

TILLY'S, INC.
Form 10-Q
September 06, 2016
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, DC 20549

FORM 10-Q

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

For the quarterly period ended July 30, 2016

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 (I.R.S. Employer
incorporation or organization) Identification No.)
10 Whatney
Irvine, CA 92618
(Address of principal executive offices)
(949) 609-5599
(Registrant's telephone number, including area code)

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

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

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

Large accelerated filer Accelerated filer
Non-accelerated filer (do not check if a smaller reporting company) Smaller reporting company

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Indicate by check mark whether the registrant is a shell company (as defined in Exchange Act Rule 12b-2) Yes No

As of August 31, 2016, the registrant had the following shares of common stock outstanding:

Class A common stock \$0.001 par value 12,478,580

Class B common stock \$0.001 par value 16,069,097

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Part I. Financial Information

Item 1. Financial Statements (Unaudited)

TILLY'S, INC.

CONSOLIDATED BALANCE SHEETS

(In thousands, except par value)

(Unaudited)

| | July 30, 2016 | January 30, 2016 |
|--|------------------|------------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$56,466 | \$51,020 |
| Marketable securities | 39,926 | 49,932 |
| Receivables | 8,940 | 5,397 |
| Merchandise inventories | 76,820 | 51,357 |
| Prepaid expenses and other current assets | 15,022 | 12,968 |
| Total current assets | 197,174 | 170,674 |
| Property and equipment, net | 97,424 | 99,026 |
| Other assets | 1,367 | 1,051 |
| Total assets | \$295,965 | \$270,751 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current liabilities: | | |
| Accounts payable | \$41,408 | \$16,022 |
| Accrued expenses | 22,319 | 18,901 |
| Deferred revenue | 6,340 | 8,174 |
| Accrued compensation and benefits | 6,755 | 5,751 |
| Current portion of deferred rent | 6,237 | 6,106 |
| Current portion of capital lease obligation | 885 | 858 |
| Total current liabilities | 83,944 | 55,812 |
| Long-term portion of deferred rent | 38,365 | 40,891 |
| Long-term portion of capital lease obligation | 386 | 835 |
| Total long-term liabilities | 38,751 | 41,726 |
| Total liabilities | 122,695 | 97,538 |
| Commitments and contingencies (Note 5) | | |
| Stockholders' equity: | | |
| Common stock (Class A), \$0.001 par value; July 30, 2016 - 100,000 shares authorized, 12,479 shares issued and outstanding; January 30, 2016 - 100,000 shares authorized, 12,305 shares issued and outstanding | 12 | 12 |
| Common stock (Class B), \$0.001 par value; July 30, 2016 - 35,000 shares authorized, 16,069 shares issued and outstanding; January 30, 2016 - 35,000 shares authorized, 16,169 shares issued and outstanding | 16 | 16 |
| Preferred stock, \$0.001 par value; July 30, 2016 and January 30, 2016 - 10,000 shares authorized, no shares issued or outstanding | — | — |
| Additional paid-in capital | 134,910 | 133,550 |
| Retained earnings | 38,301 | 39,613 |
| Accumulated other comprehensive income | 31 | 22 |
| Total stockholders' equity | 173,270 | 173,213 |

Total liabilities and stockholders' equity

\$295,965 \$270,751

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

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TILLY'S, INC.

CONSOLIDATED STATEMENTS OF INCOME (LOSS)

(In thousands, except per share data)

(Unaudited)

| | Three Months | | Six Months Ended | |
|---|--------------|-----------|------------------|-----------|
| | Ended | | July 30, | August 1, |
| | July 30, | August 1, | July 30, | August 1, |
| | 2016 | 2015 | 2016 | 2015 |
| Net sales | \$136,412 | \$130,023 | \$256,630 | \$250,213 |
| Cost of goods sold (includes buying, distribution, and occupancy costs) | 97,575 | 93,427 | 185,206 | 177,565 |
| Gross profit | 38,837 | 36,596 | 71,424 | 72,648 |
| Selling, general and administrative expenses | 36,605 | 35,492 | 73,159 | 69,415 |
| Operating income (loss) | 2,232 | 1,104 | (1,735) | 3,233 |
| Other income, net | 91 | 10 | 167 | 18 |
| Income (Loss) before income taxes | 2,323 | 1,114 | (1,568) | 3,251 |
| Income tax expense (benefit) | 890 | 554 | (256) | 1,409 |
| Net income (loss) | \$1,433 | \$560 | \$(1,312) | \$1,842 |
| Basic earnings (loss) per share of Class A and Class B common stock | \$0.05 | \$0.02 | \$(0.05) | \$0.07 |
| Diluted earnings (loss) per share of Class A and Class B common stock | \$0.05 | \$0.02 | \$(0.05) | \$0.06 |
| Weighted average basic shares outstanding | 28,462 | 28,333 | 28,443 | 28,253 |
| Weighted average diluted shares outstanding | 28,466 | 28,426 | 28,443 | 28,403 |

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

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TILLY'S, INC.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

(In thousands)

(Unaudited)

| | Three Months Ended | | Six Months Ended | |
|--|--------------------|----------------|------------------|----------------|
| | July 30, 2016 | August 1, 2015 | July 30, 2016 | August 1, 2015 |
| Net income (loss) | \$1,433 | \$ 560 | \$(1,312) | \$ 1,842 |
| Other comprehensive income (loss): | | | | |
| Net change in unrealized gain on available-for-sale securities, net of tax | 19 | (7) | 9 | (8) |
| Other comprehensive income (loss) | 19 | (7) | 9 | (8) |
| Comprehensive income (loss) | \$1,452 | \$ 553 | \$(1,303) | \$ 1,834 |

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

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TILLY'S, INC.

CONSOLIDATED STATEMENT OF STOCKHOLDERS' EQUITY

(In thousands)

(Unaudited)

| | Number of Shares | | | | | Accumulated | Total |
|---|---------------------------------|---------------------------------|-----------------|----------------------------------|----------------------|----------------------------------|-------------------------|
| | Common Stock (Class A) | Common Stock (Class B) | Common Stock | Additional Paid-in Capital | Retained Earnings | Other Comprehensive Income | Stockholders' Equity |
| Balance at January 30, 2016 | 12,305 | 16,169 | \$ 28 | \$133,550 | \$39,613 | \$ 22 | \$ 173,213 |
| Net loss | — | — | — | — | (1,312) | — | (1,312) |
| Restricted stock | 74 | — | — | — | — | — | — |
| Taxes paid in lieu of shares issued | — | — | — | (99) | — | — | (99) |
| Shares converted by founders | 100 | (100) | — | — | — | — | — |
| Stock-based compensation expense | — | — | — | 1,459 | — | — | 1,459 |
| Change in unrealized gain on available-for-sale securities | — | — | — | — | — | 9 | 9 |
| Balance at July 30, 2016 | 12,479 | 16,069 | \$ 28 | \$134,910 | \$38,301 | \$ 31 | \$ 173,270 |

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

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

| | Six Months Ended | |
|--|------------------|----------------------|
| | July 30, 2016 | August 1, 2015 |
| Cash flows from operating activities | | |
| Net (loss) income | \$(1,312) | \$1,842 |
| Adjustments to reconcile net (loss) income to net cash provided by operating activities: | | |
| Depreciation and amortization | 11,650 | 11,260 |
| Stock-based compensation expense | 1,459 | 2,301 |
| Impairment of assets | 1,523 | 367 |
| (Gain) loss on disposal of assets | (16) | 67) |
| Gain on sales and maturities of marketable securities | (106) | (65)) |
| Deferred income taxes | (226) | (147)) |
| Excess tax benefit from stock-based compensation | — | (95)) |
| Changes in operating assets and liabilities: | | |
| Receivables | (3,543) | (6,702)) |
| Merchandise inventories | (25,463) | (28,416)) |
| Prepaid expenses and other assets | (2,150) | (877)) |
| Accounts payable | 25,100 | 15,928 |
| Accrued expenses | 2,521 | 6,149 |
| Accrued compensation and benefits | 1,004 | 411 |
| Deferred rent | (2,395) | 353) |
| Deferred revenue | (1,834) | (1,769)) |
| Net cash provided by operating activities | 6,212 | 607 |
| Cash flows from investing activities | | |
| Purchase of property and equipment | (10,415) | (11,481)) |
| Proceeds from sale of property and equipment | 43 | — |
| Purchases of marketable securities | (39,873) | (19,982)) |
| Maturities of marketable securities | 50,000 | 30,000 |
| Net cash used in investing activities | (245) | (1,463)) |
| Cash flows from financing activities | | |
| Proceeds from exercise of stock options | — | 3,094 |
| Payment of capital lease obligation | (422) | (397)) |
| Taxes paid in lieu of shares issued for stock-based compensation | (99) | — |
| Excess tax benefit from stock-based compensation | — | 95 |
| Net cash (used in) provided by financing activities | (521) | 2,792 |
| Change in cash and cash equivalents | 5,446 | 1,936 |
| Cash and cash equivalents, beginning of period | 51,020 | 49,789 |
| Cash and cash equivalents, end of period | \$56,466 | \$51,725 |
| Supplemental disclosures of cash flow information | | |
| Interest paid | \$48 | \$73 |
| Income taxes paid | \$3,520 | \$3,716 |
| Supplemental disclosure of non-cash activities | | |
| Unpaid purchases of property and equipment | \$3,000 | \$1,605 |
| The accompanying notes are an integral part of these consolidated financial statements. | | |

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TILLY'S, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Note 1: Description of the Company and Basis of Presentation

Tillys is a leading destination specialty retailer of West Coast inspired casual apparel, footwear and accessories for young men, young women, boys and girls. Tillys is headquartered in Irvine, California and we operated 225 stores in 32 states as of July 30, 2016. 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 substantially similar assortment of products we carry 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.

On May 2, 2012, the shareholders of WOJT contributed all of their equity interests in WOJT to Tilly's, Inc. in exchange for shares of Tilly's, Inc. Class B common stock on a one-for-one basis. In addition, WOJT terminated its "S" Corporation status and became a "C" Corporation. These events are collectively referred to as the "Reorganization Transaction". As a result of the Reorganization Transaction, 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 the Reorganization Transaction (as defined above), and to Tilly's, Inc. and its subsidiary after the Reorganization Transaction.

We have prepared the accompanying unaudited consolidated financial statements in accordance with accounting principles generally accepted in the United States of America ("GAAP"), for interim financial reporting. These consolidated financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (the "SEC"). Certain information and footnote disclosures normally included in financial statements prepared in accordance with GAAP have been omitted from this Quarterly Report on Form 10-Q as is permitted by SEC rules and regulations.

In the opinion of management, the accompanying unaudited consolidated financial statements contain all normal and recurring adjustments necessary to present fairly the financial condition, results of operations and cash flows for the interim periods presented. The results of operations for the three and six months ended July 30, 2016 and August 1, 2015 are not necessarily indicative of results to be expected for the full fiscal year. These interim consolidated financial statements should be read in conjunction with the consolidated financial statements and notes included in our Annual Report on Form 10-K for the fiscal year ended January 30, 2016.

Fiscal Periods

Our fiscal year ends on the Saturday closest to January 31. References to the fiscal quarters ended July 30, 2016 and August 1, 2015 refer to the three and six months ended as of those dates.

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

Information regarding significant accounting policies is contained in Note 2, "Summary of Significant Accounting Policies", of the consolidated financial statements in our Annual Report on Form 10-K for the fiscal year ended January 30, 2016.

Income Taxes

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

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In the fourth quarter of fiscal year 2015, the Internal Revenue Service initiated an examination of our federal income tax return for the year ended January 31, 2015. The examination was completed without penalty to the Company in the first quarter of fiscal 2016.

Our effective income tax rate for the three and six months ended July 30, 2016 was 38% and 16%, respectively, which includes the write-off of deferred tax assets for discrete items related to the settlement of restricted stock units and the expiration of stock options. Our effective income tax rate for the three and six months ended August 1, 2015 was 50% and 43%, respectively.

New Accounting Standards

In February 2016, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU"), No. 2016-02, Leases (ASC 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. The standard is effective for us in the first quarter of fiscal 2019, with early adoption permitted. 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.

In March 2016, the FASB issued 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 classification in the statement of cash flows. The standard is effective for us in the first quarter of fiscal 2017, with early adoption permitted. We are in the process of evaluating the impact of adopting the new standard on our consolidated financial statements.

Note 3: Marketable Securities

Marketable securities are classified as available-for-sale and, as of July 30, 2016 and January 30, 2016, consisted entirely of commercial paper, all of which was less than one year from maturity.

The following table summarizes our investments in marketable securities at July 30, 2016 and January 30, 2016 (in thousands):

| July 30, 2016 | | | | |
|------------------|----------|---|--|------------|
| | Cost | Gross Unrealized Holding Gains | Gross Unrealized Holding Losses | Fair Value |
| Commercial paper | \$39,874 | \$ 52 | \$ | —\$ 39,926 |
| January 30, 2016 | | | | |
| | Cost | Gross Unrealized Holding Gains | Gross Unrealized Holding Losses | Fair Value |
| Commercial paper | \$49,894 | \$ 38 | \$ | —\$ 49,932 |

We recognized gains on investments for commercial paper that matured during the three and six months ended July 30, 2016 and August 1, 2015. Upon recognition of the gains, we reclassified these amounts out of accumulated other comprehensive income and into "Other income, net" on the Consolidated Statements of Income (Loss).

The following table summarizes our gains on investments for commercial paper (in thousands):

| Three Months Ended | Six Months Ended |
|--------------------------|---------------------|
|--------------------------|---------------------|

| | July | August | July | August |
|----------------------|------|--------|-------|--------|
| | 30, | 1, | 30, | 1, |
| | 2016 | 2015 | 2016 | 2015 |
| Gains on investments | \$55 | \$ 34 | \$106 | \$ 65 |

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Note 4: 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 May 31, 2017. The interest rate charged on borrowings is selected at our discretion at the time of draw between the London Interbank Offered Rate, plus 1.00%, or at the Bank's prime rate. The credit agreement is secured by substantially all of our assets. As a sub-feature under the credit agreement, 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 credit agreement. The financial covenants require certain levels of leverage and profitability, such as (i) an aggregate maximum net loss after taxes not to exceed \$5.0 million (measured at the end of each fiscal quarter), with no more than one annual net loss after taxes for any fiscal year (in either case, excluding all charges for impairment of goodwill, other intangibles and store assets impairment on the balance sheet, in an aggregate amount of up to \$2.0 million for the relevant period), and (ii) a maximum ratio of 2.00 to 1.00 for "balance sheet leverage", defined as total liabilities divided by total tangible net worth.

As of July 30, 2016, we were in compliance with all of our covenants and had no outstanding borrowings under the revolving credit facility.

Note 5: Commitments and Contingencies

From time to time, we may become involved in lawsuits and other claims arising from our ordinary course of business. We have established loss provisions of approximately \$2.2 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.

Kirstin Christiansen, Shellie Smith and Paul Haug, on behalf of themselves and all others similarly situated vs. World of Jeans & Tops, Superior Court of California, County of Sacramento, Case No. 34-2013-139010. On January 29, 2013, the plaintiffs in this matter filed a putative class action lawsuit against us alleging violations of California Civil Code Section 1747.08, which prohibits requesting or requiring personal identification information from a customer paying for goods with a credit card and recording such information, subject to exceptions. The complaint seeks certification of a class, unspecified damages, injunctive relief and attorneys' fees. In June 2013, the court granted our motion to strike portions of the plaintiffs' complaint and granted plaintiffs leave to amend. The parties completed class certification discovery and briefing, and a hearing was held on August 13, 2015. On September 17, 2015, the court issued an order denying plaintiff's motion for class certification. On or around November 30, 2015, plaintiffs filed a notice of appeal of the court's order denying plaintiffs' motion for class certification. The deadline for plaintiffs to file their opening brief has been extended until September 9, 2016 and no opening brief has been filed yet. We intend to defend this case vigorously.

Maria Rebolledo, individually and on behalf of all others similarly situated and on behalf of the general public vs. Tilly's, Inc.; World of Jeans & Tops, Superior Court of the State of California, County of Orange, Case No. 30-2012-00616290-CU-OE-CXC. On December 5, 2012, the plaintiff in this matter filed a putative class action lawsuit against us alleging violations of California's wage and hour, meal break and rest break rules and regulations, and unfair competition law, among other things. An amended complaint was filed on February 22, 2013, to add a claim for penalties under the California Private Attorneys General Act of 2004. In March 2013, we filed a motion to compel arbitration, which was denied in June 2013 and later affirmed on appeal. In October 2014, we filed an answer to the amended complaint. The parties attended a mediation proceeding and reached a resolution that will be presented to the court for approval. A final approval hearing is scheduled with the court on November 4, 2016.

Karina Whitten, on behalf of herself and all others similarly situated, v. Tilly's Inc., Superior Court of California, County of Los Angeles, Case No. BC 548252. On June 10, 2014, 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 seeks class certification, penalties, restitution, injunctive relief and attorneys' fees and costs. The plaintiff filed a first amended complaint on December 3, 2014, dismissing an expense reimbursement claim. We answered the complaint on January 8, 2015, denying all allegations, after which the case was stayed pending mediation. We engaged in mediation in May 2016, and the parties reached a resolution that will be presented to the court for preliminary approval on September 13, 2016.

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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. On September 1, 2015, the plaintiff filed a putative class action lawsuit against us, alleging violations of California's wage and hour rules and regulations and unfair competition law. Specifically, the complaint asserts a violation of the applicable California Wage Order for alleged failure to pay reporting time pay, as well as several derivative claims. The complaint seeks certification of a class, unspecified damages, unpaid wages, penalties, restitution, and attorneys' fees. We are defending this case vigorously. On June 21, 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. 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. At the hearing on the plaintiff's demurrer, the court granted the plaintiff leave to amend her complaint. The plaintiff filed an amended complaint on July 5, 2016, which brought the same claims as her original complaint but added various factual allegations. On August 5, 2016, we filed a demurrer as to the plaintiff's amended complaint, on the grounds that the plaintiff's amended complaint still failed to state a cause of action against Tilly's, for the same reasons that the court granted our demurrer as to the plaintiff's original complaint. The hearing date on our demurrer is currently set for October 19, 2016, as is the next status conference. On August 30, 2016, however, the parties submitted a joint stipulation to continue the hearing and status conference date to October 26, 2016. The plaintiff filed her opposition on August 24, 2016. Per the parties' stipulation, our reply is due October 12, 2016. On June 10, 2015, we and one of our vendors entered into a settlement arrangement with a plaintiff who filed a copyright infringement lawsuit against us and the vendor related to certain vendor products we sell. The settlement requires that the vendor pay \$2.0 million to the plaintiff over three years and we have agreed to guarantee such payments. In the event of the vendor's default, the current estimated range of a reasonably possible loss is zero to \$1.5 million. If required to perform under this settlement, we would utilize all available rights of offset to reduce our potential loss, including application of amounts owed by us to the vendor from our ongoing purchases of the vendor's merchandise and/or the enforcement of a security interest we have in the vendor's intellectual property.

Note 6: Fair Value Measurements

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

During the three and six months ended July 30, 2016 and August 1, 2015, we did not make any transfers between Level 1 and Level 2 financial assets. Furthermore, as of July 30, 2016 and January 30, 2016, 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.

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Financial Assets

We have categorized our financial assets based on the priority of the inputs to the valuation technique for the instruments as follows (in thousands):

| | July 30, 2016 | | | January 30, 2016 | | |
|-------------------------|---------------|----------|---------|------------------|----------|---------|
| | Level 1 | Level 2 | Level 3 | Level 1 | Level 2 | Level 3 |
| Cash equivalents: | | | | | | |
| Money market securities | \$50,848 | \$— | \$— | —\$42,626 | \$— | \$— |
| Marketable securities: | | | | | | |
| Commercial paper | \$— | \$39,926 | \$— | —\$— | \$49,932 | \$— |

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 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 six 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 during the three and six months ended July 30, 2016 of approximately \$0.8 million and \$1.5 million, respectively, to write-down the carrying value of certain long-lived store assets to their estimated fair values.

| | Three Months Ended | | Six Months Ended | |
|--|--------------------|----------------|------------------|----------------|
| | July 30, 2016 | August 1, 2015 | July 30, 2016 | August 1, 2015 |
| | (\$ in thousands) | | | |
| Carrying value of assets with impairment | \$840 | \$645 | \$1,696 | \$645 |
| Fair value of assets impaired | \$— | \$278 | \$173 | \$278 |
| Number of stores tested for impairment | 12 | 12 | 13 | 18 |
| Number of stores with impairment | 3 | 1 | 6 | 1 |

Note 7: Share-Based Compensation

The Tillys 2012 Amended and Restated Equity and Incentive 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 July 30, 2016, there were 2,561,656 shares still available for future issuance under the 2012 Plan.

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Stock Options

We grant stock options to certain employees that give 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 nonqualified 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 the stock option activity for the six months ended July 30, 2016 (aggregate intrinsic value in thousands):

| | Stock Options | Grant Date Weighted Average Exercise Price | Weighted Average Remaining Contractual Life (in Years) | Aggregate Intrinsic Value (1) |
|--|------------------|---|--|-------------------------------------|
| Outstanding at January 30, 2016 | 1,811,325 | \$ 10.93 | | |
| Granted | 403,500 | \$ 6.66 | | |
| Forfeited | (85,250) | \$ 10.62 | | |
| Expired | (32,875) | \$ 14.27 | | |
| Outstanding at July 30, 2016 | 2,096,700 | \$ 10.07 | 7.4 | \$ — |
| Vested and expected to vest at July 30, 2016 | 1,995,002 | \$ 10.21 | 7.3 | \$ — |
| Exercisable at July 30, 2016 | 906,950 | \$ 12.94 | 5.2 | \$ — |

Intrinsic value for stock options is defined as the difference between the market price of our Class A common stock (1) on the last business day of the fiscal quarter and the weighted average exercise price of in-the-money stock options outstanding at the end of each fiscal period. The market value per share was \$5.69 at July 30, 2016.

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 estimate forfeitures based on an analysis of the award recipients' positions and the vesting period of the awards. We will issue shares of Class A common stock when the options are exercised.

The fair values of stock options granted during the three and six months ended July 30, 2016 and August 1, 2015 were estimated on the grant date using the following assumptions:

| | Three Months Ended | | Six Months Ended | |
|---|--------------------|-------------------|------------------|----------------------|
| | July 30, 2016 | August 1, 2015 | July 30, 2016 | August 1, 2015 |
| Weighted average grant-date fair value per option granted | \$3.33 | \$4.20 | \$3.52 | \$5.79 |
| Expected option term (1) | 5.0 years | 5.0 years | 5.0 years | 5.0 years |
| Weighted average expected volatility factor (2) | 66.2 % | 45.2 % | 62.1 % | 46.7 % |
| Weighted average risk-free interest rate (3) | 1.2 % | 1.6 % | 1.4 % | 1.5 % |
| Expected annual dividend yield | — % | — % | — % | — % |

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

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

Restricted Stock

Restricted stock awards ("RSAs") represent restricted shares of our common stock issued upon the date of grant in which the recipient's rights in the stock are restricted until the shares are vested, and restricted stock units ("RSUs") represent a commitment to issue shares of our common stock in the future upon vesting. Under the 2012 Plan, we may grant RSAs to

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independent members of our Board of Directors and RSUs to certain employees. RSAs granted to Board members vest at a rate of 50% on each of the first two anniversaries of the grant date provided that the respective award recipient continues to serve on our Board of Directors through each of those vesting dates. RSUs granted to certain employees vest at a rate of 25% on each of the first four anniversaries of the grant date provided that the respective recipient continues to be employed by us through each of those vesting dates. We determine the fair value of restricted stock underlying the RSAs and RSUs based upon the closing price of our Class A common stock on the date of grant. A summary of the status of non-vested restricted stock changes during the six months ended July 30, 2016 are presented below:

| | Restricted Stock | Weighted Average Grant-Date Fair Value |
|-------------------------------|------------------|--|
| Nonvested at January 30, 2016 | 224,588 | \$ 14.02 |
| Granted | 51,864 | \$ 6.17 |
| Vested | (80,093) | \$ 12.45 |
| Forfeited | (23,024) | \$ 15.00 |
| Nonvested at July 30, 2016 | 173,335 | \$ 12.27 |

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

| | Three Months Ended | | Six Months Ended | |
|--|--------------------|----------------|------------------|----------------|
| | July 30, 2016 | August 1, 2015 | July 30, 2016 | August 1, 2015 |
| Cost of goods sold | \$222 | \$284 | \$542 | \$523 |
| Selling, general and administrative expenses | 387 | 748 | 917 | 1,778 |
| Stock-based compensation | \$609 | \$1,032 | \$1,459 | \$2,301 |

At July 30, 2016, there was \$5.2 million of total unrecognized stock-based compensation expense related to unvested stock options and restricted stock. This cost has a weighted average remaining recognition of 2.7 years.

Note 8: Earnings (Loss) Per Share

Earnings (loss) per share is computed under the provisions of ASC Topic 260, Earnings Per Share. Basic income (loss) per share is computed based on the weighted average number of common shares outstanding during the period. Diluted earnings (loss) per share is computed based on the weighted average number of shares of common stock plus the effect of dilutive potential common shares outstanding during the period using the treasury stock method, whereby proceeds from such exercise, unamortized compensation and hypothetical excess tax benefits, if any, on share-based awards are assumed to be used by us to purchase the common shares at the average market price during the period. Potentially dilutive shares of common stock represent outstanding stock options and restricted stock awards.

The components of basic and diluted earnings (loss) per share are as follows (in thousands, except per share amounts):

| | Three Months Ended | | Six Months Ended | |
|---|--------------------|----------------|------------------|----------------|
| | July 30, 2016 | August 1, 2015 | July 30, 2016 | August 1, 2015 |
| Net income (loss) | \$1,433 | \$ 560 | \$(1,312) | \$ 1,842 |
| Weighted average basic shares outstanding | 28,462 | 28,333 | 28,443 | 28,253 |
| Dilutive effect of stock options and restricted stock | 4 | 93 | — | 150 |
| Weighted average shares for diluted earnings (loss) per share | 28,466 | 28,426 | 28,443 | 28,403 |

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| | | | | |
|---|--------|---------|-----------|---------|
| Basic earnings (loss) per share of Class A and Class B common stock | \$0.05 | \$ 0.02 | \$(0.05) | \$ 0.07 |
| Diluted earnings (loss) per share of Class A and Class B common stock | \$0.05 | \$ 0.02 | \$(0.05) | \$ 0.06 |

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The following stock options and restricted stock have been excluded from the calculation of diluted earnings (loss) per share as the effect of including these stock options and restricted stock would have been anti-dilutive:

| | Three Months Ended | | Six Months Ended | |
|------------------|--------------------|-------------------|------------------|-------------------|
| | July 30, 2016 | August 1, 2015 | July 30, 2016 | August 1, 2015 |
| Stock options | 2,096,700 | 2,198,775 | 2,096,700 | 2,193,775 |
| Restricted stock | 51,864 | 245,500 | 173,335 | 245,500 |
| Total | 2,148,564 | 2,444,275 | 2,270,035 | 2,439,275 |

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

The following discussion and analysis of the financial condition and results of our operations should be read together with the financial statements and related notes of Tilly's, Inc. included in Part II Item 1 of this Quarterly Report on Form 10-Q and with our audited consolidated financial statements and the related notes included in our Annual Report on Form 10-K for the fiscal year ended January 30, 2016. As used in this Quarterly Report on Form 10-Q, except where the context otherwise requires or where otherwise indicated, the terms "company", "World of Jeans & Tops", "we", "our", "us", "Tillys" and "Tilly's" refer to Tilly's, Inc. and its subsidiary.

Cautionary Statement Regarding Forward-Looking Statements

This Quarterly Report on Form 10-Q contains forward-looking statements that involve risks and uncertainties, as well as assumptions that, if they never materialize or prove incorrect, could cause our results to differ materially from those expressed or implied by such forward-looking statements. The statements contained in this Quarterly Report on Form 10-Q that are not purely historical are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, or the Exchange Act. Forward-looking statements are often identified by the use of words such as, but not limited to, "anticipate", "believe", "can", "continue", "could", "estimate", "expect", "intend", "may", "plan", "project", "seek", "should", "target", "will", "would", "expressions or variations intended to identify forward-looking statements. These statements are based on the beliefs and assumptions of our management based on information currently available to management. These forward-looking statements are subject to numerous risks and uncertainties, including the risks and uncertainties described under the section titled "Risk Factors" in our Annual Report on Form 10-K for the fiscal year ended January 30, 2016, those identified in this "Management's Discussion and Analysis of Financial Condition and Results of Operations" and elsewhere in this Quarterly Report on Form 10-Q, and in other filings we may make with the Securities and Exchange Commission from time to time. Moreover, we operate in an evolving environment. New risk factors and uncertainties emerge from time to time and it is not possible for our management to predict all risk factors and uncertainties, nor can we assess the impact of all factors on our business or the extent to which any factor, or combination of factors may cause actual results to differ materially from those contained in any forward-looking statement. We qualify all of our forward-looking statements by these cautionary statements.

Overview

Tillys is a destination specialty retailer of West Coast inspired apparel, footwear and accessories. We believe we bring together an unparalleled selection of the most sought-after brands rooted in action sports, music, art and fashion. Our West Coast heritage dates back to 1982 when Hezy Shaked and Tilly Levine opened our first store in Orange County, California. As of July 30, 2016, we operated 225 stores, averaging 7,600 square feet, in 32 states. We also sell our products through our e-commerce website, www.tillys.com.

Known or Anticipated Trends

We, and teen retail in general, have experienced a downward trend in traffic to brick-and-mortar stores for an extended period of time. Conversely, online shopping has generally increased and resulted in sustained online sales growth. We believe these traffic trends and shopping behaviors will continue in the remainder of fiscal 2016. As a result, we expect to slow the pace of new store openings during the remainder of fiscal 2016 to focus our efforts on improving the performance of 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.

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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.

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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. In those periods, various costs, such as 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.

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Results of Operations

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

| | Three Months Ended | | Six Months Ended | |
|--|--------------------|-------------------|------------------|-------------------|
| | July 30, 2016 | August 1, 2015 | July 30, 2016 | August 1, 2015 |
| | (in thousands) | | (in thousands) | |
| Statements of Income (Loss) Data: | | | | |
| Net sales | \$136,412 | \$130,023 | \$256,630 | \$250,213 |
| Cost of goods sold | 97,575 | 93,427 | 185,206 | 177,565 |
| Gross profit | 38,837 | 36,596 | 71,424 | 72,648 |
| Selling, general and administrative expenses | 36,605 | 35,492 | 73,159 | 69,415 |
| Operating income (loss) | 2,232 | 1,104 | (1,735) | 3,233 |
| Other income, net | 91 | 10 | 167 | 18 |
| Income (Loss) before income taxes | 2,323 | 1,114 | (1,568) | 3,251 |
| Income tax expense (benefit) | 890 | 554 | (256) | 1,409 |
| Net income (loss) | \$1,433 | \$560 | \$(1,312) | \$1,842 |

Percentage of Net Sales:

| | | | | | |
|--|-------|---------|---------|---------|---|
| Net sales | 100.0 | % 100.0 | % 100.0 | % 100.0 | % |
| Cost of goods sold | 71.5 | % 71.9 | % 72.2 | % 71.0 | % |
| Gross profit | 28.5 | % 28.1 | % 27.8 | % 29.0 | % |
| Selling, general and administrative expenses | 26.8 | % 27.3 | % 28.5 | % 27.7 | % |
| Operating income (loss) | 1.7 | % 0.8 | % (0.7) |)% 1.3 | % |
| Other income, net | 0.0 | % 0.1 | % 0.1 | % 0.0 | % |
| Income (Loss) before income taxes | 1.7 | % 0.9 | % (0.6) |)% 1.3 | % |
| Income tax expense (benefit) | 0.6 | % 0.5 | % (0.1) |)% 0.6 | % |
| Net income (loss) | 1.1 | % 0.4 | % (0.5) |)% 0.7 | % |

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

| | Three Months Ended | | Six Months Ended | |
|---|--------------------|-------------------|------------------|-------------------|
| | July 30, 2016 | August 1, 2015 | July 30, 2016 | August 1, 2015 |
| Store Operating Data: | | | | |
| Stores operating at end of period | 225 | 216 | 225 | 216 |
| Comparable store sales change (1) | 0.9 | % 0.5 | % (1.4 |)% 1.2 |
| Total square feet at end of period (in thousands) | 1,713 | 1,655 | 1,713 | 1,655 |
| Average net sales per brick-and-mortar store (in thousands) (2) | \$533 | \$540 | \$1,001 | \$1,043 |
| Average net sales per square foot (2) | \$70 | \$71 | \$132 | \$136 |

(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 on 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 are excluded from net sales in deriving average net sales per brick-and-mortar store.

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Second Quarter Ended July 30, 2016 Compared to Second Quarter Ended August 1, 2015

Net Sales

Net sales were \$136.4 million in the second quarter of fiscal 2016 compared to \$130.0 million in the second quarter of fiscal 2015, an increase of \$6.4 million, or 4.9%. The components of the increase in net sales were as follows:

\$ millions Attributable to

\$5.2 Increase in non-comparable store sales due to opening nine net new stores in the prior twelve months.

1.2 Increase in comparable store sales of 0.9%.

\$6.4 Total

Comparable store sales increased due to strong e-commerce growth, partially offset by slightly negative comparable store sales in our physical stores. Our comparable store sales increase was due to stronger conversion rates and higher average dollar sales, partially offset by lower traffic as compared to the second quarter of fiscal 2015. Our comparable store sales were driven by single-digit percentage growth across all departments with the exception of womens, which declined in the single-digits on a percentage basis.

Gross Profit

Gross profit was \$38.8 million in the second quarter of fiscal 2016 compared to \$36.6 million in the second quarter of fiscal 2015, an increase of \$2.2 million, or 6.1%. Gross margin, or gross profit as a percentage of net sales, was 28.5% and 28.1% during the second quarter of fiscal 2016 and second quarter of fiscal 2015, respectively. The components of the 0.4% increase in gross margin were as follows:

% Attributable to

0.7% Decrease in distribution, buying and occupancy costs as a percentage of net sales primarily due to a lease assignment and certain other favorable lease negotiations.

(0.3)% Decrease in product margins primarily due to higher markdowns.

0.4% Total

Selling, General and Administrative Expenses

SG&A expenses were \$36.6 million in the second quarter of fiscal 2016 compared to \$35.5 million in the second quarter of fiscal 2015, an increase of \$1.1 million, or 3.1%. As a percentage of net sales, SG&A expenses were 26.8% and 27.3% during the second quarter of fiscal 2016 and second quarter of fiscal 2015, respectively. The components of the SG&A decrease, both in terms of percentage of net sales and total dollars, were as follows:

% \$ millions Attributable to

0.1% \$1.0 Increase due to higher store payroll associated with nine net new stores coupled with minimum wage increases.

0.3% 0.5 Increase due to higher store impairment charges.

(0.5)% (0.5) Decrease due to more efficient marketing spend.

(0.5)% (0.3) Decrease due to reductions in corporate office payroll and benefits.

0.1% 0.4 Increase in various other SG&A expenses.

(0.5)% \$1.1 Total

Operating Income

Operating income was \$2.2 million in the second quarter of fiscal 2016 compared to \$1.1 million for the second quarter of fiscal 2015, an increase of \$1.1 million, or 102.2%. As a percentage of net sales, operating income was 1.7% and 0.8% for the second quarter of fiscal 2016 and fiscal 2015, respectively. The increase was attributable to higher gross profit and the lower SG&A as a percentage of net sales as discussed above.

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Income Tax Expense

Income tax expense was \$0.9 million and \$0.6 million for the second quarter of fiscal 2016 and second quarter of fiscal 2015, respectively. Our effective tax rates were 38% and 50% for the second quarter of fiscal 2016 and fiscal 2015, respectively. The decrease in our effective tax rate for the second quarter of fiscal 2016 was primarily due to the tax impact of discrete items related to the settlement of restricted stock units and stock option expirations.

Net Income and Earnings Per Share

Net income was \$1.4 million for the second quarter of fiscal 2016 compared to \$0.6 million for the second quarter of fiscal 2015, an increase of \$0.9 million, due to the factors discussed above. Basic and diluted earnings per share was \$0.05 for the second quarter of fiscal 2016 compared to basic and diluted earnings per share of \$0.02 for the second quarter of fiscal 2015.

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First Half Ended July 30, 2016 Compared to First Half Ended August 1, 2015

Net Sales

Net sales were \$256.6 million in the first half of fiscal 2016 as compared to \$250.2 million in the first half of fiscal 2015, an increase of \$6.4 million, or 2.6%. The components of our net sales increase were as follows:

\$ millions Attributable to

\$9.8 Increase in non-comparable store sales due to opening nine net new stores in the prior twelve months.

(3.4) Decrease in comparable store sales of 1.4%.

\$6.4 Total

Comparable store sales decreased due to negative comparable store sales at our brick and mortar stores offset by strong e-commerce growth. Our comparable store sales decrease was due to lower traffic, partially offset by stronger conversion rates as compared to the first half of fiscal 2015. Our comparable store sales were characterized by low single-digit percentage decreases across most departments, with the exception of boys and footwear which increased by a single-digit percentage.

Gross Profit

Gross profit was \$71.4 million in the first half of fiscal 2016 compared to \$72.6 million in first half of fiscal 2015, a decrease of \$1.2 million, or 1.7%. Gross margin, or gross profit as a percentage of net sales, was 27.8% and 29.0% during the first half of fiscal 2016 and fiscal 2015, respectively. The components of the 1.2% decrease in gross margin were as follows:

% Attributable to

(0.6)% Decrease in product margins due to higher markdowns.

(0.6)% Increase in occupancy costs as a percentage of net sales primarily due to negative comparable store sales and the opening nine net new stores in the prior twelve months.

(1.2)% Total

Selling, General and Administrative Expenses

SG&A expenses were \$73.2 million in the first half of fiscal 2016 compared to \$69.4 million in the first half of fiscal 2015, an increase of \$3.7 million, or 5.4%. As a percentage of net sales, SG&A expenses were 28.5% and 27.7% during the first half of fiscal 2016 and fiscal 2015, respectively. The components of the SG&A increase, both in terms of percentage of net sales and total dollars, were as follows:

% \$ millions Attributable to

0.5% \$1.2 Increase due to a legal provision.

0.5% 1.2 Increase in non-cash store impairment charges.

0.3% 1.6 Increase in store payroll dollars associated with nine net new stores and minimum wage increases

(0.5)% (1.0) Decrease due to reductions in corporate office payroll and benefits.

—% 0.7 Increase in all other SG&A expenses.

0.8% \$3.7 Total

Operating (Loss) Income

Operating loss was \$1.7 million for the first half of fiscal 2016 compared to net income of \$3.2 million for the first half of fiscal 2015, a decrease of \$5.0 million. As a percentage of net sales, operating loss was 0.7% for the first half of fiscal 2016 compared to operating income of 1.3% for the first half of fiscal 2015. These decreases were primarily attributable to the decrease in gross profit and the increase in SG&A as discussed above.

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Income Tax (Benefit) Expense

Income tax benefit was \$0.3 million for the first half of fiscal 2016 compared to income tax expense of \$1.4 million for the first half of fiscal 2015. Our effective tax rates were 16% and 43% for the first half of fiscal 2016 and fiscal 2015, respectively. The decrease in our effective tax rate in the first half of fiscal 2016 was primarily due to discrete items related to expiration of stock options and the settlement of restricted stock units.

Net (Loss) Income and (Loss) Earnings Per Share

Net loss was \$1.3 million for the first half of fiscal 2016 compared to net income of \$1.8 million for the first half of fiscal 2015, due to the factors discussed above. Loss per share was \$0.05 for the first half of fiscal 2016 compared to diluted earnings per share of \$0.06 for the first half of fiscal 2015.

Liquidity and Capital Resources

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

Working capital at July 30, 2016, was \$113.2 million compared to \$114.9 million at January 30, 2016, a decrease of \$1.7 million, or 1.5%. The changes in our working capital during the first half of fiscal 2016 were as follows:

\$ millions Description

| | |
|---------|---|
| \$114.9 | Working capital at January 30, 2016 |
| (4.6) | Decrease in cash and cash equivalents |
| 2.1 | Increase in prepaid expenses and other assets |
| 0.8 | Net increase from changes in all other current assets and liabilities |
| \$113.2 | Working capital at July 30, 2016 |

Cash Flow Analysis

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

| | Six Months Ended | |
|---|---------------------|----------------------|
| | July 30, 2016 | August 1, 2015 |
| | (in thousands) | |
| Net cash provided by operating activities | \$6,212 | \$607 |
| Net cash used in investing activities | (245) | (1,463) |
| Net cash (used in) provided by financing activities | (521) | 2,792 |
| Net increase in cash and cash equivalents | \$5,446 | \$1,936 |
| Net Cash Provided by Operating Activities | | |

Operating activities consist primarily of net (loss) 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 flows provided by operating activities were \$6.2 million during the first half of fiscal 2016 compared to \$0.6 million in the first half of fiscal 2015. This \$5.6 million increase was primarily due to the timing of vendor payments partially offset by lower operating results.

Net Cash Used in Investing Activities

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

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Net cash used in investing activities was \$0.2 million during the first half of fiscal 2016 compared to \$1.5 million during the first half of fiscal 2015. Net cash used in investing activities in the first half of fiscal 2016 consisted of capital expenditures totaling \$10.4 million, partially offset by net proceeds from marketable securities of \$10.2 million. We currently expect total capital expenditures for fiscal 2016 not to exceed \$20 million. Net cash used in investing activities during the first half of fiscal 2015 primarily consisted of capital expenditures totaling \$11.5 million, partially offset by net proceeds from marketable securities of \$10.0 million.

Net Cash (Used in) Provided By Financing Activities

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

Net cash used in financing activities was \$0.5 million during the first half of fiscal 2016 compared to net cash provided by financing activities of \$2.8 million during the first half of fiscal 2015. Financing activities in the first half of fiscal 2016 consisted of cash payments on our capital lease obligation of \$0.4 million and employee taxes paid of \$0.1 million as a result of a net settlement of issued restricted stock. Financing activities in the first half of fiscal 2015 primarily consisted of proceeds from employee exercises of stock options and excess tax benefits of stock-based compensation totaling \$3.2 million and cash payments on our capital lease obligation of \$0.4 million.

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 May 31, 2017. The interest rate charged on borrowings is selected at our discretion at the time of draw between the London Interbank Offered Rate, plus 1.00%, or at the Bank's prime rate. The credit agreement is secured by substantially all of our assets. As a sub-feature under the credit agreement, 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 credit agreement. The financial covenants require certain levels of leverage and profitability, such as (i) an aggregate maximum net loss after taxes not to exceed \$5.0 million (measured at the end of each fiscal quarter), with no more than one annual net loss after taxes for any fiscal year (in either case, excluding all charges for impairment of goodwill, other intangibles and store assets impairment on the balance sheet, in an aggregate amount of up to \$2.0 million for the relevant period), and (ii) a maximum ratio of 2.00 to 1.00 for "balance sheet leverage", defined as total liabilities divided by total tangible net worth.

As of July 30, 2016, we were in compliance with all of our covenants and had no outstanding borrowings under the revolving credit facility.

Contractual Obligations

As of July 30, 2016, there were no material changes to our contractual obligations as described in the "Management's Discussion and Analysis of Financial Condition and Results of Operations" section of our Annual Report on Form 10-K for the fiscal year ended January 30, 2016.

Off-Balance Sheet Arrangements

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

Critical Accounting Policies and Estimates

The preparation of financial statements in accordance with accounting principles generally accepted in the U.S. requires the appropriate application of certain accounting policies, some of which require us to make estimates and assumptions about future events and their impact on amounts reported in our consolidated financial statements. Since future events and their impact cannot be determined with absolute certainty, the actual results will inevitably differ from our estimates. A summary of our significant accounting policies is included in Note 2 to the consolidated financial statements in our Annual Report on Form 10-K for the fiscal year ended January 30, 2016.

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New Accounting Standards

In February 2016, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU"), No. 2016-02, Leases (ASC 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. The standard is effective for us in the first quarter of fiscal 2019, with early adoption permitted. 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.

In March 2016, the FASB issued 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 classification in the statement of cash flows. The standard is effective for us in the first quarter of fiscal 2017, with early adoption permitted. We are in the process of evaluating the impact of adopting the new standard on our consolidated financial statements.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

As of July 30, 2016, there were no material changes in the market risks described in the "Quantitative and Qualitative Disclosure of Market Risks" section of our Annual Report on Form 10-K for the fiscal year ended January 30, 2016.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Our management, with the participation of our Disclosure Committee, including our Chief Executive Officer and our Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures as of July 30, 2016. The term "disclosure controls and procedures," as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act, means controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to our management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure. Based on the evaluation of our disclosure controls and procedures as of July 30, 2016, our Chief Executive Officer and Chief Financial Officer concluded that, as of such date, our disclosure controls and procedures were effective at the reasonable assurance level.

Changes in Internal Control Over Financial Reporting

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

Inherent Limitations on Effectiveness of Controls

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

absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, have been detected.

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

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Part II. Other Information

Item 1. Legal Proceedings

From time to time, we may become involved in lawsuits and other claims arising from our ordinary course of business. We have established loss provisions of approximately \$2.2 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.

Kirstin Christiansen, Shellie Smith and Paul Haug, on behalf of themselves and all others similarly situated vs. World of Jeans & Tops, Superior Court of California, County of Sacramento, Case No. 34-2013-139010. On January 29, 2013, the plaintiffs in this matter filed a putative class action lawsuit against us alleging violations of California Civil Code Section 1747.08, which prohibits requesting or requiring personal identification information from a customer paying for goods with a credit card and recording such information, subject to exceptions. The complaint seeks certification of a class, unspecified damages, injunctive relief and attorneys' fees. In June 2013, the court granted our motion to strike portions of the plaintiffs' complaint and granted plaintiffs leave to amend. The parties completed class certification discovery and briefing, and a hearing was held on August 13, 2015. On September 17, 2015, the court issued an order denying plaintiff's motion for class certification. On or around November 30, 2015, plaintiffs filed a notice of appeal of the court's order denying plaintiffs' motion for class certification. The deadline for plaintiffs to file their opening brief has been extended until September 9, 2016 and no opening brief has been filed yet. We intend to defend this case vigorously.

Maria Rebolledo, individually and on behalf of all others similarly situated and on behalf of the general public vs. Tilly's, Inc.; World of Jeans & Tops, Superior Court of the State of California, County of Orange, Case No. 30-2012-00616290-CU-OE-CXC. On December 5, 2012, the plaintiff in this matter filed a putative class action lawsuit against us alleging violations of California's wage and hour, meal break and rest break rules and regulations, and unfair competition law, among other things. An amended complaint was filed on February 22, 2013, to add a claim for penalties under the California Private Attorneys General Act of 2004. In March 2013, we filed a motion to compel arbitration, which was denied in June 2013 and later affirmed on appeal. In October 2014, we filed an answer to the amended complaint. The parties attended a mediation proceeding and reached a resolution that will be presented to the court for approval. A final approval hearing is scheduled with the court on November 4, 2016.

Karina Whitten, on behalf of herself and all others similarly situated, v. Tilly's Inc., Superior Court of California, County of Los Angeles, Case No. BC 548252. On June 10, 2014, 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 seeks class certification, penalties, restitution, injunctive relief and attorneys' fees and costs. The plaintiff filed a first amended complaint on December 3, 2014, dismissing an

expense reimbursement claim. We answered the complaint on January 8, 2015, denying all allegations, after which the case was stayed pending mediation. We engaged in mediation in May 2016, and the parties reached a resolution that will be presented to the court for preliminary approval on September 13, 2016.

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. On September 1, 2015, the plaintiff filed a putative class action lawsuit against us, alleging violations of California's wage and hour rules and regulations and unfair competition law. Specifically, the complaint asserts a violation of the applicable California Wage Order for alleged failure to pay reporting time pay, as well as several derivative claims. The complaint seeks certification of a class, unspecified damages, unpaid wages,

penalties, restitution, and attorneys' fees. We are defending this case vigorously. On June 21, 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. 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. At the hearing on the plaintiff's demurrer, the court granted the plaintiff leave to amend her complaint. The plaintiff filed an amended complaint on July 5, 2016, which brought the same claims as her original complaint but added various factual allegations. On August 5, 2016, we filed a demurrer as to the plaintiff's amended complaint, on the grounds that the plaintiff's amended complaint still failed to state a cause of action against Tilly's, for the same reasons that the court granted our demurrer as to the plaintiff's original

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complaint. The hearing date on our demurrer is currently set for October 19, 2016, as is the next status conference. On August 30, 2016, however, the parties submitted a joint stipulation to continue the hearing and status conference date to October 26, 2016. The plaintiff filed her opposition on August 24, 2016. Per the parties' stipulation, our reply is due October 12, 2016.

On June 10, 2015, we and one of our vendors entered into a settlement arrangement with a plaintiff who filed a copyright infringement lawsuit against us and the vendor related to certain vendor products we sell. The settlement requires that the vendor pay \$2.0 million to the plaintiff over three years and we have agreed to guarantee such payments. In the event of the vendor's default, the current estimated range of a reasonably possible loss is zero to \$1.5 million. If required to perform under this settlement, we would utilize all available rights of offset to reduce our potential loss, including application of amounts owed by us to the vendor from our ongoing purchases of the vendor's merchandise and/or the enforcement of a security interest we have in the vendor's intellectual property.

Item 1A. Risk Factors

We operate in a rapidly changing environment that involves a number of risks that could materially and adversely affect our business, financial condition, prospects, operating results or cash flows. For a detailed discussion of the risks that affect our business, please refer to the section entitled "Risk Factors" in our Annual Report on Form 10-K for the fiscal year ended January 30, 2016. There have been no material changes to our risk factors as previously disclosed in our Annual Report on Form 10-K.

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Item 6. Exhibits

| Exhibit No. | Description of Exhibit |
|-------------|--|
| 10.1 | Offer Letter, dated July 22, 2016, for Jon Kubo (incorporated by reference to Exhibit 10.1 to the Registrant's Current Report on Form 8-K filed on August 15, 2016). |
| 31.1* | Certification of Chief Executive Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended. |
| 31.2* | Certification of Chief Financial Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended. |
| 32.1** | Certification of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 101 | Interactive data files from Tilly's, Inc.'s Quarterly Report on Form 10-Q for the quarter ended July 30, 2016, formatted in XBRL (eXtensible Business Reporting Language): (i) the Consolidated Balance Sheets; (ii) the Consolidated Statements of Income (Loss); (iii) the Consolidated Statements of Comprehensive Income (Loss); (iv) the Consolidated Statement of Stockholders' Equity; (v) the Consolidated Statements of Cash Flows and (vi) Notes to Consolidated Financial Statements. |

*Filed herewith

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

**

SIGNATURES

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

Tilly's, Inc.

Date: September 6, 2016

/s/ Edmond S. Thomas
Edmond S. Thomas
President, Chief Executive Officer and Director
(Principal Executive Officer)

Date: September 6, 2016

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

