paid	—	—	—	—	(20,080)	—	(20,080)
Shares converted by founders	1,141	(1,141)	—	—	—	—	—
Stock-based compensation expense	—	—	—	2,411	—	—	2,411
Restricted stock	44	—	—	—	—	—	—
Exercise of stock options	308	—	—	3,394	—	—	3,394
Taxes paid in lieu of shares issued for stock based compensation	—	—	—	(101)	—	—	(101)
Net change in unrealized gain on available-for-sale securities	—	—	—	—	—	(52)	(52)
Balance at February 3, 2018	14,927	14,188	$ 29	$ 143,984	$ 16,398	$ 14	$ 160,425

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

Tilly’s, Inc.
Consolidated Statements of Cash Flows
(In thousands)

	Fiscal Year Ended February 3, 2018	January 28, 2017	January 30, 2016
Cash flows from operating activities			
Net income	$14,700	$11,410	$7,541
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	23,389	23,266	22,808
Stock-based compensation expense	2,411	2,572	3,926
Impairment of assets	848	2,352	2,593
Loss on disposal of assets	192	16	304
Gain on sales and maturities of marketable securities	(782)	(251)	(100)
Deferred income taxes	2,933	(1,174)	1,554
Changes in operating assets and liabilities:			
Receivables	(363)	1,395	(715)
Merchandise inventories	(5,448)	3,589	150
Prepaid expenses and other assets	(562)	(449)	(293)
Accounts payable	3,559	1,623	(6,993)
Accrued expenses	(2,732)	6,562	6,199
Accrued compensation and benefits	(1,140)	1,508	(160)
Deferred rent	(4,973)	(5,464)	(948)
Deferred revenue	676	1,554	1,079
Net cash provided by operating activities	32,708	48,509	36,945
Cash flows from investing activities			
Purchase of property and equipment	(13,753)	(17,047)	(23,100)
Proceeds from sale of property and equipment	—	43	7
Purchases of marketable securities	(152,389)	(99,675)	(74,873)
Maturities of marketable securities	125,264	95,021	60,000
Net cash used in investing activities	(40,878)	(21,658)	(37,966)
Cash flows from financing activities			
Dividends paid	(20,080)	—	—
Proceeds from exercise of stock options	3,394	2,080	3,094
Payment of capital lease obligation	(835)	(858)	(807)
Taxes paid in lieu of shares issued for stock-based compensation	(101)	(99)	(35)
Net cash (used in) provided by financing activities	(17,622)	1,123	2,252
Change in cash and cash equivalents	(25,792)	27,974	1,231
Cash and cash equivalents, beginning of period	78,994	51,020	49,789
Cash and cash equivalents, end of period	$53,202	$78,994	$51,020
Supplemental disclosures of cash flow information			
Interest paid	$26	$82	$133
Income taxes paid	$11,534	$8,806	$7,473
Supplemental disclosure of non-cash activities			
Unpaid purchases of property and equipment	$4,778	$640	$1,817
Dividends declared	$29,067	$—	$—

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

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Tilly’s, Inc.
Notes to Consolidated Financial Statements
Note 1: Description of the Company and Basis of Presentation

Tillys is a leading destination specialty retailer of casual apparel, footwear and accessories for young men, young women, boys and girls with an extensive selection of iconic global, emerging, and proprietary brands rooted in an active and social lifestyle. Tillys is headquartered in Irvine, California and we operated 219 stores in 32 states as of February 3, 2018. Our stores are located in malls, lifestyle centers, ‘power’ centers, community centers, outlet centers and street-front locations. Customers may also shop online, where we feature the same assortment of products as carried in our brick-and-mortar stores, supplemented by additional online only styles. Our goal is to serve as a destination for the latest, most relevant merchandise and brands important to our customers.

The Tillys concept began in 1982 when our co-founders, Hezy Shaked and Tilly Levine, opened their first store in Orange County, California. Since 1984 the business has been conducted through World of Jeans & Tops, a California corporation, or “WOJT”, which operates under the name “Tillys”. In May 2011, Tilly’s, Inc., a Delaware corporation, was formed solely for the purpose of reorganizing the corporate structure of WOJT in preparation for an initial public offering. As part of the initial public offering in May 2012, WOJT became a wholly owned subsidiary of Tilly's, Inc.

As used in these Notes to Consolidated Financial Statements, except where the context otherwise requires or where otherwise indicated, the terms "the Company", "World of Jeans and Tops", "WOJT", "we", "our", "us" and "Tillys" refer to WOJT before our initial public offering, and to Tilly's, Inc. and its subsidiary after our initial public offering.

Fiscal Year

Our fiscal year ends on the Saturday closest to January 31. Fiscal years 2017, 2016 and 2015 ended on February 3, 2018, January 28, 2017 and January 30, 2016, respectively. Fiscal year 2017, included 53 weeks and fiscal years 2016 and 2015 each included 52 weeks.

Segment Reporting

Accounting principles generally accepted in the United States (“GAAP”) has established guidance for reporting information about a company’s operating segments, including disclosures related to our products and services, geographic areas and major customers. We identify our operating segments based on how our business is managed and evaluated. Our operating segments have been aggregated into one reportable segment based on the similar nature of products sold, production, merchandising and distribution processes involved, target customers and economic characteristics. All of our identifiable assets are in the United States.

Note 2: Summary of Significant Accounting Policies

Cash and Cash Equivalents

We consider all short-term investments with an initial maturity of 90 days or less when purchased to be cash equivalents.

Marketable Securities

Marketable securities are classified as available-for-sale and held-to-maturity and are carried at fair value and amortized cost plus accrued income, respectively. Unrealized holding gains and losses, net of income taxes, on available-for-sale securities are reflected as a separate component of stockholders’ equity until realized. For the purposes of computing realized and unrealized gains and losses, cost is determined on a specific identification basis. We classify all marketable securities within current assets on our accompanying Consolidated Balance Sheets, including those with maturity dates beyond twelve months, as they are available to support our current operational liquidity needs.

Merchandise Inventories

Merchandise inventories are comprised of finished goods offered for sale at our retail stores and online. Inventories are stated at the lower of cost or net realizable value using the retail inventory method. An initial markup is applied to inventory at cost in order to establish a cost-to-retail ratio. We believe that the retail inventory method approximates cost. Shipping and handling costs for merchandise shipped to customers of \$7.9 million, \$8.1 million and \$6.7 million in fiscal years 2017, 2016 and 2015, respectively, are included in cost of goods sold in the accompanying Consolidated Statements of Income.

We review our inventory levels to identify slow-moving merchandise and generally use markdowns to clear this merchandise. At any given time, merchandise inventories include items that have been marked down to management's best estimate of their fair market value at retail price, with a proportionate write-down to the cost of the inventory. Our management bases the decision to mark down merchandise primarily upon its current sell-through rate and the age of the item, among other factors.

These markdowns may have an adverse impact on earnings, depending on the extent and amount of inventory affected. Markdowns are recorded as an increase to cost of goods sold in the accompanying Consolidated Statements of Income. Total markdowns, including permanent and promotional markdowns, on a cost basis were $50.0 million, $49.2 million and $41.5 million in fiscal years 2017, 2016 and 2015, respectively. In addition, we accrued $1.1 million and $1.3 million for planned but unexecuted markdowns, including markdowns related to slow moving merchandise, as of February 3, 2018 and January 28, 2017, respectively.

Property and Equipment

Property and equipment are stated at cost less accumulated depreciation. Depreciation is calculated using the straight-line method over the estimated useful lives of the assets. Equipment is depreciated over five to seven years. Furniture and fixtures are depreciated over five years. Computer software is depreciated over three years. Leasehold improvements and the cost of acquiring leasehold rights are amortized over the lesser of the term of the lease or the estimated useful life of the improvement. The cost of assets sold or retired and the related accumulated depreciation is removed from the accounts with any resulting gain or loss included in net income.

Repairs and maintenance costs are charged directly to expense as incurred. Major renewals, replacements and improvements that substantially extend the useful life of an asset are capitalized and depreciated.

Impairment of Long-Lived Assets

Impairments are recorded on long-lived assets used in operations whenever events or changes in circumstances indicate that the net carrying amounts may not be recoverable. Factors considered important that could result in an impairment review include, but are not limited to, significant under-performance relative to historical or planned operating results, significant changes in the manner of use of the assets or significant changes in business strategies. At least quarterly, an evaluation is performed using estimated undiscounted future cash flows from operating activities compared to the carrying value of related assets for the individual stores. If the undiscounted future cash flows are less than the carrying value, an impairment loss is recognized for the difference between the carrying value and the estimated fair value of the assets based on the discounted cash flows of the assets using a rate that approximates the weighted average cost of capital. With regard to retail store assets, which are comprised of leasehold improvements, fixtures and computer hardware and software, we consider the assets at each individual retail store to represent an asset group. In addition, we have considered the relevant valuation techniques that could be applied without undue cost and effort and have determined that the discounted estimated future cash flow approach provides the most relevant and reliable means by which to determine fair value in this circumstance. Refer to "Note 11: Fair Value Measurements", for further information.

Operating Leases

We lease our retail stores under non-cancellable operating leases. Most store leases include tenant allowances from landlords, rent escalation clauses and/or contingent rent provisions. We recognize rent expense on a straight-line basis over the lease term, excluding contingent rent, and record the difference between the amount charged to expense and the rent paid as a deferred rent liability. Contingent rent, determined based on a percentage of sales in excess of specified levels, is recognized as rent expense when the achievement of the specified sales that triggers the contingent rent is probable.

Deferred Rent and Tenant Allowances

Deferred rent is recognized when a lease contains fixed rent escalations. We recognize the related rent expense on a straight-line basis starting from the date of possession and record the difference between the recognized rental expense and cash rent payable as deferred rent. Deferred rent also includes tenant allowances received from landlords in accordance with negotiated lease terms. The tenant allowances are amortized as a reduction to rent expense on a straight-line basis over the term of the lease starting at the date of possession.

Revenue Recognition

Revenue is recognized for store sales when the customer receives and pays for the merchandise at the register, net of estimated returns. Taxes collected from our customers are recorded on a net basis. For e-commerce sales, we recognize revenue, net of sales taxes and estimated sales returns, and the related cost of goods sold at the time the merchandise is received by the customer. We defer e-commerce revenue that are in-transit to the customer. Customers typically receive goods within four days of shipment. Amounts related to shipping and handling that are billed to customers are reflected in net sales, and the related costs are reflected in cost of goods sold in the accompanying Consolidated Statements of Income. For fiscal years 2017, 2016 and 2015, shipping and handling fee revenue included in net sales was $3.3 million, $3.3 million, and $2.7 million, respectively.

We accrue for estimated sales returns by customers based on historical sales return results. As of February 3, 2018 and January 28, 2017, our reserve for sales returns was $1.1 million.

We recognize revenue from gift cards as they are redeemed for merchandise. Prior to redemption, we maintain a current liability for unredeemed gift card balances. The customer liability balance was $9.2 million as of February 3, 2018 and January 28, 2017, and is included in deferred revenue on the accompanying Consolidated Balance Sheets. Our gift cards do not have expiration dates; however, over time, the redemption of some gift cards becomes remote and in most cases there is no legal obligation to remit the unredeemed gift cards to relevant jurisdictions (gift card "breakage"). An assessment of the ultimate non-redemption rate of gift cards is performed when enough time has passed since the activation of the cards to enable a determination of the ultimate breakage rate based upon historical redemption experience. This date of assessment has historically been two full fiscal years after the fiscal year the cards were activated. At the time of assessment a breakage estimate is calculated and recorded in net sales. Breakage revenue for gift cards was $1.4 million, $0.9 million and $0.8 million in fiscal years 2017, 2016 and 2015, respectively.

Loyalty Program

In fiscal 2016, we launched a customer loyalty program where customers accumulate points based on purchase activity. Once a loyalty member achieves a certain point level, the member earns awards that may be redeemed for merchandise. Unredeemed awards and accumulated partial points are accrued as deferred revenue and awards redeemed by the member for merchandise are recorded as an increase to net sales. We expire unredeemed awards after 45 days from date of issuance and accumulated partial points 365 days after the last purchase activity. The deferred revenue for this program was $1.2 million and $0.6 million as of February 3, 2018 and January 28, 2017.

Cost of Goods Sold

Cost of goods sold includes product costs and buying, distribution and store occupancy costs as follows:

- Costs of products sold include:
- freight expenses associated with merchandise received from our vendors into our distribution centers;
- vendor allowances;
- cash discounts on payments to merchandise vendors;
- physical inventory losses; and
- markdowns of inventory.
- Buying, distribution and occupancy costs include:
- payroll, benefit costs, and incentive compensation for merchandising personnel;
- customer shipping and handling expenses;
- costs associated with operating our distribution and fulfillment center, including payroll and benefit costs for our distribution center, occupancy costs, and depreciation;
- freight expenses associated with shipping merchandise inventories from our distribution center to our stores and e-commerce customers; and
- store occupancy costs, including rent, maintenance, utilities, property taxes, business licenses, security costs and depreciation.

Selling, General and Administrative Expenses

- Payroll, benefit costs and incentive compensation for store, regional, e-commerce and corporate employees;
- Occupancy and maintenance costs of corporate office facilities;
- Depreciation related to corporate office assets;
- Advertising and marketing costs, net of reimbursement from vendors;
- Tender costs, including costs associated with credit and debit card interchange fees;
- Long-lived asset impairment charges;
- Legal provisions;
- Other administrative costs such as supplies, consulting, audit and tax preparation fees, travel and lodging; and
- Charitable contributions.

Store Pre-opening Costs

Store pre-opening costs consist primarily of occupancy costs, which are included in cost of goods sold, and payroll expenses, which are included in selling, general and administrative expenses, in the accompanying Consolidated

Statements of Income.

Advertising

We expense advertising costs as incurred, except for direct-mail advertising expenses which are recognized at the time of mailing. Advertising costs include such things as production and distribution of print and digital catalogs; print, online and mobile advertising costs; radio advertisements; and grand openings and other events. Advertising expense, which is classified in selling, general and administrative expenses in the accompanying Consolidated Statements of Income, was $12.1 million, $15.4 million and $19.7 million in fiscal years 2017, 2016 and 2015, respectively.

Share-Based Compensation

We apply the provisions of Financial Accounting Standards Board (“FASB”) Accounting Standards Codification (“ASC”) Topic 718, Compensation-Stock Compensation (“ASC 718”), for accounting for equity instruments exchanged for employee services. Under the provisions of this statement, share-based compensation expense is measured at the grant date, based on the calculated fair value of the award, and is recognized as an expense on a straight-line basis over the employee’s requisite service period (generally the vesting period of the equity grant). Changes in these inputs and assumptions can materially affect the measurement of the estimated fair value of share-based compensation expense. Refer to “Note 12: Share-Based Compensation”, for further information.

Income Taxes

We account for income taxes and the related accounts using the asset and liability method in accordance with FASB ASC Topic 740, Income Taxes (“ASC 740”). Under this method, we accrue income taxes payable or refundable and recognize deferred tax assets and liabilities based on differences between GAAP and tax bases of assets and liabilities. We measure deferred tax assets and liabilities using enacted tax rates in effect for the years in which the differences are expected to reverse, and recognize the effect of a change in enacted rates in the period of enactment.

We establish assets and liabilities for uncertain positions taken or expected to be taken in income tax returns, using a more-likely-than-not recognition threshold. We include in income tax expense any interest and penalties related to uncertain tax positions.

We have included the estimated impact of the Tax Act in our financial results for the period ended February 3, 2018. The Securities and Exchange Commission ("SEC") has issued interpretive guidance under Staff Accounting Bulletin No. 118 ("SAB 118") that allows for a measurement period up to one year after the enactment date of the Tax Act to finalize the recording of the related tax impacts. Our accounting for the income tax effects of the new tax legislation, based on available guidance and interpretation, is included in our provision amount and we do not anticipate material adjustments to such accounting in future periods. Refer to “Note 14: Income Taxes”, for further information.

Earnings per Share

Basic earnings per share is computed using the weighted average number of shares outstanding. Diluted earnings per share is computed using the weighted average number of shares outstanding adjusted for the incremental shares attributed to outstanding options to purchase common stock. Incremental shares of 270 thousand, 33 thousand and 70 thousand in fiscal years 2017, 2016 and 2015, respectively, were used in the calculation of diluted earnings per share. Refer to “Note 15: Earnings Per Share”, for further information.

Concentration of Credit Risk

Financial instruments that potentially subject the Company to credit risk consist principally of cash and cash equivalents. At February 3, 2018 and January 28, 2017, and at various times throughout these years, we had cash in financial institutions in excess of the $250,000 amount insured by the Federal Deposit Insurance Corporation. We typically invest our cash in highly rated, short-term commercial paper, interest-bearing money market funds, municipal bonds and certificates of deposit.

Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions. These estimates and assumptions 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 net sales and expenses during the reporting period. Actual results could differ from those estimates. On an ongoing basis, management reviews its estimates based on currently available information. Changes in facts and circumstances may result in revised estimates.

New Accounting Standards Not Yet Adopted

In May 2014, the FASB issued Accounting Standards Update ("ASU") No. 2014-09, Revenue from Contracts with Customers (“ASU 2014-09”), along with amendments issued in 2015 and 2016, which amends the existing accounting standards for revenue recognition. ASU 2014-09 outlines principles that govern revenue recognition at an amount an entity expects to be entitled when products are transferred to customers. ASU 2014-09, which will become effective for us in the first quarter of fiscal 2018, may be applied retrospectively for each period presented (the "full retrospective method") or retrospectively with the cumulative effect recognized in the opening retained earnings balance in fiscal year 2018 (the "modified retrospective method"). We are adopting the standard using the modified retrospective method. We have determined that the adoption will change the timing of recognition of gift card breakage income, which is currently recognized when the probability of the redemption is remote and recorded in net sales. The new guidance will require recognition of gift card breakage income proportionately in net sales as redemptions occur. Additionally, we have determined that revenue for merchandise shipped to the customer from a distribution center or store will be recognized at the shipping point rather than upon receipt by the customer. Lastly, under the new guidance, we will recognize allowances for estimated sales returns on a gross basis rather than net basis on the consolidated balance sheets. The new guidance also requires enhanced disclosures, such as disaggregation of revenues and revenue recognition policies that require significant judgment and identification of performance obligations to customers. We have determined that the new standard will result in a net cumulative effect adjustment to increase beginning retained earnings by approximately $1.4 million. We currently do not expect the adoption of this update to have a material effect on our consolidated financial statements.

In February 2016, the FASB issued ASU No. 2016-02, Leases (Topic 842). The new standard requires lessees to apply a dual approach, classifying leases as either finance or operating leases based on the principle of whether or not the lease is effectively a financed purchase by the lessee. This classification will determine whether lease expense is recognized based on an effective interest method or on a straight-line basis over the term of the lease. A lessee is also required to record a right-of-use asset and a lease liability for all leases with a term of greater than 12 months regardless of their classification. Leases with a term of 12 months or less will be accounted for similar to existing guidance for operating leases. ASU 2016-02, which will become effective for us in the first quarter of fiscal 2019, with early adoption permitted, must be adopted using the modified retrospective method. The new standard is expected to impact our consolidated financial statements as we conduct all of our retail sales and corporate operations in leased facilities. We are in the process of evaluating the impact of adopting the new standard on our consolidated financial statements.

Accounting Standard Adopted in Fiscal 2017

On January 29, 2017, we adopted FASB ASU No. 2016-09, Improvements to Employee Share-Based Payment Accounting, which simplifies the accounting and reporting for share-based compensation, including the accounting for income taxes, forfeitures and statutory tax withholding requirements, as well as the classification in the statement of cash flows. We elected to account for forfeitures as they occur, rather than estimate expected forfeitures. The adoption of ASU 2016-09 resulted in a cumulative-effect adjustment of $0.2 million decrease to retained earnings and a $0.2 million increase to additional paid-in-capital as of January 29, 2017, related to the recognition of previously estimated expected forfeitures using the modified retrospective method. We adopted the cash flow presentation which requires excess tax benefits to be presented as an operating activity rather than a financing activity. The adoption of this update did not have an effect on our consolidated results of operations.

Note 3: Marketable Securities

Marketable securities as of February 3, 2018 consisted of commercial paper classified as available-for-sale and fixed income securities, that we have the intent and ability to hold to maturity and therefore, are classified as held-to-maturity. Our investments in commercial paper and fixed income securities are recorded at fair value and amortized cost, which approximates fair value, respectively. All of our marketable securities are less than one year from maturity.

The following table summarizes investments in marketable securities at February 3, 2018 and January 28, 2017 (in thousands):

	February 3, 2018		
	Cost or Amortized Cost	Gross Unrealized Holding Gains	Estimated Fair Value
Commercial paper	$59,566	$23	$59,589
Fixed income securities	23,119	42	23,161
	$82,685	$65	$82,750

	January 28, 2017		
	Cost or Amortized Cost	Gross Unrealized Holding Gains	Estimated Fair Value

Commercial paper	$44,785	$107	$44,892
Fixed income securities	10,017	14	10,031
	$54,802	$121	$54,923

For fiscal years 2017, 2016 and 2015, we recognized gains on investments of $0.8 million, $0.3 million and $0.1 million, respectively, for commercial paper which matured during the period. Upon recognition of the gains, we reclassified these amounts out of accumulated other comprehensive income and into other income (expense), net, on the accompanying Consolidated Statements of Income.

Note 4: Receivables

At February 3, 2018 and January 28, 2017, receivables consisted of the following (in thousands):

	February 3, 2018	January 28, 2017
Credit and debit card receivables	$ 2,480	$2,450
Tenant allowances due from landlords	1,004	14
Vendor receivables	874	1,807
Less: Allowance for doubtful accounts	(6)	(282)
Total receivables	$ 4,352	$3,989

We establish a receivable for amounts we expect to collect. We make estimates for the allowance for doubtful accounts against receivables for any potential uncollectible amounts. The year-end receivables are primarily collected within the following fiscal quarter.

Note 5: Prepaid Expenses and Other Current Assets

At February 3, 2018 and January 28, 2017, prepaid expenses and other current assets consisted of the following (in thousands):

	February 3, 2018	January 28, 2017
Prepaid rent	$ 7,095	$7,507
Prepaid maintenance	999	690
Prepaid insurance	673	504
Other	767	840
Total prepaid expenses and other current assets	$ 9,534	$9,541

Note 6: Property and Equipment

At February 3, 2018 and January 28, 2017, property and equipment consisted of the following (in thousands):

	February 3, 2018	January 28, 2017
Leasehold improvements	$132,428	$137,287
Furniture and fixtures	43,983	43,160
Computer hardware and software	37,722	30,091
Machinery and equipment	31,509	31,089
Vehicles	1,891	1,821
Construction in progress	1,854	2,273
Building under capital lease	—	7,840
	249,387	253,561
Accumulated depreciation	(166,066)	(164,342)
Property and equipment, net	$83,321	$89,219

Depreciation expense related to property and equipment was $23.4 million, $23.3 million and $22.8 million in fiscal years 2017, 2016 and 2015, respectively.

Cash paid for capital expenditures during fiscal 2017, 2016 and 2015, were approximately $13.8 million, $17.0 million and $23.1 million, respectively.

Impairments are recorded on long-lived assets used in operations whenever events or changes in circumstances indicate that the net carrying amounts may not be recoverable. We recorded non-cash impairment charges of $0.8 million, $2.4 million and $2.6 million in selling, general and administrative expenses in fiscal years 2017, 2016 and 2015, respectively, to write down the carrying value of long-lived assets to their estimated fair values. Refer to "Note 11: Fair Value Measurements", for further information.

If we are not able to achieve our projected key financial metrics, we may incur additional impairment in the future for long-lived assets.

Note 7: Accrued Expenses

At February 3, 2018 and January 28, 2017, accrued expenses consisted of the following (in thousands):

	February 3, 2018	January 28, 2017
Loss contingencies (Note 10)	$ 6,466	$ 2,198
Sales and use taxes payable	2,192	5,730
Accrued construction	2,075	484
Accrued freight	1,997	2,884
Merchandise returns	1,133	1,078
Income taxes payable	343	4,374
Other	8,525	7,124
Total accrued expenses	$ 22,731	$ 23,872

Note 8: Line of Credit

Our amended and restated credit agreement with Wells Fargo Bank, N.A. ("Bank") provides for a $25.0 million revolving line of credit with a maturity date of January 26, 2020. The interest rate charged on borrowings is selected at our discretion at the time of draw between the London Interbank Offered Rate, plus 0.75%, or at the Bank's prime rate. The agreement allows for the declaration and payment of dividends or distributions to stockholders. On February 20, 2018 and February 24, 2017, we paid a special dividend of $1.00 per share and $0.70 per share, respectively. Refer to "Note 18: Shareholders' Equity", for further information. The line of credit is secured by substantially all of our assets. As a sub-feature under the revolving line of credit, the Bank may also issue stand-by and/or commercial letters of credit up to $15.0 million.

We are required to maintain certain financial and non-financial covenants in accordance with the line of credit. The financial covenants require certain levels of leverage and profitability, such as (i) income before income taxes not to be less than $1 million (measured at the end of each fiscal quarter), (ii) a maximum ratio of 4.00 to 1.00 as of each quarter end for "Funded Debt to EBITDAR", defined as the sum of total debt, capital leases and annual rent expense multiplied by 6 divided by the sum of net income, interest expense, taxes, depreciation, amortization and annual rent expense, and (iii) requires minimum eligible inventory of $50 million as of the end of each quarter. In addition, maximum investment in fixed assets in any fiscal year of $50 million.

In September 2016, we established a $750,000 standby letter of credit as security against insurance claims as required by our workers compensation insurance policy. As of February 3, 2018, there has been no activity under this letter of credit since its inception.

As of February 3, 2018, we were in compliance with all of our covenants and had no outstanding borrowings under the revolving credit facility.

Note 9: Leases

We conduct all of our retail sales and corporate operations in leased facilities. Lease terms generally range up to ten years and provide for escalations in base rents. We are generally not obligated to renew leases. Certain leases provide for additional rent based on a percentage of sales and annual rent increases generally based upon the Consumer Price Index. In addition, many of the store leases contain certain co-tenancy provisions that permit us to pay rent based on a pre-determined percentage of sales when the occupancy of the retail center falls below minimums established in the lease.

Operating leases

We lease office and warehouse space (10 and 12 Whatney, Irvine, California) from a company that is owned by the co-founders of Tillys. This lease was amended in December 2017 and was re-classified from a capital lease to an operating lease. The lease expires on December 31, 2027. We incurred rent expense of $0.2 million in fiscal year 2017 under the operating lease classification, see Capital lease section for incurred rent expense in prior years.

We lease office and warehouse space (11 Whatney, Irvine, California) from a company that is owned by one of the co-founders of Tillys. We incurred rent expense of $0.4 million in each of the fiscal years 2017, 2016 and 2015, related to this lease. Pursuant to the lease agreement, the lease payment adjusts annually based upon the Los Angeles/Anaheim/Riverside Urban Consumer Price Index, not to exceed 7%, but a minimum of 3%, in any one annual increase. The lease expires on June 30, 2022.

We lease a building (17 Pasteur, Irvine, California) from a company that is owned by one of the co-founders of Tillys. We use this property as our e-commerce distribution center. We incurred rent expense of $1.0 million, $0.9 million and $0.9 million in fiscal years 2017, 2016 and 2015, respectively, related to this lease. Pursuant to the lease agreement, the lease payment adjusts annually based upon the Los Angeles/Anaheim/Riverside Urban Consumer Price Index, not to exceed 7%, but a minimum of 3%, in any one annual increase. The lease expires on October 31, 2021.

Future minimum rental commitments, by year and in the aggregate, under non-cancellable operating leases, including fixed common area maintenance charges, if any, for the above buildings and all of our store locations as of February 3, 2018 are as follows (in thousands):

Fiscal Year	Related Party	Other	Total
2018	$3,233	$65,796	$69,029
2019	3,330	59,383	62,713
2020	3,429	54,356	57,785
2021	3,258	48,192	51,450
2022	2,276	39,966	42,242
Thereafter	11,274	72,326	83,600
Total	$26,800	$340,019	$366,819

Rent expense under non-cancellable operating leases for fiscal years 2017, 2016 and 2015 was as follows (in thousands):

	February 3, 2018	January 28, 2017	January 30, 2016
Minimum rentals	$ 44,520	$42,988	$ 43,176
Contingent rentals	1,552	1,212	403
Total rent expense	$ 46,072	$44,200	$ 43,579

Capital lease

Prior to December 2017, our corporate headquarters and distribution center (10 and 12 Whatney, Irvine, California) was leased from a company owned by the co-founders of Tillys. The land component was accounted for as an operating lease and the building component was accounted for as a capital lease. We incurred rent expense of $0.9 million, $1.0 million and $0.9 million, in fiscal years 2017, 2016 and 2015, respectively, related to the operating (land component) of this lease.

The obligation under the capital lease was $0.8 million as of January 28, 2017. The gross amount of the building under the capital lease was $7.8 million and accumulated amortization was and $7.4 million as of and January 28, 2017.

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

Note 10: Commitments and Contingencies

Indemnifications, Commitments, and Guarantees

During the normal course of business, we have made certain indemnifications, commitments, and guarantees under which we may be required to make payments for certain transactions. These indemnifications include those given to various lessors in connection with facility leases for certain claims arising from such facility or lease, and indemnifications to our directors and officers to the maximum extent permitted under the laws of the state of Delaware. The majority of these indemnifications, commitments, and guarantees do not provide for any limitation of the maximum potential future payments we could be obligated to make, and their duration may be indefinite. We have not recorded any liability for these indemnifications, commitments, and guarantees in the accompanying Consolidated Balance Sheets.

Purchase Obligations

At February 3, 2018, our future minimum payments under agreements to purchase services primarily for software maintenance aggregated to $8.3 million, payable as follows: $2.6 million in fiscal 2018, $2.4 million in fiscal 2019, $1.7 million in fiscal 2020, $1.2 million in fiscal 2021, and $0.4 million in fiscal 2022.

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Legal Proceedings

From time to time, we may become involved in lawsuits and other claims arising from our ordinary course of business. We have established loss provisions of approximately $7.5 million for matters in which losses are probable and can be reasonably estimated. For some matters, we are currently unable to predict the ultimate outcome, determine whether a liability has been incurred or make an estimate of the reasonably possible liability that could result from an unfavorable outcome because of the uncertainties related to the incurrence, amount and range of loss on any pending litigation or claim. Because of the unpredictable nature of these matters, we cannot provide any assurances regarding the outcome of any litigation or claim to which we are a party or that the ultimate outcome of any of the matters threatened or pending against us, including those disclosed below, will not have a material adverse effect on our financial condition, results of operations or cash flows.

Juan Carlos Gonzales, on behalf of himself and all others similarly situated, v. Tilly’s Inc. et al, Superior Court of California, County of Orange, Case No. 30-2017-00948710-CU-OE-CXC. In October 2017, the plaintiff filed a putative class action against us, alleging various violations of California’s wage and hour laws. The complaint seeks class certification, unspecified damages, unpaid wages, penalties, restitution, interest, and attorneys’ fees and costs. In December 2017, we filed an answer to the complaint, denying all of the claims and asserting various defenses. Subsequently, we requested the plaintiff to dismiss the class action claims based on an existing waiver in an arbitration agreement which plaintiff signed with our co-defendant, BaronHR, the staffing company that employed plaintiff to work at the Company. We intend to defend this case vigorously.

Lauren Minniti, on behalf of herself and all others similarly situated, v. Tilly’s, Inc., United States District Court, Southern District of Florida, Case No. 0:17-cv-60237-FAM. On January 30, 2017, the plaintiff filed a putative class action lawsuit against us, alleging violations of the Telephone Consumer Protection Act of 1991 (the “TCPA”). Specifically, the complaint asserts a violation of the TCPA for allegedly sending unsolicited automated messages to the cellular telephones of the plaintiff and others. The complaint seeks class certification and damages of $500 per violation plus treble damages under the TCPA. In March 2017, we filed our initial response to this matter with the court. In June 2017, the parties attended a mediation. In July 2017, the parties reached an agreement in principle to settle this matter, subject to court approval and the execution of a final settlement agreement. In March 2018, the parties executed a settlement agreement, subject to court approval.

Skylar Ward, on behalf of herself and all others similarly situated, v. Tilly’s, Inc., Superior Court of California, County of Los Angeles, Case No. BC595405. In September 2015, the plaintiff filed a putative class action lawsuit against us alleging, among other things, various violations of California's wage and hour laws. The complaint sought class certification, unspecified damages, unpaid wages, penalties, restitution, and attorneys' fees. In June 2016, the court granted our demurrer to the plaintiff's complaint on the grounds that the plaintiff failed to state a cause of action against Tilly's and dismissed the complaint. Specifically, the court agreed with us that the plaintiff's cause of action for reporting-time pay fails as a matter of law as the plaintiff and other putative class members did not "report for work" with respect to certain shifts on which the plaintiff's claims are based. In November 2016, the court entered a written order sustaining our demurrer to the plaintiff's complaint and dismissing all of plaintiff’s causes of action with prejudice. In January 2017, the plaintiff filed an appeal of the order to the California Court of Appeal. In October 2017, the plaintiff filed her opening appellate brief, and our responding appellate brief was filed in December 2017. Plaintiff's reply appellate brief is currently due to be filed in April 2018. We have defended this case vigorously and will continue to do so.

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. BC548252. In June 2014, the plaintiff filed a putative class action and representative Private Attorney General Act of 2004 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 sought class certification, penalties, restitution, injunctive relief and attorneys’ fees and costs. The plaintiff filed a first amended complaint in December 2014. We answered the complaint in January 2015, denying all allegations. We engaged in mediation in May 2016, and the parties reached a resolution that was presented to the court for preliminary approval in September 2016. The court preliminarily approved the settlement in October 2016, and notice of the settlement was issued to class members.

Upon completion of the claims process, the court approved the final settlement in February 2017. We concluded this matter with the payment of the final settlement in April 2017. The final settlement amount was not materially different from the amount previously accrued when a loss provision was established.

On June 10, 2015, we and one of our vendors entered into a settlement arrangement with a plaintiff who filed a copyright infringement lawsuit against the vendor and us related to certain vendor products we sell. The settlement requires that the vendor pay $2.0 million to the plaintiff over three years and we agreed to guarantee such payments in exchange for a security interest in the vendor's intellectual property. As of February 3, 2018, due to updated facts and circumstances, we have accrued for the remaining maximum exposure loss of $1.4 million relating to this matter. We will utilize all available rights of offset to reduce our loss, including the enforcement of the security interest we have in the vendor's intellectual property.

Note 11: Fair Value Measurements
We determine fair value based on a three-level valuation hierarchy as described below. Fair value is defined as the exit price associated with the sale of an asset or transfer of a liability in an orderly transaction between market participants at the measurement date. The three-level hierarchy of inputs used to determine fair value is as follows:
•Level 1 – Quoted prices in active markets for identical assets and liabilities.
•Level 2 – Inputs other than Level 1 that are observable, either directly or indirectly, such as quoted prices for similar assets and liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.
•Level 3 – Unobservable inputs (i.e. projections, estimates, interpretations, etc.) that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.
We measure certain financial assets at fair value on a recurring basis, including our marketable securities, which are classified as either available-for-sale securities or held-to-maturity, and certain cash equivalents, specifically money market securities, commercial paper, municipal bonds and certificates of deposits. 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.
We did not make any transfers between Level 1 and Level 2 financial assets during fiscal years 2017, 2016 and 2015. Furthermore, as of February 3, 2018 and January 28, 2017, we did not have any Level 3 financial assets. We conduct reviews on a quarterly basis to verify pricing, assess liquidity, and determine if significant inputs have changed that would impact the fair value hierarchy disclosure.
Financial Assets
In accordance with the provisions of ASC 820, we categorized our financial assets based on the priority of the inputs to the valuation technique for the instruments as follows (in thousands):

	February 3, 2018			January 28, 2017		
	Level 1	Level 2	Level 3	Level 1	Level 2	Level 3
Cash equivalents (1):						
Money market securities	$46,441	$—	$—	$76,177	$—	$—
Marketable securities:						
Commercial paper	$—	$59,589	$—	$—	$44,892	$—
Fixed income securities	—	23,161	—	—	10,031	—

(1) Excludes cash

Impairment of Long-Lived Assets
An impairment is recorded on a long-lived asset used in operations whenever events or changes in circumstances indicate that the net carrying amounts for such asset may not be recoverable. Factors considered important that could result in an impairment review include, but are not limited to, significant under-performance relative to historical or planned operating results, significant changes in the manner of use of the assets or significant changes in our business strategies. An evaluation is performed using estimated undiscounted future cash flows from operating activities compared to the carrying value of related assets for the individual stores. If the undiscounted future cash flows are less than the carrying value, an impairment loss is recognized for the difference between the carrying value and the estimated fair value of the assets based on the discounted cash flows of the assets using a rate that approximates our weighted average cost of capital. With regard to retail store assets, which are comprised of leasehold improvements, fixtures and computer hardware and software, we consider the assets at each individual retail store to represent an asset group. In addition, we have considered the relevant valuation techniques that could be applied without undue cost and effort and have determined that the discounted estimated future cash flow approach provides the most relevant and reliable means by which to determine fair value in this circumstance.
On at least a quarterly basis, we assess whether events or changes in circumstances have occurred that potentially indicate the carrying value of long-lived assets may not be recoverable. Based on Level 3 inputs of historical operating performance, including sales trends, gross margin rates, current cash flows from operations and the projected outlook

for each of our stores, we determined that certain stores would not be able to generate sufficient cash flows over the remaining term of the related leases to recover our investment in the respective stores. As a result, we recorded non-cash impairment charges of approximately $0.8 million, $2.4 million and $2.6 million in fiscal years 2017, 2016 and 2015, respectively, to write-down the carrying value of certain long-lived store assets to their estimated fair values.

	Fiscal Year Ended		
	February 3, 2018	January 28, 2017	January 30, 2016
	($ in thousands)		
Carrying value of assets with impairment	$848	$2,584	$3,589
Fair value of assets impaired	$—	$232	$996
Number of stores tested for impairment	10	15	20
Number of stores with impairment	4	9	9

Note 12: Share-Based Compensation

The Tillys 2012 Amended and Restated Equity and Incentive Award Plan, as amended in June 2014 (the "2012 Plan"), authorizes up to 4,413,900 shares for issuance of options, shares or rights to acquire our Class A common stock and allows for, among other things, operating income and comparable store sales growth targets as additional performance goals that may be used in connection with performance-based awards granted under the 2012 Plan. As of February 3, 2018, there were 1,766,014 shares still available for future issuance under the 2012 Plan.

Options

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

The following table summarizes our stock option activity for fiscal year 2017:

	Stock Options	Grant Date Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (in Years)	Aggregate Intrinsic Value(1)
			(in years)	($ in thousands)
Outstanding at January 28, 2017	1,842,375	$9.98		
Granted	411,000	$8.79		
Exercised	(308,250)	$11.01		
Forfeited	(59,000)	$8.92		
Expired	(34,875)	$14.07		
Outstanding at February 3, 2018	1,851,250	$9.50	7.2	$9,304
Vested and expected to vest at February 3, 2018	1,851,250	$9.50	7.2	$9,304
Exercisable at February 3, 2018	828,250	$11.55	5.6	$2,738

(1) Intrinsic value for stock options is defined as the difference between the market price of the our Class A common stock on the last business day of the fiscal year 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 $14.27 at February 3, 2018.

The total intrinsic value of options exercised in fiscal years 2017, 2016 and 2015 was $1.3 million, $0.9 million and $1.7 million, respectively.

The total fair value of options vested in fiscal years 2017, 2016 and 2015 was $1.6 million, $2.0 million and $4.6 million, respectively.

The total proceeds received from the exercise of stock options in fiscal years 2017, 2016 and 2015 was $3.4 million, $2.1 million and $3.1 million, respectively. The tax benefit realized from stock options exercised in fiscal years 2017, 2016 and 2015 was $0.5 million, $0.4 million and $0.7 million, respectively.

The stock option awards were measured at fair value on the grant date using the Black-Scholes option valuation model. Key input assumptions used to estimate the fair value of stock options include the exercise price of the award, the expected option term, expected volatility of our stock over the option's expected term, the risk-free interest rate over the option's expected term and our expected annual dividend yield, if any. We will issue shares of Class A common stock when the options are exercised.

The fair values of stock options granted in fiscal years 2017, 2016 and 2015 were estimated on the grant dates using the following assumptions:

	Fiscal Year Ended		
	February 3, 2018	January 28, 2017	January 30, 2016
Average fair value per option granted	\$3.99	\$3.73	\$3.06
Expected option term (1)	5.0 years	5.0 years	5.0 years
Expected volatility factor (2)	50.3%	62.8%	49.68%
Risk-free interest rate (3)	1.93%	1.34%	1.64%
Expected annual dividend yield	—%	—%	—%

(1) We have limited historical information regarding expected option term. Accordingly, we determine the expected option term of the awards using the latest historical data available from comparable public companies and management's expectation of exercise behavior.

(2) Stock volatility for each grant is measured using the weighted average of historical daily price changes of our common stock over the most recent period equal to the expected option term of the awards.

(3) The risk-free interest rate is determined using the rate on treasury securities with the same term as the expected life of the stock option as of the grant date.

Restricted Stock

Restricted stock awards ("RSAs")