ZALE CORP
Form 10-Q
March 07, 2014

Use these links to rapidly review the document
ZALE CORPORATION AND SUBSIDIARIES TABLE OF CONTENTS

Table of Contents

# UNITED STATES
# SECURITIES AND EXCHANGE COMMISSION

**WASHINGTON, D.C. 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 January 31, 2014**

**Commission File Number 1-04129**

# Zale Corporation

**A Delaware Corporation**
IRS Employer Identification No. 75-0675400

**901 W. Walnut Hill Lane**
**Irving, Texas 75038-1003**
**(972) 580-4000**

Zale Corporation (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934, as amended, during the preceding 12 months, and (2) has been subject to such filing requirements for the past 90 days.

Zale Corporation has submitted electronically and posted on the Company's website all Interactive Data Files 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 Company was required to submit and post such files).

Zale Corporation is an accelerated filer.

Zale Corporation is not a shell company.

As of March 3, 2014, 33,021,621 shares of Zale Corporation's Common Stock, par value $0.01 per share, were outstanding.

Table of Contents

**ZALE CORPORATION AND SUBSIDIARIES**

**TABLE OF CONTENTS**

Table of Contents

**PART I FINANCIAL INFORMATION**

**ITEM 1. FINANCIAL STATEMENTS**

**ZALE CORPORATION AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF OPERATIONS**

**(In thousands, except per share amounts)**

**(Unaudited)**

| | Three Months Ended January 31, | | Six Months Ended January 31, | |
|---|---|---|---|---|
| | **2014** | **2013** | **2014** | **2013** |
| Revenues | $ 656,449 | $ 670,752 | $ 1,019,063 | $ 1,028,220 |
| Cost of sales | 308,830 | 331,101 | 477,656 | 498,234 |
| Gross margin | 347,619 | 339,651 | 541,407 | 529,986 |
| Selling, general and administrative | 280,148 | 279,064 | 488,306 | 485,529 |
| Depreciation and amortization | 7,461 | 8,388 | 15,122 | 17,034 |
| Other charges (gains) | 488 | 926 | 488 | (847) |
| Operating earnings | 59,522 | 51,273 | 37,491 | 28,270 |
| Interest expense | 6,096 | 6,088 | 11,706 | 11,930 |
| Earnings before income taxes | 53,426 | 45,185 | 25,785 | 16,340 |
| Income tax expense | 2,640 | 3,977 | 2,305 | 3,396 |
| Net earnings | $ 50,786 | $ 41,208 | $ 23,480 | $ 12,944 |
| Basic net earnings per common share: | $ 1.54 | $ 1.27 | $ 0.72 | $ 0.40 |
| Diluted net earnings per common share: | $ 1.13 | $ 1.02 | $ 0.52 | $ 0.32 |
| Weighted average number of common shares outstanding: | | | | |
| Basic | 32,919 | 32,426 | 32,827 | 32,362 |
| Diluted | 45,022 | 40,305 | 44,837 | 40,470 |

See notes to consolidated financial statements.

Table of Contents

**ZALE CORPORATION AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

**(In thousands)**

**(Unaudited)**

| | Three Months Ended January 31, | | Six Months Ended January 31, | |
|---|---|---|---|---|
| | **2014** | **2013** | **2014** | **2013** |
| Net earnings | $ 50,786 | $ 41,208 | $ 23,480 | $ 12,944 |
| Foreign currency translation adjustment | (12,763) | (44) | (15,996) | 470 |
| Unrealized loss on interest rate swaps | (140) | | (2,676) | |
| Reclassification of loss on interest rate swaps to interest expense | 65 | | 85 | |
| Unrealized gain on securities, net | (128) | 76 | (54) | 21 |
| Comprehensive income | $ 37,820 | $ 41,240 | $ 4,839 | $ 13,435 |

See notes to consolidated financial statements.

Table of Contents

**ZALE CORPORATION AND SUBSIDIARIES**

**CONSOLIDATED BALANCE SHEETS**

**(In thousands)**

**(Unaudited)**

| | January 31, 2014 | July 31, 2013 | January 31, 2013 |
|---|---|---|---|
| **ASSETS** | | | |
| Current assets: | | | |
| Cash and cash equivalents | $ 23,251 | $ 17,060 | $ 18,516 |
| Merchandise inventories | 864,275 | 767,540 | 836,624 |
| Other current assets | 48,260 | 53,335 | 51,311 |
| Total current assets | 935,786 | 837,935 | 906,451 |
| Property and equipment | 666,000 | 675,705 | 688,558 |
| Less accumulated depreciation and amortization | (562,286) | (570,427) | (575,646) |
| Net property and equipment | 103,714 | 105,278 | 112,912 |
| Goodwill | 92,376 | 98,372 | 100,756 |
| Other assets | 41,718 | 38,560 | 50,471 |
| Deferred tax asset | 107,110 | 107,110 | 96,888 |
| Total assets | $ 1,280,704 | $ 1,187,255 | $ 1,267,478 |
| **LIABILITIES AND STOCKHOLDERS' INVESTMENT** | | | |
| Current liabilities: | | | |
| Accounts payable and accrued liabilities | $ 276,907 | $ 220,558 | $ 263,384 |
| Deferred revenue | 81,667 | 82,110 | 86,813 |
| Deferred tax liability | 107,479 | 107,016 | 97,233 |
| Total current liabilities | 466,053 | 409,684 | 447,430 |
| Long-term debt | 445,267 | 410,050 | 473,975 |
| Deferred revenue long-term | 105,004 | 109,135 | 115,664 |
| Other liabilities | 72,307 | 73,057 | 36,504 |
| Commitments and contingencies | | | |
| Stockholders' investment: | | | |
| Common stock | 488 | 488 | 488 |

| | | | |
|---|---|---|---|
| Additional paid-in capital | 150,459 | 155,625 | 158,422 |
| Accumulated other comprehensive income | 28,374 | 47,015 | 53,860 |
| Accumulated earnings | 458,621 | 435,140 | 438,072 |
| | 637,942 | 638,268 | 650,842 |
| Treasury stock | (445,869) | (452,939) | (456,937) |
| Total stockholders' investment | 192,073 | 185,329 | 193,905 |
| Total liabilities and stockholders' investment | $ 1,280,704 | $ 1,187,255 | $ 1,267,478 |

See notes to consolidated financial statements.

Table of Contents

**ZALE CORPORATION AND SUBSIDIARIES**

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

**(In thousands)**

**(Unaudited)**

| | Six Months Ended January 31, | |
|---|---|---|
| | **2014** | **2013** |
| **Cash Flows From Operating Activities:** | | |
| Net earnings | $ 23,480 | $ 12,944 |
| Adjustments to reconcile net earnings to net cash used in operating activities: | | |
| Non-cash interest | 1,454 | 1,452 |
| Depreciation and amortization | 15,122 | 17,034 |
| Deferred taxes | 352 | 614 |
| Loss on disposition of property and equipment | 690 | 632 |
| Impairment of property and equipment | 488 | 851 |
| Stock-based compensation | 2,261 | 1,742 |
| Changes in operating assets and liabilities: | | |
| Merchandise inventories | (108,272) | (94,676) |
| Other current assets | 3,696 | (4,898) |
| Other assets | 536 | 1,192 |
| Accounts payable and accrued liabilities | 57,515 | 56,593 |
| Deferred revenue | (2,258) | (6,144) |
| Other liabilities | (1,446) | (110) |
| Net cash used in operating activities | (6,382) | (12,774) |
| **Cash Flows From Investing Activities:** | | |
| Payments for property and equipment | (18,007) | (12,667) |
| Purchase of available-for-sale investments | (5,157) | (1,674) |
| Proceeds from sales of available-for-sale investments | 959 | 465 |
| Net cash used in investing activities | (22,205) | (13,876) |
| **Cash Flows From Financing Activities:** | | |
| Borrowings under revolving credit agreement | 2,676,300 | 2,738,400 |
| Payments on revolving credit agreement | (2,640,500) | (2,717,500) |
| Proceeds from exercise of stock options | 311 | 56 |
| Payments on capital lease obligations | (551) | (489) |
| Net cash provided by financing activities | 35,560 | 20,467 |
| Effect of exchange rate changes on cash | (782) | 96 |
| Net change in cash and cash equivalents | 6,191 | (6,087) |

| | | | | |
|---|---|---|---|---|
| Cash and cash equivalents at beginning of period | | 17,060 | | 24,603 |
| Cash and cash equivalents at end of period | $ | 23,251 | $ | 18,516 |

See notes to consolidated financial statements.

Table of Contents

**ZALE CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

## 1. BASIS OF PRESENTATION

References to the "Company," "we," "us," and "our" in this Form 10-Q are references to Zale Corporation and its subsidiaries. We are, through our wholly owned subsidiaries, a leading specialty retailer of fine jewelry in North America. At January 31, 2014, we operated 1,037 specialty retail jewelry stores and 623 kiosks located primarily in shopping malls throughout the United States, Canada and Puerto Rico.

We report our operations under three segments: Fine Jewelry, Kiosk Jewelry and All Other. Fine Jewelry is comprised of our three core national brands, Zales Jewelers®, Zales Outlet® and Peoples Jewellers® and our two regional brands, Gordon's Jewelers® and Mappins Jewellers®. Each brand specializes in fine jewelry and watches, with merchandise and marketing emphasis focused on diamond products. Zales Jewelers® is our national brand in the U.S. providing moderately priced jewelry to a broad range of guests. Zales Outlet® operates in outlet malls and neighborhood power centers and capitalizes on Zale Jewelers'® national marketing and brand recognition. Gordon's Jewelers® is a value-oriented regional jeweler. Peoples Jewellers®, Canada's largest fine jewelry retailer, provides guests with an affordable assortment and an accessible shopping experience. Mappins Jewellers® offers Canadian guests a broad selection of merchandise from engagement rings to fashionable and contemporary fine jewelry.

Kiosk Jewelry operates under the brand names Piercing Pagoda®, Plumb Gold , and Silver and Gold Connection® through mall-based kiosks and is focused on the opening price point guest. Kiosk Jewelry specializes in gold, silver and non-precious metal products that capitalize on the latest fashion trends.

All Other includes our insurance and reinsurance operations, which offer insurance coverage primarily to our private label credit card guests.

We also maintain a presence in the retail market through our ecommerce sites *www.zales.com, www.zalesoutlet.com, www.gordonsjewelers.com*, *www.peoplesjewellers.com* and *www.pagoda.com*.

We consolidate all of our U.S. operations into Zale Delaware, Inc. ("ZDel"), a wholly owned subsidiary of Zale Corporation. ZDel is the parent company for several subsidiaries, including three that are engaged primarily in providing credit insurance to our credit customers. We consolidate our Canadian retail operations into Zale Canada Holding, L.P., which is a wholly owned subsidiary of Zale Corporation. All significant intercompany transactions have been eliminated. The consolidated financial statements are unaudited and have been prepared by the Company in accordance with U.S. generally accepted accounting principles ("GAAP") for interim financial information. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In management's opinion, all material adjustments (consisting of normal recurring accruals and adjustments) and disclosures necessary for a fair presentation have been made. Because of the seasonal nature of the retail business, operating results for interim periods are not necessarily indicative of the results that may be expected for the full year. The accompanying consolidated financial statements should be read in conjunction with the audited consolidated financial statements and related notes thereto included in the Company's Annual Report on Form 10-K for the fiscal year ended July 31, 2013 filed with the Securities and Exchange Commission ("SEC") on September 27, 2013.

***Reclassification.*** Certain prior year amounts have been reclassified in the accompanying consolidated financial statements to conform to our fiscal year 2014 presentation.

Table of Contents

**ZALE CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

**2. FAIR VALUE MEASUREMENTS**

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability (an exit price) in an orderly transaction between market participants at the measurement date. In determining fair value, Accounting Standards Codification ("ASC") 820, *Fair Value Measurement*, establishes a three-tier fair value hierarchy, which prioritizes the inputs used in measuring fair values. These tiers include:

Level 1 Quoted prices for *identical* instruments in active markets;

Level 2 Quoted prices for *similar* instruments in active markets; quoted prices for identical or similar instruments in markets that are not active; and model-derived valuations whose significant inputs are observable; and

Level 3 Instruments whose significant inputs are *unobservable.*

***Assets and Liabilities that are Measured at Fair Value on a Recurring Basis***

The following tables include our assets and liabilities that are measured at fair value on a recurring basis (in thousands):

| | Fair Value as of January 31, 2014 | | |
|---|---|---|---|
| | **Level 1** | **Level 2** | **Level 3** |
| **Assets** | | | |
| U.S. Treasury securities | $ 14,306 | $ | $ |
| U.S. government agency securities | | 2,074 | |
| Corporate bonds and notes | | 5,718 | |
| Corporate equity securities | 2,706 | | |
| | $ 17,012 | $ 7,792 | $ |
| **Liabilities** | | | |
| Interest rate swaps | $ | $ 2,591 | $ |

| | Fair Value as of January 31, 2013 | | |
|---|---|---|---|
| | **Level 1** | **Level 2** | **Level 3** |
| **Assets** | | | |
| U.S. Treasury securities | $ 22,445 | $ | $ |
| U.S. government agency securities | | 2,833 | |
| Corporate bonds and notes | | 868 | |

| | | | | | | |
|---|---|---|---|---|---|---|
| Corporate equity securities | | 4,423 | | | | |
| | $ | 26,868 | $ | 3,701 | $ | |

Investments in U.S. Treasury securities and corporate equity securities are based on quoted market prices for identical instruments in active markets, and therefore were classified as a Level 1 measurement in the fair value hierarchy. Investments in U.S. government agency securities and corporate bonds and

Table of Contents

**ZALE CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

**2. FAIR VALUE MEASUREMENTS (Continued)**

notes are based on quoted prices for similar instruments in active markets, and therefore were classified as a Level 2 measurement in the fair value hierarchy (see Note 3 for additional information related to our investments).

The fair value of our interest rate swaps is calculated using significant observable inputs including the present value of estimated future cash flows using interest rate curves, and therefore were classified as a Level 2 measurement in the fair value hierarchy (see Note 4 for additional information related to our interest rate swaps).

***Assets that are Measured at Fair Value on a Nonrecurring Basis***

Impairment losses related to store-level property and equipment are calculated using significant unobservable inputs including the present value of future cash flows expected to be generated using a risk-adjusted weighted average cost of capital of 14.0 percent to 15.5 percent, and therefore are classified as a Level 3 measurement in the fair value hierarchy. For the six months ended January 31, 2014, store-level property and equipment of $0.7 million was written down to their fair value of $0.2 million, resulting in an impairment charge of $0.5 million. For the six months ended January 31, 2013, store-level property and equipment of $1.0 million was written down to their fair value of $0.1 million, resulting in an impairment charge of $0.9 million.

At the end of the second quarter of fiscal year 2014, we completed our annual impairment testing of goodwill pursuant to ASC 350, *Intangible Goodwill and Other*. Based on the test results, we concluded that no impairment was necessary for the $73.0 million of goodwill related to the Peoples Jewellers acquisition and the $19.4 million of goodwill related to the Piercing Pagoda acquisition. As of the date of the test, the fair value of the Peoples Jewellers and Piercing Pagoda reporting units would have to decline by more than 30 percent and 41 percent, respectively, to be considered for potential impairment. We calculated the estimated fair value of our reporting units using Level 3 inputs, including: (1) cash flow projections for five years; (2) terminal year growth rates of two percent based on estimates of long-term inflation expectations; and (3) discount rates of 14.0 percent to 15.5 percent based on a risk-adjusted weighted average cost of capital that reflects current market conditions. While we believe we have made reasonable estimates and assumptions to calculate the fair value of the reporting units, it is possible a material change could occur. If our actual results are not consistent with estimates and assumptions used to calculate fair value, we may be required to recognize goodwill impairments.

***Other Financial Instruments***

As cash and short-term cash investments, trade payables and certain other short-term financial instruments are all short-term in nature, their carrying amount approximates fair value. The outstanding principal of our revolving credit agreement and senior secured term loan approximates fair value as of January 31, 2014. The fair value of the revolving credit agreement and the senior secured term loan were based on estimates of current interest rates for similar debt, a Level 3 input.

Table of Contents

**ZALE CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

**3. INVESTMENTS**

Investments in debt and equity securities held by our insurance subsidiaries are reported as other assets in the accompanying consolidated balance sheets. Investments are recorded at fair value based on quoted market prices for identical or similar securities. All investments are classified as available-for-sale.

Our investments consist of the following (in thousands):

| | January 31, 2014 | | January 31, 2013 | |
|---|---|---|---|---|
| | Cost | Fair Value | Cost | Fair Value |
| U.S. Treasury securities | $ 13,492 | $ 14,306 | $ 21,086 | $ 22,445 |
| U.S. government agency securities | 1,984 | 2,074 | 2,641 | 2,833 |
| Corporate bonds and notes | 5,616 | 5,718 | 773 | 868 |
| Corporate equity securities | 1,888 | 2,706 | 3,501 | 4,423 |
| | $ 22,980 | $ 24,804 | $ 28,001 | $ 30,569 |

At January 31, 2014 and 2013, the carrying value of investments included a net unrealized gain of $1.8 million and $2.6 million, respectively, which is included in accumulated other comprehensive income. Realized gains and losses on investments are determined on the specific identification basis. There were no material net realized gains or losses during the three and six months ended January 31, 2014 and 2013. Investments with a carrying value of $7.4 million were on deposit with various state insurance departments at both January 31, 2014 and 2013, respectively, as required by law.

Debt securities outstanding as of January 31, 2014 mature as follows (in thousands):

| | Cost | Fair Value |
|---|---|---|
| Less than one year | $ 3,272 | $ 3,299 |
| Year two through year five | 11,081 | 11,853 |
| Year six through year ten | 6,680 | 6,879 |
| After ten years | 59 | 67 |
| | $ 21,092 | $ 22,098 |

**4. LONG TERM DEBT**

Long-term debt consists of the following (in thousands):

| | January 31, | |
|---|---|---|
| | 2014 | 2013 |

| | | |
|---|---|---|
| Revolving credit agreement | $ 363,000 | $ 390,700 |
| Senior secured term loan | 80,000 | 80,000 |
| Capital lease obligations | 2,267 | 3,275 |
| | $ 445,267 | $ 473,975 |

**ZALE CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

**4. LONG TERM DEBT (Continued)**

***Amended and Restated Revolving Credit Agreement***

On July 24, 2012, we amended and restated our revolving credit agreement (the "Amended Credit Agreement") with Bank of America, N.A. and certain other lenders. The Amended Credit Agreement totals $665 million, including a $15 million first-in, last-out facility (the "FILO Facility"), and matures in July 2017. Borrowings under the Amended Credit Agreement (excluding the FILO Facility) are limited to a borrowing base equal to 90 percent of the appraised liquidation value of eligible inventory (less certain reserves that may be established under the agreement), plus 90 percent of eligible credit card receivables. Borrowings under the FILO Facility are limited to a borrowing base equal to the lesser of: (i) 2.5 percent of the appraised liquidation value of eligible inventory or (ii) $15 million. The Amended Credit Agreement is secured by a first priority security interest and lien on merchandise inventory, credit card receivables and certain other assets and a second priority security interest and lien on all other assets.

Based on the most recent inventory appraisal, the monthly borrowing rates calculated from the cost of eligible inventory range from 68 to 73 percent for the period of February through September 2014, 82 to 84 percent for the period of October through December 2014 and 71 percent for January 2015.

Borrowings under the Amended Credit Agreement (excluding the FILO Facility) bear interest at either: (i) LIBOR plus the applicable margin (ranging from 175 to 225 basis points) or (ii) the base rate (as defined in the Amended Credit Agreement) plus the applicable margin (ranging from 75 to 125 basis points). Borrowings under the FILO Facility bear interest at either: (i) LIBOR plus the applicable margin (ranging from 350 to 400 basis points) or (ii) the base rate plus the applicable margin (ranging from 250 to 300 basis points). We are also required to pay a quarterly unused commitment fee of 37.5 basis points based on the preceding quarter's unused commitment.

If excess availability (as defined in the Amended Credit Agreement) falls below certain levels we will be required to maintain a minimum fixed charge coverage ratio of 1.0. Borrowing availability was approximately $259 million as of January 31, 2014, which exceeded the excess availability requirement by $197 million. The fixed charge coverage ratio was 2.47 as of January 31, 2014. The Amended Credit Agreement contains various other covenants including restrictions on the incurrence of certain indebtedness, payment of dividends, liens, investments, acquisitions and asset sales. As of January 31, 2014, we were in compliance with all covenants.

We incurred debt issuance costs associated with the revolving credit agreement totaling $12.1 million, which consisted of $5.6 million of costs related to the Amended Credit Agreement and $6.5 million of unamortized costs associated with the prior agreement. The debt issuance costs are included in other assets in the accompanying consolidated balance sheets and are amortized to interest expense on a straight-line basis over the five-year life of the agreement.

***Interest Rate Swap Agreements***

In September 2013, we executed interest rate swaps with Bank of America, N.A. to hedge the variability of cash flows resulting from fluctuations in the one-month LIBOR associated with our Amended Credit Agreement. The interest rate swaps replaced the one-month LIBOR with the fixed interest rates shown in the table below and are settled monthly. The swaps qualify as cash flow hedges and, to the extent effective, changes in their fair values are recorded in accumulated other comprehensive income in the consolidated balance sheet. The changes in fair values are reclassified from accumulated other comprehensive income to interest expense in the same period that the hedged items affect interest expense.

Table of Contents

**ZALE CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

**4. LONG TERM DEBT (Continued)**

Interest rate swaps as of January 31, 2014 are as follows:

| Period | Notional Amount (in thousands) | Fixed Interest Rate | Fair Value (in thousands) |
|---|---|---|---|
| October 2013 - July 2014 | $ 215,000 | 0.29% | $ 117 |
| August 2014 - July 2016 | $ 215,000 | 1.19% | 2,474 |
| | | | $ 2,591 |

The change in the fair value of the interest rate swaps for the three and six months ended January 31, 2014 totaled $0.1 million and $2.7 million, respectively, and is included as an unrealized loss in other comprehensive income. There were no material amounts reclassified from accumulated other comprehensive income to interest expense during the three and six months ended January 31, 2014. The current portion of the fair value of the interest rate swaps totaled $1.0 million and is included in accounts payable and accrued liabilities in the accompanying consolidated balance sheet. The current portion represents the amount that is expected to be reclassified from other comprehensive income to interest expense over the next 12 months. The non-current portion of the fair value of the interest rate swaps totaled $1.6 million and is included in other liabilities in the accompanying consolidated balance sheet.

***Amended and Restated Senior Secured Term Loan***

On July 24, 2012, we amended and restated our senior secured term loan (the "Amended Term Loan") with Z Investment Holdings, LLC, an affiliate of Golden Gate Capital. The Amended Term Loan totals $80.0 million, matures in July 2017 and is subject to a borrowing base equal to: (i) 107.5 percent of the appraised liquidation value of eligible inventory plus (ii) 100 percent of credit card receivables and an amount equal to the lesser of $40 million or 100 percent of the appraised liquidation value of intellectual property minus (iii) the borrowing base under the Amended Credit Agreement. In the event the outstanding principal under the Amended Term Loan exceeds the Amended Term Loan borrowing base, availability under the Amended Credit Agreement would be reduced by the excess. As of January 31, 2014, the outstanding principal under the Amended Term Loan did not exceed the borrowing base. The Amended Term Loan is secured by a second priority security interest on merchandise inventory and credit card receivables and a first priority security interest on substantially all other assets.

Borrowings under the Amended Term Loan bear interest at 11 percent payable on a quarterly basis. We may repay all or any portion of the Amended Term Loan with the following penalty prior to maturity: (i) the present value of the required interest payments that would have been made if the prepayment had not occurred during the first year; (ii) 4 percent during the second year; (iii) 3 percent during the third year; (iv) 2 percent during the fourth year and (v) no penalty in the fifth year. The Amended Credit Agreement restricts our ability to prepay the Amended Term Loan if the fixed charge coverage ratio is not equal to or greater than 1.0 after giving effect to the prepayment.

The Amended Term Loan includes various covenants which are consistent with the covenants in the Amended Credit Agreement, including restrictions on the incurrence of certain indebtedness, payment of dividends, liens, investments, acquisitions, asset sales and the requirement to maintain a minimum fixed charge coverage ratio of 1.0 if excess availability thresholds under the Amended Credit Agreement are not maintained. As of January 31, 2014, we were in compliance with all covenants.

Table of Contents

**ZALE CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

**4. LONG TERM DEBT (Continued)**

We incurred costs associated with the Amended Term Loan totaling $4.4 million, of which approximately $2 million was recorded in interest expense during the fourth quarter of fiscal year 2012. The remaining $2.4 million consists of debt issuance costs included in other assets in the accompanying consolidated balance sheet and are amortized to interest expense on a straight-line basis over the five-year life of the agreement.

***Warrant and Registration Rights Agreement***

In connection with the execution of the senior secured term loan in May 2010, we entered into a Warrant and Registration Rights Agreement (the "Warrant Agreement") with Z Investment Holdings, LLC ("Z Investment"). Under the terms of the Warrant Agreement, Z Investment holds 11.1 million warrants (the "Warrants") to purchase shares of our common stock, on a one-for-one basis, for an exercise price of $2.00 per share. The Warrants, which are currently exercisable and expire in May 2017, represented approximately 25 percent of our common stock on a fully diluted basis (including the shares issuable upon exercise of the Warrants and excluding certain out-of-the-money stock options) as of the date of the issuance. The number of shares and exercise price are subject to customary antidilution protection. The Warrant Agreement also entitles the holder to designate two, and in certain circumstances three, directors to our board.

The holders of the Warrants may, at their option, request that we register all or part of the common stock issuable under the Warrant Agreement for resale. In September 2013, Z Investment exercised their right to request that we register the common stock and on October 2, 2013 we filed a shelf registration statement on Form S-3 which has been declared effective by the SEC.

***Capital Lease Obligations***

We enter into capital leases related to vehicles for our field management. The vehicles are included in property and equipment in the accompanying consolidated balance sheets and are depreciated over a four-year life. Capital leases, net of accumulated depreciation, included in property and equipment as of January 31, 2014 and 2013 totaled $2.2 million and $3.2 million, respectively.

**5. OTHER CHARGES (GAINS)**

During the second quarter of fiscal years 2014 and 2013, we recorded charges related to the impairment of long-lived assets for underperforming stores, primarily in Fine Jewelry, totaling $0.5 million and $0.9 million, respectively. The impairment of long-lived assets is based on the amount that the carrying value exceeds the estimated fair value of the assets. The fair value is based on future cash flow projections over the remaining lease term using a discount rate that we believe is commensurate with the risk inherent in our current business model. If actual results are not consistent with our cash flow projections, we may be required to record additional impairments.

Beginning in June 2004, various class-action lawsuits were filed alleging that the De Beers group violated U.S. state and federal antitrust, consumer protection and unjust enrichment laws. During the six months ended January 31, 2013, we received proceeds totaling $1.9 million as a result of a settlement reached in the lawsuit.

Table of Contents

**ZALE CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

**6. EARNINGS PER COMMON SHARE**

Basic earnings per common share is computed by dividing net earnings by the weighted-average number of common shares outstanding for the reporting period. Diluted earnings per share reflect the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock. For the calculation of diluted earnings per share, the basic weighted-average number of shares is increased by the dilutive effect of stock options, restricted share awards and warrants issued in connection with the senior secured term loan determined using the Treasury Stock method.

The following table presents a reconciliation of the diluted weighted average shares (in thousands):

| | Three Months Ended January 31, | | Six Months Ended January 31, | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| Basic weighted average shares | 32,919 | 32,426 | 32,827 | 32,362 |
| Effect of potential dilutive securities: | | | | |
| Warrants | 9,597 | 6,759 | 9,495 | 6,921 |
| Stock options and restricted share awards | 2,506 | 1,120 | 2,515 | 1,187 |
| Diluted weighted average shares | 45,022 | 40,305 | 44,837 | 40,470 |

The calculation of diluted weighted average shares excludes the impact of 0.9 million and 1.8 million antidilutive stock options for the three and six months ended January 31, 2014 and 2013.

**7. ACCUMULATED OTHER COMPREHENSIVE INCOME**

The following table includes detail regarding changes in the composition of accumulated other comprehensive income (in thousands):

| | Three Months Ended January 31, | | Six Months Ended January 31, | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| Beginning of period | $ 41,340 | $ 53,828 | $ 47,015 | $ 53,369 |
| Foreign currency translation adjustment | (12,763) | (44) | (15,996) | 470 |
| Unrealized loss on interest rate swaps | (140) | | (2,676) | |
| Reclassification of loss on interest rate swaps to interest expense | 65 | | 85 | |
| Unrealized gain (loss) on securities, net | (128) | 76 | (54) | 21 |
| End of period | $ 28,374 | $ 53,860 | $ 28,374 | $ 53,860 |

**8. INCOME TAXES**

We are required to assess the available positive and negative evidence to estimate if sufficient future income will be generated to utilize deferred tax assets. A significant piece of negative evidence that we consider is cumulative losses (generally defined as losses before income taxes) incurred over the most recent three-year period. Such evidence limits our ability to consider other subjective evidence such as our projections for future growth. As of January 31, 2014 and 2013, cumulative losses were incurred over the applicable three-year period.

Table of Contents

**ZALE CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

**8. INCOME TAXES (Continued)**

Our valuation allowances totaled $82.7 million and $92.7 million as of January 31, 2014 and 2013, respectively. The valuation allowances were established due to the uncertainty of our ability to utilize certain federal, state and foreign net operating loss carryforwards in the future. The amount of the deferred tax asset considered realizable could be adjusted if negative evidence, such as three-year cumulative losses, no longer exists and additional consideration is given to our growth projections.

**9. SEGMENTS**

We report our operations under three business segments: Fine Jewelry, Kiosk Jewelry, and All Other (See Note 1). All corresponding items of segment information in prior periods have been presented consistently. Management's expectation is that overall economics of each of our major brands within each reportable segment will be similar over time.

We use earnings before unallocated corporate overhead, interest and taxes but include an internal charge for inventory carrying cost to evaluate segment profitability. Unallocated costs before income taxes include corporate employee-related costs, administrative costs, information technology costs, corporate facilities costs and depreciation and amortization. Income tax information by segment is not included as taxes are calculated at a company-wide level and not allocated to each segment.

| | Three Months Ended January 31, | | Six Months Ended January 31, | |
|---|---|---|---|---|
| **Selected Financial Data by Segment** | **2014** | **2013** | **2014** | **2013** |
| | (amounts in thousands) | | | |
| Revenues: | | | | |
| Fine Jewelry(a) | $ 580,821 | $ 590,131 | $ 894,519 | $ 897,091 |
| Kiosk | 72,801 | 77,905 | 119,000 | 125,723 |
| All Other | 2,827 | 2,716 | 5,544 | 5,406 |
| Total revenues | $ 656,449 | $ 670,752 | $ 1,019,063 | $ 1,028,220 |
| Depreciation and amortization: | | | | |
| Fine Jewelry | $ 4,954 | $ 5,393 | $ 10,013 | $ 10,914 |
| Kiosk | 516 | 689 | 1,093 | 1,428 |
| All Other | | | | |
| Unallocated | 1,991 | 2,306 | 4,016 | 4,692 |
| Total depreciation and amortization | $ 7,461 | $ 8,388 | $ 15,122 | $ 17,034 |
| Operating earnings: | | | | |
| Fine Jewelry | $ 58,273 | $ 47,712 | $ 46,272 | $ 31,010 |
| Kiosk | 10,622 | 10,513 | 8,067 | 8,764 |

| | | | | |
|---|---|---|---|---|
| All Other | 1,309 | 1,094 | 2,501 | 1,906 |
| Unallocated(b) | (10,682) | (8,046) | (19,349) | (13,410) |
| Total operating earnings | $ 59,522 | $ 51,273 | $ 37,491 | $ 28,270 |

(a) Includes $111.2 million and $120.4 million for the three months ended January 31, 2014 and 2013, respectively, and $174.1 million and $183.4 million for the six months ended January 31, 2014 and 2013, respectively, related to foreign operations.

(b) Includes credits of $17.1 million and $16.9 million for the three months ended January 31, 2014 and 2013, respectively, and $32.9 million and $32.0 million for the six months ended January 31, 2014 and 2013, respectively, to offset internal carrying costs charged to the segments. The six months ended January 31, 2013 also includes a gain totaling $1.9 million related to the De Beers settlement.

**ZALE CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

**10. CONTINGENCIES**

The Company is a defendant in three purported class action lawsuits, *Tessa Hodge v. Zale Delaware, Inc., d/b/a Piercing Pagoda* which was filed on April 23, 2013 in the Superior Court of the State of California, County of San Bernardino, *Naomi Tapia v. Zale* which was filed on July 3, 2013 in the U.S. District Court, Southern District of California, and *Melissa Roberts v. Zale Delaware, Inc.* which was filed on October 7, 2013 in the Superior Court of the State of California, County of Los Angeles. All three cases include allegations that the Company violated various wage and hour labor laws. Relief is sought on behalf of current and former Piercing Pagoda and Zales employees. The lawsuits seek to recover damages, penalties and attorneys' fees as a result of the alleged violations. The Company is investigating the underlying allegations and intends to vigorously defend its position against them. The Company cannot reasonably estimate the potential loss or range of loss, if any, for the lawsuits.

The Company and its directors have been named as defendants in four purported shareholder class action lawsuits filed in the Court of Chancery of the State of Delaware: *Andrew Breyer v. Zale Corporation, et al.* filed on February 24, 2014, *Marc Stein v. Zale Corporation, et al.* and *Ravinder Singh v. Zale Corporation, et al.* each filed on March 3, 2014 and *Mary Smart v. Zale Corporation, et al.* filed on March 6, 2014. Each lawsuit alleges that, in connection with the proposed transaction between the Company and Signet Jewelers Limited, entered into on February 19, 2014, the Company's directors breached their fiduciary duties to the Company's shareholders and that the Company, Signet Jewelers Limited and Carat Merger Sub, Inc. aided and abetted such breaches. Each lawsuit seeks injunctive relief, rescission in the event the merger is consummated, monetary damages and attorneys' and other fees and costs. The Company and its directors believe that the claims in the lawsuits are without merit, and intend to vigorously defend each pending lawsuit. The Company cannot reasonably estimate the potential loss or range of loss, if any, for the lawsuits.

We are involved in legal and governmental proceedings as part of the normal course of our business. Reserves have been established based on management's best estimates of our potential liability in these matters. These estimates have been developed in consultation with internal and external counsel and are based on a combination of litigation and settlement strategies. Management believes that such litigation and claims will be resolved without material effect on our financial position or results of operations.

**11. DEFERRED REVENUE**

We offer our Fine Jewelry guests lifetime warranties on certain products that cover sizing and breakage with an option to purchase theft protection for a two-year period. Revenues related to lifetime warranty sales are recognized in proportion to when the expected costs will be incurred, which we estimate to be over an eight-year period. A significant change in estimates related to the time period or pattern in which warranty-related costs are expected to be incurred could adversely impact our revenues and earnings. Revenues related to the optional theft protection are recognized over the two-year contract period on a straight-line basis. We also offer our Fine Jewelry guests a two-year watch warranty and our Fine Jewelry and Kiosk Jewelry guests a one-year warranty that covers breakage. The revenue from the two-year watch warranty and one-year breakage warranty is recognized on a straight-line basis over the respective contract terms.

Table of Contents

**ZALE CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

**11. DEFERRED REVENUE (Continued)**

The change in deferred revenue associated with the sale of warranties is as follows (in thousands):

| | Three Months Ended January 31, | | Six Months Ended January 31, | |
|---|---|---|---|---|
| | **2014** | **2013** | **2014** | **2013** |
| Deferred revenue, beginning of period | $ 183,224 | $ 199,239 | $ 191,245 | $ 208,516 |
| Warranties sold(a) | 43,907 | 44,569 | 69,841 | 69,549 |
| Revenue recognized | (40,460) | (41,331) | (74,415) | (75,588) |
| Deferred revenue, end of period | $ 186,671 | $ 202,477 | $ 186,671 | $ 202,477 |

(a) Warranty sales for the three and six months ended January 31, 2014 include approximately $1.8 million and $2.3 million, respectively, related to the depreciation in the Canadian currency rate on the beginning of the period deferred revenue balance. The change in the Canadian currency rate did not have a significant impact on the beginning of the period deferred revenue balance for the three and six months ended January 31, 2013.

Gross margin associated with warranties totaled $32.7 million and $34.2 million, respectively, during the three months ended January 31, 2014 and 2013 and $60.1 million and $62.3 million, respectively, during the six months ended January 31, 2014 and 2013.

**12. SUBSEQUENT EVENTS**

***Merger Agreement***

On February 19, 2014, the Company entered into an Agreement and Plan of Merger (the "Merger Agreement") with Signet Jewelers Limited, a Bermuda corporation ("Signet"), and Carat Merger Sub, Inc., a Delaware corporation and a wholly owned subsidiary of Signet ("Merger Sub"). The Merger Agreement provides for, subject to the satisfaction or waiver of specified conditions, the acquisition of the Company by Signet at a price of $21 per share in cash. Subject to the terms and conditions of the Merger Agreement, Merger Sub will be merged with and into the Company (the "Merger"), with the Company surviving the Merger as a wholly owned subsidiary of Signet. Consummation of the Merger is subject to various customary conditions set forth in the Merger Agreement, including, among other things, the adoption of the Merger Agreement by the Company's stockholders, the absence of laws or orders prohibiting or restraining the Merger and the receipt of certain required antitrust approvals. We cannot predict with certainty whether and when any of these conditions will be satisfied. For additional information regarding the Merger and the Merger Agreement, please refer to our Current Report on Form 8-K filed with the SEC on February 19, 2014 (the "February $19^{th}$ 8-K"). The foregoing description of the Merger Agreement does not purport to be complete and is qualified in its entirety by reference to the Merger Agreement, a copy of which is attached as Exhibit 2.1 to the February $19^{th}$ 8-K.

***Voting and Support Agreement***

On February 19, 2014, and in connection with the execution of the Merger Agreement, Z Investment entered into a Voting and Support Agreement with Signet and the Company (the "Voting Agreement"). Pursuant to the Voting Agreement, Z Investment has agreed, among other things, to exercise its Warrants (see Note 4) and to vote, or cause to be voted, the shares of the Company's common stock issued upon such exercise in favor of the adoption of the Merger Agreement. The foregoing description of the Voting

15

Table of Contents

**ZALE CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**(Unaudited)**

**12. SUBSEQUENT EVENTS (Continued)**

Agreement does not purport to be complete and is qualified in its entirety by reference to the Voting Agreement, a copy of which is attached as Exhibit 10.1 to the February 19th 8-K.

Table of Contents

## ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

This discussion and analysis should be read in conjunction with the unaudited consolidated financial statements of the Company (and the related notes thereto included elsewhere in this quarterly report), and the audited consolidated financial statements of the Company (and the related notes thereto) and Management's Discussion and Analysis of Financial Condition and Results of Operations in the Company's Annual Report on Form 10-K for the fiscal year ended July 31, 2013.

### Overview

We are a leading specialty retailer of fine jewelry in North America. At January 31, 2014, we operated 1,037 fine jewelry stores and 623 kiosks located primarily in shopping malls throughout the United States, Canada and Puerto Rico.

We report our business under three operating segments: Fine Jewelry, Kiosk Jewelry and All Other. Fine Jewelry is comprised of our three core national brands, Zales Jewelers®, Zales Outlet® and Peoples Jewellers® and our two regional brands, Gordon's Jewelers® and Mappins Jewellers®. Each brand specializes in fine jewelry and watches, with merchandise and marketing emphasis focused on diamond products. These five brands have been aggregated into one reportable segment. Kiosk Jewelry operates under the brand names Piercing Pagoda®, Plumb Gold , and Silver and Gold Connection® through mall-based kiosks and is focused on the opening price point guest. Kiosk Jewelry specializes in gold, silver and non-precious metal products that capitalize on the latest fashion trends. All Other includes our insurance and reinsurance operations, which offer insurance coverage primarily to our private label credit card guests.

Revenues for the quarter ended January 31, 2014 decreased 2.1 percent compared to the same period in the prior year. The decrease in revenues was primarily the result of 86 store closures since January 31, 2013 (net of store openings) and the depreciation in the Canadian currency rate, partially offset by an increase in comparable store sales. Comparable store sales increased 0.6 percent during the second quarter of fiscal year 2014, or 1.9 percent at constant exchange rates. Gross margin increased by 240 basis points to 53.0 percent during the second quarter of fiscal year 2014 compared to the same quarter in the prior year. The increase is due primarily to benefits realized from our sourcing initiative launched in fiscal year 2013, lower commodity costs and a more disciplined approach to our promotional programs. Net earnings for the quarter were $50.8 million compared to $41.2 million for the same period in the prior year. The $9.6 million improvement is primarily the result of the increase in gross margin.

Revenues associated with warranties totaled $40.5 million and $41.3 million, respectively, during the three months ended January 31, 2014 and 2013 and $74.4 million and $75.6 million, respectively, during the six months ended January 31, 2014 and 2013. Gross margin associated with warranties totaled $32.7 million and $34.2 million, respectively, during the three months ended January 31, 2014 and 2013 and $60.1 million and $62.3 million, respectively, during the six months ended January 31, 2014 and 2013.

On February 19, 2014, the Company entered into the Merger Agreement with Signet and Merger Sub, providing for, subject to the satisfaction or waiver of specified conditions, the acquisition of the Company by Signet at a price of $21 per share in cash. Subject to the terms and conditions of the Merger Agreement, Merger Sub will be merged with and into the Company, with the Company surviving as a wholly owned subsidiary of Signet. For additional information regarding the Merger and the Merger Agreement, please refer to the February 19$^{th}$ 8-K. The foregoing description of the Merger Agreement does not purport to be complete and is qualified in its entirety by reference to the Merger Agreement, a copy of which is attached as Exhibit 2.1 to the February 19$^{th}$ 8-K.

In connection with the Merger, the Company intends to file relevant materials with the SEC, including the Company's proxy statement in preliminary and definitive form. Stockholders of the Company are urged

Table of Contents

to read all relevant documents filed with the SEC, including the Company's proxy statement when it becomes available, because they will contain important information about the Merger. Investors and security holders will be able to obtain the documents (once available) free of charge at the SEC's web site, http://www.sec.gov, or for free from the Company by contacting its Investor Relations department by phone at (972) 580-4391 or by e-mail at ir@zalecorp.com.

**Outlook for Fiscal Year 2014**

The fiscal year 2014 outlook excludes the impact of the Merger and other transactions contemplated by the Merger Agreement.

In fiscal year 2014, we will continue to invest in the business to drive profitable growth and increase shareholder value. We expect to achieve this growth as a result of:

- positive comparable store sales in our Zales and Peoples brands and the growth of our exclusive, branded merchandise, offset by net store closures and the impact of the Canadian exchange rate;
- gross margin improvement related primarily to benefits from the sourcing initiative launched in fiscal year 2013 and a more favorable commodity cost environment;
- slightly higher selling, general and administrative expenses, as a percent of revenues, due primarily to initiatives targeted at driving future revenue growth;
- an improvement in operating margin of 50 basis points or more;
- interest expense consistent with fiscal year 2013; and
- income tax expense of $2 million to $3 million.

We anticipate capital expenditures will be between $45 million and $50 million in fiscal year 2014. The increase in capital expenditures compared to the $21 million spent in fiscal year 2013 is primarily the result of new store openings, refurbishment of existing stores, upgrades to our point-of-sale hardware and software and improved connectivity in our stores. We expect net store closures in fiscal year 2014 of 70 to 75 locations, primarily in Gordon's, Mappins and Piercing Pagoda. The closures are expected to impact total revenues by approximately 280 basis points.

**Comparable Store Sales**

Comparable store sales include internet sales and repair sales but exclude revenue recognized from warranties and insurance premiums related to credit insurance policies sold to guests who purchase merchandise under our proprietary credit programs. The sales results of new stores are included beginning with their thirteenth full month of operation. The results of stores that have been relocated, renovated or refurbished are included in the calculation of comparable store sales on the same basis as other stores. However, stores closed for more than 90 days due to unforeseen events (e.g., hurricanes, etc.) are excluded from the calculation of comparable store sales.

Table of Contents

The following table presents comparable store sales for each of our brands for the periods presented:

| | Three Months Ended January 31, | | Six Months Ended January 31, | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| ***Comparable Store Sales*** | | | | |
| Zales | 4.0% | 3.7% | 5.4% | 4.1% |
| Zales Outlet | 3.2% | 3.6% | 3.5% | 3.7% |
| Peoples | (4.3)% | 6.4% | (1.8)% | 7.2% |
| Gordon's | (4.5)% | (3.3)% | (4.3)% | (3.0)% |
| Mappins | (11.4)% | (5.6)% | (8.2)% | (5.6)% |
| Piercing Pagoda | (4.6)% | 1.0% | (3.5)% | 1.4% |
| Total Company | 0.6% | 2.8% | 1.9% | 3.2% |
| ***Comparable Store Sales (in constant currency)*** | | | | |
| Peoples | 2.7% | 3.0% | 4.6% | 4.4% |
| Mappins | (4.9)% | (8.6)% | (2.2)% | (8.1)% |
| Total Company | 1.9% | 2.2% | 3.0% | 2.7% |

**Non-GAAP Financial Measure**

We report our consolidated financial statements in accordance with U.S. generally accepted accounting principles ("GAAP"). However, the non-GAAP performance measure of EBITDA (defined as earnings before interest, income taxes and depreciation and amortization) is presented to enhance investors' ability to analyze trends in our business and evaluate our performance relative to other companies. We use the non-GAAP financial measure to monitor the performance of our business and assist us in explaining underlying trends in the business.

EBITDA is a non-GAAP financial measure and should not be considered in isolation of, or as a substitute for, net earnings or other GAAP measures as an indicator of operating performance. In addition, EBITDA should not be considered as an alternative to operating earnings or net earnings as a measure of operating performance. Our calculation of EBITDA may differ from others in our industry and is not necessarily comparable with similar titles used by other companies.

The following table reconciles EBITDA to net earnings as presented in our consolidated statements of operations:

| | Three Months Ended January 31, | | Six Months Ended January 31, | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| Net earnings | $ 50,786 | $ 41,208 | $ 23,480 | $ 12,944 |
| Depreciation and amortization | 7,461 | 8,388 | 15,122 | 17,034 |
| Interest expense | 6,096 | 6,088 | 11,706 | 11,930 |
| Income tax expense | 2,640 | 3,977 | 2,305 | 3,396 |
| EBITDA | $ 66,983 | $ 59,661 | $ 52,613 | $ 45,304 |

Table of Contents

**Results of Operations**

The following table sets forth certain financial information from our unaudited consolidated statements of operations expressed as a percentage of total revenues:

| | Three Months Ended January 31, | | Six Months Ended January 31, | |
|---|---|---|---|---|
| | 2014 | 2013 | 2014 | 2013 |
| Revenues | 100.0% | 100.0% | 100.0% | 100.0% |
| Cost of sales | 47.0 | 49.4 | 46.9 | 48.5 |
| Gross margin | 53.0 | 50.6 | 53.1 | 51.5 |
| Selling, general and administrative | 42.7 | 41.6 | 47.9 | 47.2 |
| Depreciation and amortization | 1.1 | 1.3 | 1.5 | 1.7 |
| Other charges (gains) | 0.1 | 0.1 | | (0.1) |
| Operating earnings | 9.1 | 7.6 | 3.7 | 2.7 |
| Interest expense | 0.9 | 0.9 | 1.1 | 1.2 |
| Earnings before income taxes | 8.1 | 6.7 | 2.5 | 1.6 |
| Income tax expense | 0.4 | 0.6 | 0.2 | 0.3 |
| Net earnings | 7.7% | 6.1% | 2.3% | 1.3% |

**Three Months Ended January 31, 2014 Compared to Three Months Ended January 31, 2013**

***Revenues.*** Revenues for the quarter ended January 31, 2014 were $656.4 million, a decrease of 2.1 percent compared to revenues of $670.8 million for the same period in the prior year. The decrease in revenues was the result of a $16.9 million decrease related to 86 store closures since January 31, 2013 (net of store openings) and an $8.2 million decrease related to the depreciation in the Canadian currency rate, partially offset by an increase in comparable store sales. Comparable store sales increased 0.6 percent during the second quarter of fiscal year 2014, or 1.9 percent at constant exchange rates. The increase in comparable store sales was primarily attributable to a 7.5 percent increase in the number of units sold in Fine Jewelry, partially offset by a decrease in the average price per unit.

Fine Jewelry contributed $580.8 million of revenues in the quarter ended January 31, 2014, a decrease of 1.6 percent compared to $590.1 million for the same period in the prior year.

Kiosk Jewelry contributed $72.8 million of revenues in the quarter ended January 31, 2014, a decrease of 6.5 percent compared to $77.9 million in the same period in the prior year. The decrease in revenues is due to a 5.2 percent decrease in the average price per unit, partially offset by an increase in the number of units sold. The decrease in revenues is also due to 20 kiosk closures since January 31, 2013 (net of openings).

All Other contributed $2.8 million in revenues for the three months ended January 31, 2014, an increase of 4.1 percent compared to $2.7 million for the same period in the prior year.

During the quarter ended January 31, 2014, we closed 22 stores in Fine Jewelry and two locations in Kiosk Jewelry. In addition, we opened two stores in Fine Jewelry.

***Gross Margin.*** Gross margin represents net sales less cost of sales. Cost of sales includes cost related to merchandise sold, receiving and distribution, guest repairs and repairs associated with warranties. Gross margin was 53.0 percent of revenues for the quarter ended January 31, 2014, compared to 50.6 percent for the same period in the prior year. The 240 basis point improvement was due primarily to benefits realized from our sourcing initiative launched in fiscal year 2013, lower commodity costs and a more disciplined approach to our promotional programs.

Table of Contents

***Selling, General and Administrative.*** Included in SG&A are store operating, advertising, buying, cost of insurance operations and general corporate overhead expenses. SG&A was 42.7 percent of revenues for the quarter ended January 31, 2014 compared to 41.6 percent for the same period in the prior year. SG&A increased by $1.1 million to $280.1 million for the quarter ended January 31, 2014. The increase is due to an $8.6 million increase in costs primarily related to higher labor and marketing costs, partially offset by the impact of 86 store closures since January 31, 2013 (net of store openings).

***Depreciation and Amortization.*** Depreciation and amortization as a percentage of revenues for the quarters ended January 31, 2014 and 2013 was 1.1 percent and 1.3 percent, respectively. The decrease is primarily the result of 86 store closures (net of store openings), partially offset by additional capital expenditures.

***Other Charges (Gains).*** Other charges for the quarters ended January 31, 2014 and 2013 consists of a $0.5 million and $0.9 million charge, respectively, related to the impairment of long-lived assets associated with underperforming stores.

***Interest Expense.*** Interest expense remained flat at $6.1 million, or 0.9 percent of revenues, for the quarters ended January 31, 2014 and 2013.

***Income Tax Expense.*** Income tax expense totaled $2.6 million for the three months ended January 31, 2014, as compared to $4.0 million for the same period in the prior year. Income tax expense for both periods was primarily associated with operating earnings related to our Canadian subsidiaries.

**Six Months Ended January 31, 2014 Compared to Six Months Ended January 31, 2013**

***Revenues.*** Revenues for the six months ended January 31, 2014 were $1,019.1 million, a decrease of 0.9 percent compared to revenues of $1,028.2 million for the same period in the prior year. The decrease in revenues was the result of a $25.1 million decrease related to 86 store closures since January 31, 2013 (net of store openings) and an $11.4 million decrease related to the depreciation in the Canadian currency rate, partially offset by an increase in comparable store sales. Comparable store sales increased 1.9 percent during the six months ended January 31, 2014, or 3.0 percent at constant exchange rates. The increase in comparable store sales was primarily attributable to 7.7 percent increase in the number of units sold in Fine Jewelry, partially offset by a decrease in the average price per unit.

Fine Jewelry contributed $894.5 million of revenues in the six months ended January 31, 2014, a decrease of 0.3 percent compared to $897.1 million for the same period in the prior year.

Kiosk Jewelry contributed $119.0 million of revenues in the six months ended January 31, 2014, a decrease of 5.3 percent compared to $125.7 million in the same period in the prior year. The decrease in revenues is due to a 2.8 percent decrease in the average price per unit and a decrease in the number of units sold. The decrease in revenues is also due to 20 kiosk closures since January 31, 2013 (net of openings).

All Other contributed $5.5 million in revenues for the six months ended January 31, 2014, an increase of 2.6 percent compared to $5.4 million for the same period in the prior year.

During the six months ended January 31, 2014, we closed 29 stores in Fine Jewelry and seven locations in Kiosk Jewelry. In addition, we opened two stores in Fine Jewelry.

***Gross Margin.*** Gross margin represents net sales less cost of sales. Cost of sales includes cost related to merchandise sold, receiving and distribution, guest repairs and repairs associated with warranties. Gross margin was 53.1 percent of revenues for the six months ended January 31, 2014, compared to 51.5 percent for the same period in the prior year. The 160 basis point improvement was due primarily to benefits realized from our sourcing initiative launched in fiscal year 2013, lower commodity costs and a more disciplined approach to our promotional programs.

Table of Contents

***Selling, General and Administrative.*** Included in SG&A are store operating, advertising, buying, cost of insurance operations and general corporate overhead expenses. SG&A was 47.9 percent of revenues for the six months ended January 31, 2014 compared to 47.2 percent for the same period in the prior year. SG&A increased by $2.8 million to $488.3 million for the six months ended January 31, 2014. The increase is due to a $13.7 million increase in costs primarily related to higher labor, marketing and legal related costs, partially offset by the impact of 86 store closures since January 31, 2013 (net of store openings).

***Depreciation and Amortization.*** Depreciation and amortization as a percentage of revenues for the six months ended January 31, 2014 and 2013 was 1.5 percent and 1.7 percent, respectively. The decrease is primarily the result of 86 store closures (net of store openings), partially offset by additional capital expenditures.

***Other Charges (Gains).*** Other charges for the six months ended January 31, 2014 consists of a $0.5 million charge related to the impairment of long-lived assets associated with underperforming stores. Other gains for the six months ended January 31, 2013 includes proceeds totaling $1.9 million related to the De Beers settlement, partially offset by a $0.9 million charge related to the impairment of long-lived assets associated with underperforming stores.

***Interest Expense.*** Interest expense as a percentage of revenues remained relatively flat at 1.1 percent for the six months ended January 31, 2014 compared to 1.2 percent for the same period in the prior year.

***Income Tax Expense.*** Income tax expense totaled $2.3 million for the six months ended January 31, 2014, as compared to $3.4 million for the same period in the prior year. Income tax expense for both periods was primarily associated with operating earnings related to our Canadian subsidiaries.

**Liquidity and Capital Resources**

Our cash requirements consist primarily of funding ongoing operations, including inventory requirements, capital expenditures for new stores, renovation of existing stores, upgrades to our information technology systems and debt service. Our cash requirements are funded through cash flows from operations and our revolving credit agreement with a syndicate of lenders led by Bank of America, N.A. We manage availability under the revolving credit agreement by monitoring the timing of merchandise purchases and vendor payments. At January 31, 2014, we had borrowing availability under the revolving credit agreement of approximately $259 million. The average vendor payment terms during the six months ended January 31, 2014 and 2013 were approximately 46 days and 54 days, respectively. As of January 31, 2014, we had cash and cash equivalents totaling $23.3 million. We believe that our operating cash flows and available credit facility are sufficient to finance our cash requirements for at least the next twelve months.

Net cash used in operating activities improved from $12.8 million for the six months ended January 31, 2013 to $6.4 million for the six months ended January 31, 2014. The $6.4 million improvement is primarily the result of a $9.2 million increase in operating earnings.

Our business is highly seasonal, with a disproportionate amount of sales (approximately 30 percent) occurring in the Holiday season, which encompasses November and December of each year. Other important selling periods include Valentine's Day and Mother's Day. We purchase inventory in anticipation of these periods and, as a result, have higher inventory and inventory financing needs immediately prior to these periods. Inventory owned at January 31, 2014 was $864.3 million, an increase of $27.7 million compared to January 31, 2013. The increase is primarily due to the expansion of our exclusive, branded merchandise collections, partially offset by the impact of 86 store closures (net of store openings) since January 31, 2013.

Table of Contents

***Amended and Restated Revolving Credit Agreement***

On July 24, 2012, we amended and restated our revolving credit agreement (the "Amended Credit Agreement") with Bank of America, N.A. and certain other lenders. The Amended Credit Agreement totals $665 million, including a $15 million first-in, last-out facility (the "FILO Facility"), and matures in July 2017. Borrowings under the Amended Credit Agreement (excluding the FILO Facility) are limited to a borrowing base equal to 90 percent of the appraised liquidation value of eligible inventory (less certain reserves that may be established under the agreement), plus 90 percent of eligible credit card receivables. Borrowings under the FILO Facility are limited to a borrowing base equal to the lesser of: (i) 2.5 percent of the appraised liquidation value of eligible inventory or (ii) $15 million. The Amended Credit Agreement is secured by a first priority security interest and lien on merchandise inventory, credit card receivables and certain other assets and a second priority security interest and lien on all other assets.

Based on the most recent inventory appraisal, the monthly borrowing rates calculated from the cost of eligible inventory range from 68 to 73 percent for the period of February through September 2014, 82 to 84 percent for the period of October through December 2014 and 71 percent for January 2015.

Borrowings under the Amended Credit Agreement (excluding the FILO Facility) bear interest at either: (i) LIBOR plus the applicable margin (ranging from 175 to 225 basis points) or (ii) the base rate (as defined in the Amended Credit Agreement) plus the applicable margin (ranging from 75 to 125 basis points). Borrowings under the FILO Facility bear interest at either: (i) LIBOR plus the applicable margin (ranging from 350 to 400 basis points) or (ii) the base rate plus the applicable margin (ranging from 250 to 300 basis points). We are also required to pay a quarterly unused commitment fee of 37.5 basis points based on the preceding quarter's unused commitment.

If excess availability (as defined in the Amended Credit Agreement) falls below certain levels we will be required to maintain a minimum fixed charge coverage ratio of 1.0. Borrowing availability was approximately $259 million as of January 31, 2014, which exceeded the excess availability requirement by $197 million. The fixed charge coverage ratio was 2.47 as of January 31, 2014. The Amended Credit Agreement contains various other covenants including restrictions on the incurrence of certain indebtedness, payment of dividends, liens, investments, acquisitions and asset sales. As of January 31, 2014, we were in compliance with all covenants.

We incurred debt issuance costs associated with the revolving credit agreement totaling $12.1 million, which consisted of $5.6 million of costs related to the Amended Credit Agreement and $6.5 million of unamortized costs associated with the prior agreement. The debt issuance costs are included in other assets in the accompanying consolidated balance sheets and are amortized to interest expense on a straight-line basis over the five-year life of the agreement.

***Interest Rate Swap Agreements***

In September 2013, we executed interest rate swaps with Bank of America, N.A. to hedge the variability of cash flows resulting from fluctuations in the one-month LIBOR associated with our Amended Credit Agreement. The interest rate swaps replaced the one-month LIBOR with the fixed interest rates shown in the table below and are settled monthly. The swaps qualify as cash flow hedges and, to the extent effective, changes in their fair values are recorded in accumulated other comprehensive income in the consolidated balance sheet. The changes in fair values are reclassified from accumulated other comprehensive income to interest expense in the same period that the hedged items affect interest expense.

Table of Contents

Interest rate swaps as of January 31, 2014 are as follows:

| Period | Notional Amount (in thousands) | Fixed Interest Rate | Fair Value (in thousands) |
|---|---|---|---|
| October 2013 - July 2014 | $ 215,000 | 0.29% | $ 117 |
| August 2014 - July 2016 | $ 215,000 | 1.19% | 2,474 |
| | | | $ 2,591 |

The change in the fair value of the interest rate swaps for the three and six months ended January 31, 2014 totaled $0.1 million and $2.7 million, respectively, and is included as an unrealized loss in other comprehensive income. There were no material amounts reclassified from accumulated other comprehensive income to interest expense during the three and six months ended January 31, 2014. The current portion of the fair value of the interest rate swaps totaled $1.0 million and is included in accounts payable and accrued liabilities in the accompanying consolidated balance sheet. The current portion represents the amount that is expected to be reclassified from other comprehensive income to interest expense over the next 12 months. The non-current portion of the fair value of the interest rate swaps totaled $1.6 million and is included in other liabilities in the accompanying consolidated balance sheet.

***Amended and Restated Senior Secured Term Loan***

On July 24, 2012, we amended and restated our senior secured term loan (the "Amended Term Loan") with Z Investment Holdings, LLC, an affiliate of Golden Gate Capital. The Amended Term Loan totals $80.0 million, matures in July 2017 and is subject to a borrowing base equal to: (i) 107.5 percent of the appraised liquidation value of eligible inventory plus (ii) 100 percent of credit card receivables and an amount equal to the lesser of $40 million or 100 percent of the appraised liquidation value of intellectual property minus (iii) the borrowing base under the Amended Credit Agreement. In the event the outstanding principal under the Amended Term Loan exceeds the Amended Term Loan borrowing base, availability under the Amended Credit Agreement would be reduced by the excess. As of January 31, 2014, the outstanding principal under the Amended Term Loan did not exceed the borrowing base. The Amended Term Loan is secured by a second priority security interest on merchandise inventory and credit card receivables and a first priority security interest on substantially all other assets.

Borrowings under the Amended Term Loan bear interest at 11 percent payable on a quarterly basis. We may repay all or any portion of the Amended Term Loan with the following penalty prior to maturity: (i) the present value of the required interest payments that would have been made if the prepayment had not occurred during the first year; (ii) 4 percent during the second year; (iii) 3 percent during the third year; (iv) 2 percent during the fourth year and (v) no penalty in the fifth year. The Amended Credit Agreement restricts our ability to prepay the Amended Term Loan if the fixed charge coverage ratio is not equal to or greater than 1.0 after giving effect to the prepayment.

The Amended Term Loan includes various covenants which are consistent with the covenants in the Amended Credit Agreement, including restrictions on the incurrence of certain indebtedness, payment of dividends, liens, investments, acquisitions, asset sales and the requirement to maintain a minimum fixed charge coverage ratio of 1.0 if excess availability thresholds under the Amended Credit Agreement are not maintained. As of January 31, 2014, we were in compliance with all covenants.

We incurred costs associated with the Amended Term Loan totaling $4.4 million, of which approximately $2 million was recorded in interest expense during the fourth quarter of fiscal year 2012. The remaining $2.4 million consists of debt issuance costs included in other assets in the accompanying consolidated balance sheet and are amortized to interest expense on a straight-line basis over the five-year life of the agreement.

Table of Contents

***Warrant and Registration Rights Agreement***

In connection with the execution of the senior secured term loan in May 2010, we entered into a Warrant and Registration Rights Agreement (the "Warrant Agreement") with Z Investment Holdings, LLC ("Z Investment"). Under the terms of the Warrant Agreement, Z Investment holds 11.1 million warrants (the "Warrants") to purchase shares of our common stock, on a one-for-one basis, for an exercise price of $2.00 per share. The Warrants, which are currently exercisable and expire in May 2017, represented approximately 25 percent of our common stock on a fully diluted basis (including the shares issuable upon exercise of the Warrants and excluding certain out-of-the-money stock options) as of the date of the issuance. The number of shares and exercise price are subject to customary antidilution protection. The Warrant Agreement also entitles the holder to designate two, and in certain circumstances three, directors to our board.

The holders of the Warrants may, at their option, request that we register all or part of the common stock issuable under the Warrant Agreement for resale. In September 2013, Z Investment exercised their right to request that we register the common stock and on October 2, 2013 we filed a shelf registration statement on Form S-3 which has been declared effective by the SEC.

***Capital Lease Obligations***

We enter into capital leases related to vehicles for our field management. The vehicles are included in property and equipment in the accompanying consolidated balance sheets and are depreciated over a four-year life. Capital leases, net of accumulated depreciation, included in property and equipment as of January 31, 2014 and 2013 totaled $2.2 million and $3.2 million, respectively.

***Customer Credit Programs***

We have a Merchant Services Agreement ("MSA") with Citibank (South Dakota), N.A. ("Citibank"), under which Citibank provides financing for our U.S. guests to purchase merchandise through private label credit cards. The MSA can be terminated by either party upon certain breaches by the other party and also can be terminated by Citibank if our net credit card sales during any twelve-month period are less than $315 million or if net card sales during a twelve-month period decrease by 20 percent or more from the prior twelve-month period. After any termination, we may purchase or be obligated to purchase the credit card portfolio upon termination with Citibank as a result of insolvency, material breaches of the MSA or violations of applicable law related to the credit card program. As of January 31, 2014, we were in compliance with all covenants under the MSA. We currently expect to exceed the $315 million threshold for the program year ending September 30, 2014. The MSA expires in October 2015 and will automatically renew for successive two-year periods, unless either party notifies the other in writing of its intent not to renew. In July 2013, the Company provided written notice to Citibank of its intent not to renew the agreement. During the six months ended January 31, 2014 and 2013, our guests used our private label credit card to pay for approximately 34 percent and 33 percent, respectively, of purchases in the U.S.

On July 9, 2013, we entered into a Private Label Credit Card Program Agreement (the "ADS Agreement") with an affiliate of Alliance Data Systems Corporation ("ADS") to provide financing to our U.S. guests to purchase merchandise through private label credit cards beginning no later than October 1, 2015. In addition, ADS will provide marketing, analytical and technical services and has the option to participate in certain special financing programs prior to the commencement of the agreement. The ADS Agreement will replace our current agreement with Citibank which expires on October 1, 2015. The ADS Agreement has an initial term of the later of the seventh anniversary of the commencement date of the agreement or October 1, 2022 and automatically renews for successive two-year periods, unless either party notifies the other of its intent not to renew. If ADS meets certain performance criteria during the first three years of the agreement, they will have the option to extend the initial term of the ADS Agreement by two years. In July 2013, we received a $38.0 million commencement payment upon signing the ADS

Table of Contents

Agreement. The commencement payment will be amortized over the initial term of the ADS Agreement as a reduction of merchant fees beginning on the commencement date of the agreement. The ADS agreement can be terminated by either party upon certain breaches by the other party.

We have a Private Label Credit Card Program Agreement (the "TD Agreement") with TD Financing Services Inc. ("TDFS"), under which TDFS provides financing for our Canadian guests to purchase merchandise through private label credit cards. In addition, TDFS provides credit insurance for our guests and receives 40 percent of the net profits, as defined, and the remaining 60 percent is paid to us. The TD Agreement expires in June 2015 and will automatically renew for successive one-year periods, unless either party notifies the other in writing of its intent not to renew. The agreement may be terminated at any time during the 90-day period following the end of a program year in the event that credit sales are less than $50 million in the immediately preceding year. We currently expect to exceed the $50 million threshold for the program year ending June 30, 2014. During the six months ended January 31, 2014 and 2013, our guests used our private label credit card to pay for approximately 18 percent and 17 percent, respectively, of purchases in Canada.

We have also entered into agreements with certain other lenders to offer alternative financing options to our U.S. guests who have been declined by Citibank.

**Capital Expenditures**

During the six months ended January 31, 2014, we invested $11.7 million to remodel, relocate and refurbish stores and to complete store enhancement projects. We also invested $6.3 million in infrastructure, primarily related to information technology. We anticipate investing between $45 million and $50 million in capital expenditures in fiscal year 2014.

**Recent Accounting Pronouncement**

In July 2013, the FASB issued ASU 2013-11, *Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists* ("ASU 2013-11"), which requires an unrecognized tax benefit to be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, similar tax loss, or a tax credit carryforward. To the extent the tax benefit is not available at the reporting date under the governing tax law or if the entity does not intend to use the deferred tax asset for such purpose, the unrecognized tax benefit should be presented as a liability and not combined with deferred tax assets. ASU 2013-11 is effective for annual periods, and interim periods within those years, beginning after December 15, 2013. The amendments are to be applied to all unrecognized tax benefits that exist as of the effective date and may be applied retrospectively to each prior reporting period presented. We do not expect a material impact from the adoption of this guidance on our consolidated financial statements.

Table of Contents

## ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

***Inflation.*** Substantially all U.S. inventories represent finished goods, which are valued using the last-in, first-out ("LIFO") retail inventory method. We are required to determine the LIFO cost on an interim basis by estimating annual inflation trends, annual purchases and ending inventory. The inflation rates pertaining to merchandise inventories, especially as they relate to diamond, gold and silver costs, are primary components in determining our LIFO inventory. We recorded a benefit related to LIFO in cost of sales totaling $3.7 million during the six months ended January 31, 2014 primarily as a result of the sourcing initiative launched in fiscal year 2013 and lower commodity costs. We recorded LIFO charges in cost of sales totaling $2.6 million during the six months ended January 31, 2013. The LIFO inventory reserve included in the consolidated balance sheets as of January 31, 2014 and 2013 totaled $59.2 million and $60.9 million, respectively.

***Foreign Currency Risk.*** We are not subject to significant gains or losses as a result of currency fluctuations because most of our purchases are U.S. dollar-denominated. However, we enter into foreign currency contracts to manage the currency fluctuations associated with purchases for our Canadian operations. The gains or losses related to the settlement of foreign currency contracts are included in SG&A in our consolidated statements of operations. The Company recognized a $0.5 million gain on the settlement of foreign currency contracts during the six months ended January 31, 2014. There were no material gains or losses recognized during the six months ended January 31, 2013. There were no outstanding foreign currency contracts as of January 31, 2014.

We are exposed to foreign currency exchange risks through our business operations in Canada, which may adversely affect our results of operations. During the six months ended January 31, 2014 and 2013, the average Canadian currency rate depreciated by approximately six percent and appreciated by approximately two percent, respectively, relative to the U.S. dollar. The depreciation in the Canadian currency rate for the six months ended January 31, 2014 resulted in an $11.4 million decrease in reported revenues, partially offset by a $9.9 million decrease in costs. The appreciation in the Canadian currency rate for the six months ended January 31, 2013 resulted in a $4.7 million increase in reported revenues, partially offset by a $4.1 million increase in costs.

***Interest Rate Risk.*** Our Amended Term Loan bears interest at a fixed rate of 11 percent and would not be affected by interest rate changes. As of January 31, 2014, we had borrowings of $363.0 million under our Amended Credit Agreement that are subject to variable interest rates.

In September 2013, we executed interest rate swaps with Bank of America, N.A. to hedge the variability of cash flows resulting from fluctuations in the one-month LIBOR associated with our Amended Credit Agreement. The interest rate swaps replaced the one-month LIBOR with the fixed interest rates shown in the table below and are settled monthly. The swaps qualify as cash flow hedges and, to the extent effective, changes in their fair values are recorded in accumulated other comprehensive income in the consolidated balance sheet. The changes in fair values are reclassified from accumulated other comprehensive income to interest expense in the same period that the hedged items affect interest expense.

Interest rate swaps as of January 31, 2014 are as follows:

| **Period** | **Notional Amount (in thousands)** | **Fixed Interest Rate** | **Fair Value (in thousands)** |
|---|---|---|---|
| October 2013 - July 2014 | $ 215,000 | 0.29% | $ 117 |
| August 2014 - July 2016 | $ 215,000 | 1.19% | 2,474 |
| | | | $ 2,591 |

Table of Contents

The change in the fair value of the interest rate swaps for the three and six months ended January 31, 2014 totaled $0.1 million and $2.7 million, respectively, and is included as an unrealized loss in other comprehensive income. There were no material amounts reclassified from accumulated other comprehensive income to interest expense during the three and six months ended January 31, 2014. The current portion of the fair value of the interest rate swaps totaled $1.0 million and is included in accounts payable and accrued liabilities in the accompanying consolidated balance sheet. The current portion represents the amount that is expected to be reclassified from other comprehensive income to interest expense over the next 12 months. The non-current portion of the fair value of the interest rate swaps totaled $1.6 million and is included in other liabilities in the accompanying consolidated balance sheet.

***Investment Risk.*** We do not use derivative financial instruments for trading or other speculative purposes and are not party to any leveraged financial instruments. The investments of our insurance subsidiaries, primarily stocks and bonds, had a market value of $24.8 million at January 31, 2014.

***Commodity Risk.*** Our results are subject to fluctuations in the underlying cost of diamonds, gold, silver and other metals which are key raw material components of the products sold by us. We address commodity risk principally through retail price point adjustments.

## ITEM 4. CONTROLS AND PROCEDURES

***Disclosure Controls and Procedures***

Under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, we have evaluated the effectiveness of our disclosure controls and procedures as of the end of the period covered by this report. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer have concluded that these disclosure controls and procedures are effective in enabling us to record, process, summarize and report information required to be included in the Company's periodic SEC filings within the required time period, and that such information is accumulated and communicated to the Company's management, including the Chief Executive Officer and Chief Financial Officer, to allow timely decisions regarding required disclosure.

***Changes in Internal Control over Financial Reporting***

There have been no changes in our internal controls over financial reporting during the quarter ended January 31, 2014 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Table of Contents

## PART II. OTHER INFORMATION

### ITEM 1. LEGAL PROCEEDINGS

Information regarding legal proceedings is incorporated by reference from Note 10 to our consolidated financial statements set forth, under the heading, "Contingencies," in Part I of this report.

### ITEM 1A. RISK FACTORS

We make forward-looking statements in this Quarterly Report on Form 10-Q and in other reports we file with the Securities and Exchange Commission ("SEC"). In addition, members of our senior management make forward-looking statements orally in presentations to analysts, investors, the media and others. Forward-looking statements include statements regarding our objectives and expectations with respect to our financial plan (including expectations for earnings, comparable store sales, gross margin, selling, general and administrative expenses, operating margin, interest expense, income tax expense and capital expenditures for fiscal year 2014), merchandising and marketing strategies, acquisitions and dispositions, share repurchases, store openings, renovations, remodeling and expansion, inventory management and performance, liquidity and cash flows, capital structure, capital expenditures, development of our information technology and telecommunications plans and related management information systems, ecommerce initiatives, human resource initiatives and other statements regarding our plans and objectives. In addition, the words "plans to," "anticipate," "estimate," "project," "intend," "expect," "believe," "forecast," "can," "could," "should," "will," "may," or similar expressions may identify forward-looking statements, but some of these statements may use other phrasing. These forward-looking statements are intended to relay our expectations about the future, and speak only as of the date they are made. We disclaim any obligation to update or revise publicly or otherwise any forward-looking statements to reflect subsequent events, new information or future circumstances.

Forward-looking statements are not guarantees of future performance and a variety of factors, including without limitation those described below, could cause our actual results to differ materially from the anticipated or expected results expressed in or suggested by these forward-looking statements.

***The announcement and pendency of the proposed Merger with Signet could have a material and adverse effect on our business, financial results and operations.***

The announcement and pendency of the proposed acquisition of our Company by Signet could cause disruptions and create uncertainty surrounding our business, including affecting our relationships with our customers, suppliers and employees, which could have an adverse effect on our business, financial results and operations, regardless of whether the proposed Merger is completed. In particular, we could potentially lose important personnel as a result of the departure of employees who decide to pursue other opportunities in light of the proposed Merger. We could also potentially lose customers or suppliers, or our supply arrangements could be disrupted. In addition, we have diverted, and will continue to divert, significant management resources towards the completion of the proposed Merger, which could have a material and adverse effect on our business, financial results and operations.

We are also subject to restrictions on the conduct of our business prior to the consummation of the Merger as provided in the Merger Agreement, including, among other things, certain restrictions on our ability to acquire other businesses, sell, transfer or license our assets, amend our organizational documents and incur indebtedness. These restrictions could result in our inability to respond effectively to competitive pressures, industry developments and future opportunities and may otherwise have a material and adverse effect on our business, financial results and operations.

Table of Contents

***The failure to complete the proposed Merger with Signet may have a material and adverse effect on our business, financial results, operations and share price.***

There is no assurance that the closing of the Merger will occur. Consummation of the Merger is subject to various customary conditions set forth in the Merger Agreement, including, among other things, the adoption of the Merger Agreement by the Company's stockholders, the absence of laws or orders prohibiting or restraining the Merger and the receipt of certain required antitrust approvals. We cannot predict with certainty whether and when any of these conditions will be satisfied. In addition, the Merger Agreement may be terminated under certain specified circumstances, including, but not limited to, a change in the recommendation of the board of directors of the Company or a termination of the Merger Agreement by the Company in order to enter into an agreement for a Superior Proposal (as defined in the Merger Agreement). If the Merger is not consummated, our stock price will likely decline, as our stock has recently traded at prices based on the proposed per share price for the Merger. We will have incurred significant expenses and costs in connection with the Merger and the Merger Agreement, including, among other things, the diversion of management resources, for which we will have received little or no benefit if the closing of the Merger does not occur. Furthermore, a failed transaction may result in negative publicity and a negative impression of us in the investment community. The occurrence of any of these events individually or in combination could have a material and adverse effect on our business, financial results, operations and stock price.

***If the general economy performs poorly, discretionary spending on goods that are, or are perceived to be, "luxuries" may not grow and may decrease.***

Jewelry purchases are discretionary and may be affected by adverse trends in the general economy (and consumer perceptions of those trends). In addition, a number of other factors affecting consumers such as employment, wages and salaries, business conditions, energy costs, credit availability and taxation policies, for the economy as a whole and in regional and local markets where we operate, can impact sales and earnings.

***A serious economic downturn could have a material and adverse effect on our business and financial condition.***

Declining confidence in either the U.S. or Canadian economies where we are active could adversely affect consumers' ability and willingness to purchase our products in those regions. Should either of these economies suffer a serious economic downturn, it could have a material and adverse effect on our business and financial condition.

***The concentration of a substantial portion of our sales in three relatively brief selling periods means that our performance is more susceptible to disruptions.***

A substantial portion of our sales are derived from three selling periods Holiday (Christmas), Valentine's Day and Mother's Day. Because of the briefness of these three selling periods, the opportunity for sales to recover in the event of a disruption or other difficulty is limited, and the impact of disruptions and difficulties can be significant. For instance, adverse weather (such as a blizzard or hurricane), a significant interruption in the receipt of products (whether because of vendor or other product problems), or a sharp decline in mall traffic occurring during one of these selling periods could materially impact sales for the affected period and, because of the importance of each of these selling periods, commensurately impact overall sales and earnings.

Table of Contents

***Any disruption in the supply of finished goods from our largest merchandise vendors could adversely impact our sales.***

We purchase substantial amounts of finished goods from our five largest merchandise vendors. If our supply with these top vendors was disrupted, particularly at certain critical times of the year, our sales could be adversely affected in the short-term until alternative supply arrangements could be established.

***Most of our sales are of products that include diamonds, precious metals and other commodities. A substantial portion of our purchases and sales occur outside the United States. Fluctuations in the availability and pricing of commodities or exchange rates could impact our ability to obtain, produce and sell products at favorable prices.***

The supply and price of diamonds in the principal world market are significantly influenced by the Diamond Trading Company ("DTC"), which has traditionally controlled the marketing of a substantial majority of the world's supply of diamonds and sells rough diamonds to worldwide diamond cutters at prices determined in its sole discretion. The DTC's share of the diamond supply chain has decreased over recent years, which may result in more volatility in rough diamond prices. The availability of diamonds is also somewhat dependent on the political conditions in diamond-producing countries and on the continuing supply of raw diamonds. Any sustained interruption in this supply could have an adverse affect on our business.

We are affected by fluctuations in the price of diamonds, gold and other commodities. A significant change in prices of key commodities could adversely affect our business by reducing operating margins or decreasing consumer demand if retail prices are increased significantly. In the past, our vendors have experienced significant increases in commodity costs, especially diamond, gold and silver costs. If significant increases in commodity prices occur in the future, it could result in higher merchandise costs, which could materially impact our earnings. In addition, foreign currency exchange rates and fluctuations impact costs and cash flows associated with our Canadian operations and the acquisition of inventory from international vendors.

A substantial portion of our raw materials and finished goods are sourced in countries generally described as having developing economies. Any instability in these economies could result in an interruption of our supplies, increases in costs, legal challenges and other difficulties.

In August 2012, the SEC issued rules that require companies that manufacture products using certain minerals, including gold, to determine whether those minerals originated in the Democratic Republic of Congo ("DRC") or adjoining countries. If the minerals originate in the DRC, or if companies are not able to establish where they originated, extensive disclosure regarding the sources of those minerals, and in some instances an independent audit of the supply chain, is required. The costs of complying with the new rules are not expected to be material. The Company will be required to file its first disclosure report by May 31, 2014 for the calendar year ending December 31, 2013.

There may also be reputational risks with guests and other stakeholders if, due to the complexity of the global supply chain, we are unable to sufficiently verify the origin for the relevant metals. Also, if the responses of portions of our supply chain to the verification requests are adverse, it may harm our ability to obtain merchandise and add to compliance costs. Other minerals, such as diamonds, could be added to those currently covered by these rules.

***Our sales are dependent upon mall traffic.***

Our stores and kiosks are located primarily in shopping malls throughout the U.S., Canada and Puerto Rico. Our success is in part dependent upon the continued popularity of malls as a shopping destination and the ability of malls, their tenants and other mall attractions to generate customer traffic. Accordingly, a significant decline in this popularity, especially if it is sustained, would substantially harm our sales and earnings. In addition, even assuming this popularity continues, mall traffic can be negatively impacted by mall renovations, weather, gas prices and similar factors.

***We operate in a highly competitive and fragmented industry.***

The retail jewelry business is highly competitive and fragmented, and we compete with nationally recognized jewelry chains as well as a large number of independent regional and local jewelry retailers and other types of retailers who sell jewelry and gift items, such as department stores and mass merchandisers. We also compete with internet sellers of jewelry. Because of the breadth and depth of this competition, we are constantly under competitive pressure that both constrains pricing and requires extensive merchandising efforts in order for us to remain competitive.

***Any failure by us to manage our inventory effectively, including judgments related to consumer preferences and demand, will negatively impact our financial condition, sales and earnings.***

We purchase much of our inventory well in advance of each selling period. In the event we do not stock merchandise consumers wish to purchase or misjudge consumer demand, we will experience lower sales than expected and will have excessive inventory that may need to be written down in value or sold at prices that are less than expected, which could have a material adverse impact on our business and financial condition.

***Omnichannel retailing is rapidly evolving and our inability to keep pace with consumer preferences and expectations could adversely affect our financial performance.***

Our guests are increasingly using computers, tablets, mobile phones and other devices to shop in our stores and online for our products. There are various risks relating to omnichannel retailing, including the need to keep pace with rapid technological change, internet security risks, risks of systems failure or inadequacy and increased competition. If we are unable to timely and appropriately respond to these risks, including through maintenance of customer service and guest relationships, demand for our products and services and our financial performance could be adversely affected. Further, governmental regulation of internet-based commerce continues to evolve in areas such as taxation, privacy, data protection and mobile communications. Unfavorable changes to regulations in these areas could have a negative effect on our business.

***Unfavorable consumer responses to price increases or misjudgments about the level of markdowns could have a material adverse impact on our sales and earnings.***

From time to time, and especially in periods of rising raw material costs, we increase the retail prices of our products. Significant price increases could impact our earnings depending on, among other factors, the pricing by competitors of similar products and the response by the guest to higher prices. Such price increases may result in lower unit sales and a subsequent decrease in gross margin and adversely impact earnings. In addition, if we misjudge the level of markdowns required to sell our merchandise at acceptable turn rates, sales and earnings could be negatively impacted.

***Any failure of our pricing and promotional strategies to be as effective as desired will negatively impact our sales and earnings.***

We set the prices for our products and establish product specific and store-wide promotions in order to generate store traffic and sales. While these decisions are intended to maximize our sales and earnings, in some instances they do not. For instance, promotions, which can require substantial lead time, may not be as effective as desired or may prove unnecessary in certain economic circumstances. Where we have implemented a pricing or promotional strategy that does not work as expected, our sales and earnings will be adversely impacted.

Table of Contents

***Any inability to recruit, train, motivate and retain suitably qualified sales associates could adversely impact sales and earnings.***

In specialty jewelry retailing, the level and quality of customer service is a key competitive factor as nearly every in-store transaction involves the sales associate taking a piece of jewelry or a watch out of a display case and presenting it to the potential guest. Competition for suitable individuals or changes in labor and healthcare laws could require us to incur higher labor costs. Therefore an inability to recruit, train, motivate and retain suitably qualified sales associates could adversely impact sales and earnings.

***Because of our dependence upon a small concentrated number of landlords for a substantial number of our locations, any significant erosion of our relationships with those landlords or their financial condition would negatively impact our ability to obtain and retain store locations.***

We are significantly dependent on our ability to operate stores in desirable locations with capital investment and lease costs that allow us to earn a reasonable return on our locations. We depend on the leasing market and our landlords to determine supply, demand, lease cost and operating costs and conditions. We cannot be certain as to when or whether desirable store locations will become or remain available to us at reasonable lease and operating costs. Several large landlords dominate the ownership of prime malls, and we are dependent upon maintaining good relations with those landlords in order to obtain and retain store locations on optimal terms. From time to time, we do have disagreements with our landlords and a significant disagreement, if not resolved, could have an adverse impact on our business. In addition, any financial weakness on the part of our landlords could adversely impact us in a number of ways, including decreased marketing by the landlords and the loss of other tenants that generate mall traffic.

***Any disruption in, or changes to, our private label credit card arrangements may adversely affect our ability to provide consumer credit and write credit insurance.***

We rely on third party credit providers to provide financing for our guests to purchase merchandise and credit insurance through private label credit cards. Any disruption in, or changes to, our credit card agreements could adversely affect our sales and earnings.

***Significant restrictions in the amount of credit available to our guests could negatively impact our business and financial condition.***

Our guests rely heavily on financing provided by credit lenders to purchase our merchandise. The availability of credit to our guests is impacted by numerous factors, including general economic conditions and regulatory requirements relating to the extension of credit. Numerous federal and state laws impose disclosure and other requirements upon the origination, servicing and enforcement of credit accounts and limitations on the maximum amount of finance charges that may be charged by a credit provider. Regulations implementing the Credit Card Accountability Responsibility and Disclosure Act of 2009 imposed restrictions on credit card pricing, finance charges and fees, customer billing practices and payment application. Future regulations or changes in the application of current laws could further impact the availability of credit to our guests. If the amount of available credit provided to our guests is significantly restricted, our sales and earnings would be negatively impacted.

***We are dependent upon our revolving credit agreement, senior secured term loan and other third party financing arrangements for our liquidity needs.***

We have a revolving credit agreement and a senior secured term loan that contain various financial and other covenants. Should we be unable to fulfill the covenants contained in these loans, we would be in default, all outstanding amounts would be immediately due, and we would be unable to fund our operations without a significant restructuring of our business.

Table of Contents

***If the credit markets deteriorate, our ability to obtain the financing needed to operate our business could be adversely impacted.***

We utilize a revolving credit agreement to finance our working capital requirements, including the purchase of inventory, among other things. If our ability to obtain the financing needed to meet these requirements was adversely impacted as a result of a deterioration in the credit markets, our business could be significantly impacted. In addition, the amount of available borrowings under our revolving credit agreement is based, in part, on the appraised liquidation value of our inventory. Any declines in the appraised value of our inventory could impact our ability to obtain the financing necessary to operate our business.

***Any security breach with respect to our information technology systems could result in legal or financial liabilities, damage to our reputation and a loss of guest confidence.***

During the course of our business, we regularly obtain and transmit through our information technology systems customer credit and other data. If our information technology systems are breached due to the actions of outside parties, or otherwise, an unauthorized third party may obtain access to confidential guest information. Any breach of our systems that results in unauthorized access to guest information could cause us to incur significant legal and financial liabilities, damage to our reputation and a loss of customer confidence. In each case, these impacts could have an adverse effect on our business and results of operations.

***Acquisitions and dispositions involve special risk, including the risk that we may not be able to complete proposed acquisitions or dispositions or that such transactions may not be beneficial to us.***

We have made significant acquisitions and dispositions in the past and may in the future make additional acquisitions and dispositions. Difficulty integrating an acquisition into our existing infrastructure and operations may cause us to fail to realize expected return on investment through revenue increases, cost savings, increases in geographic or product presence and guest reach or other projected benefits from the acquisition. In addition, we may not achieve anticipated cost savings or may be unable to find attractive investment opportunities for funds received in connection with a disposition. Additionally, attractive acquisition or disposition opportunities may not be available at the time or pursuant to terms acceptable to us and we may be unable to complete the acquisition or disposition.

***Our net operating loss carryforwards could be subject to limitations under the Internal Revenue Code.***

If we were to experience an "ownership change" under Section 382 of the Internal Revenue Code, our net operating loss carryforwards ("NOLs") would be subject to annual limitations that could impact the timing of the utilization of our NOLs as well as our ability to fully utilize our NOLs prior to their expiration. The determination of whether an ownership change has occurred is complex and depends upon a number of factors, including new issuances of shares by the Company and purchases and sales of shares by large stockholders, including the exercise of the outstanding warrants.

***Litigation and claims can adversely impact us.***

We are involved in various legal proceedings as part of the normal course of our business. Where appropriate, we establish reserves based on management's best estimates of our potential liability in these matters. While management believes that all current litigation and claims will be resolved without material effect on our financial position or results of operations, as with all litigation it is possible that there will be a significant adverse outcome.

Table of Contents

***Ineffective internal controls can have adverse impacts on the Company.***

Under Federal law, we are required to maintain an effective system of internal controls over financial reporting. Should we not maintain an effective system, it would result in a violation of those laws and could impair our ability to produce accurate and timely financial statements. In turn, this could result in increased audit costs, a loss of investor confidence, difficulties in accessing the capital markets, and regulatory and other actions against us. Any of these outcomes could be costly to both our shareholders and us.

***Changes in estimates, assumptions and judgments made by management related to our evaluation of goodwill and other long-lived assets for impairment could significantly affect our financial results.***

Evaluating goodwill and other long-lived assets for impairment is highly complex and involves many subjective estimates, assumptions and judgments by our management. For instance, management makes estimates and assumptions with respect to future cash flow projections, terminal growth rates, discount rates and long-term business plans. If our actual results are not consistent with our estimates, assumptions and judgments made by management, we may be required to recognize impairments.

***Changes in estimates related to the recognition of revenue associated with lifetime warranty sales could significantly affect our financial results.***

We recognize revenue related to lifetime warranty sales in proportion to when the expected costs will be incurred, which we estimate will be over an eight-year period. A significant change in estimates related to the time period or pattern in which warranty-related costs are expected to be incurred could adversely affect our revenues and earnings.

***Our share price may be volatile.***

Our share price may fluctuate substantially as a result of variations in our actual or anticipated results and financial condition. In addition, the stock market has experienced price and volume fluctuations that have affected the market price of many retail shares and other shares in a manner unrelated, or disproportionate to, the operating performance of those companies. In addition, our share price could fluctuate substantially in the future in response to sales of our common stock, including the sale of common stock issuable under the Warrant Agreement.

***Additional factors may adversely affect our financial performance.***

Increases in expenses that are beyond our control including items such as increases in interest rates, inflation, fluctuations in foreign currency rates, higher tax rates and changes in laws and regulations (such as the Patient Protection and Affordable Care Act), may negatively impact our operating results.

Table of Contents

**ITEM 6. EXHIBITS**

The following exhibits are filed as part of, or incorporated by reference into, this Quarterly Report on Form 10-Q.

| Exhibit Number | Description of Exhibit |
|---|---|
| 10.1* | First Amendment to Private Label Credit Card Program Agreement with Alliance Data Systems Corporation |
| 10.2 | Agreement and Plan of Merger, dated as of February 19, 2014, among Zale Corporation, Signet Jewelers Limited and Carat Merger Sub, Inc. (incorporated by reference to Exhibit 2.1 to the Company's Current Report on Form 8-K dated February 19, 2014, File No. 1-04129) |
| 10.3 | Voting and Support Agreement dated as of February 19, 2014, among Signet Jewelers Limited, Zale Corporation and Z Investment Holdings, LLC. (incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K dated February 19, 2014, File No. 1-04129) |
| 10.4* | Amended and Restated Executive Severance Plan for Zale Corporation and its Affiliates |
| 31.1* | Rule 13a-14(a) Certification of Principal Executive Officer |
| 31.2* | Rule 13a-14(a) Certification of Chief Administrative Officer |
| 31.3* | Rule 13a-14(a) Certification of Principal Financial Officer |
| 32.1* | Section 1350 Certification of Principal Executive Officer |
| 32.2* | Section 1350 Certification of Chief Administrative Officer |
| 32.3* | Section 1350 Certification of Principal Financial Officer |
| 101.INS** | XBRL Instance Document |
| 101.SCH** | XBRL Taxonomy Extension Schema |
| 101.CAL** | XBRL Taxonomy Extension Calculation Linkbase |
| 101.DEF** | XBRL Taxonomy Extension Definition Linkbase |
| 101.LAB** | XBRL Taxonomy Extension Label Linkbase |
| 101.PRE** | XBRL Taxonomy Extension Presentation Linkbase |

* Filed herewith.

** These exhibits are furnished herewith. In accordance with Rule 406T of Regulation S-T, these exhibits are not deemed to be filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, are not deemed to be filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and otherwise are not subject to liability under these sections.

Table of Contents

## SIGNATURE

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.

**ZALE CORPORATION**
(Registrant)

| | | |
|---|---|---|
| Date: March 7, 2014 | By: | /s/ THOMAS A. HAUBENSTRICKER |
| | | Thomas A. Haubenstricker<br>*Chief Financial Officer*<br>*(principal financial officer of the registrant)* |