bebe stores, inc.
Form 10-Q
February 13, 2014


UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended January 4, 2014

OR

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

Commission File Number 0-24395

bebe stores, inc.
(Exact name of registrant as specified in its charter)

| | |
|---|---|
| California<br>(State or Jurisdiction of<br>Incorporation or Organization) | 94-2450490<br>(IRS Employer<br>Identification Number) |

400 Valley Drive
Brisbane, California 94005
(Address of principal executive offices)
Telephone: (415) 715-3900

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

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

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

| | |
|---|---|
| Large accelerated filer ¨ | Accelerated filer x |
| Non-accelerated filer ¨ (Do not check if a smaller reporting company) | Smaller reporting company ¨ |

Indicate by check mark whether the registrant is a shell company (as defined in Rule12b-2 of the Exchange Act). Yes ¨ No x

The number of shares of the registrant’s common stock, par value $0.001 per share, outstanding as of January 31, 2014 was 79,174,920.

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PART I. FINANCIAL INFORMATION

ITEM 1. Condensed Consolidated Financial Statements
bebe stores, inc.
CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands, except share data)
(unaudited)

| | As of January 4, 2014 | As of July 6, 2013 | As of December 29, 2012 |
|---|---|---|---|
| Assets: | | | |
| Current assets: | | | |
| Cash and equivalents | $130,862 | $86,965 | $92,653 |
| Available for sale securities | 21,977 | 38,945 | 64,086 |
| Receivables (net of allowance of $97, $97 and $1,356) | 7,780 | 7,051 | 8,436 |
| Inventories, net | 31,877 | 33,862 | 37,421 |
| Deferred income taxes, net | 168 | — | 4,609 |
| Prepaid and other | 13,819 | 13,543 | 21,694 |
| Total current assets | 206,483 | 180,366 | 228,899 |
| Available for sale securities | 11,124 | 54,181 | 59,240 |
| Property and equipment, net | 99,593 | 104,720 | 112,595 |
| Deferred income taxes, net | 1,166 | 1,188 | 24,486 |
| Intangible asset | 917 | 912 | 912 |
| Other assets | 3,524 | 3,449 | 4,009 |
| Total assets | $322,807 | $344,816 | $430,141 |
| Liabilities and Shareholders' Equity: | | | |
| Current liabilities: | | | |
| Accounts payable | $15,127 | $18,209 | $13,076 |
| Accrued liabilities | 30,404 | 29,647 | 30,028 |
| Income taxes payable | 150 | — | — |
| Deferred income taxes, net | 535 | 553 | — |
| Total current liabilities | 46,216 | 48,409 | 43,104 |
| Deferred rent and other lease incentives | 31,866 | 36,358 | 37,531 |
| Uncertain tax positions | 383 | 549 | 2,280 |
| Total liabilities | 78,465 | 85,316 | 82,915 |
| Commitments and contingencies | | | |
| Shareholders' equity: | | | |
| Preferred stock-authorized 1,000,000 shares at $0.001 par value per share; no shares issued and outstanding | — | — | — |
| Common stock-authorized 135,000,000 shares at $0.001 par value per share; issued and outstanding 79,173,655, 79,040,866 and 82,622,158 shares | 79 | 79 | 83 |
| Additional paid-in capital | 140,251 | 138,307 | 142,368 |
| Accumulated other comprehensive income | 2,257 | 784 | 2,439 |
| Retained earnings | 101,755 | 120,330 | 202,336 |
| Total shareholders' equity | 244,342 | 259,500 | 347,226 |
| Total liabilities and shareholders' equity | $322,807 | $344,816 | $430,141 |

See accompanying notes to condensed consolidated financial statements.

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bebe stores, inc.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE LOSS
(In thousands, except per share data)
(unaudited)

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | January 4, 2014 | December 29, 2012 | January 4, 2014 | December 29, 2012 |
| Net sales | $129,974 | $135,535 | $244,101 | $252,626 |
| Cost of sales, including production and occupancy | 86,319 | 89,607 | 159,826 | 164,423 |
| Gross margin | 43,655 | 45,928 | 84,275 | 88,203 |
| Selling, general and administrative expenses | 49,265 | 53,393 | 99,341 | 99,588 |
| Operating loss | (5,610) | (7,465) | (15,066) | (11,385) |
| Interest and other income, net | 86 | 219 | 244 | 452 |
| Loss before income taxes | (5,524) | (7,246) | (14,822) | (10,933) |
| Income tax benefit | (59) | (2,427) | (203) | (3,533) |
| Net loss | $(5,465) | $(4,819) | $(14,619) | $(7,400) |
| Basic per share amounts: | | | | |
| Net loss | $(0.07) | $(0.06) | $(0.18) | $(0.09) |
| Diluted per share amounts: | | | | |
| Net loss | $(0.07) | $(0.06) | $(0.18) | $(0.09) |
| Basic weighted average shares outstanding | 79,119 | 84,054 | 79,087 | 84,216 |
| Diluted weighted average shares outstanding | 79,119 | 84,054 | 79,087 | 84,216 |
| Other comprehensive income (loss) | | | | |
| Gain (loss) on available for sale securities | $(3) | $467 | $1,793 | $1,638 |
| Foreign currency translation adjustments | 991 | (633) | (321) | 649 |
| Other comprehensive income (loss) | 988 | (166) | 1,472 | 2,287 |
| Comprehensive loss | $(4,477) | $(4,985) | $(13,147) | $(5,113) |

See accompanying notes to condensed consolidated financial statements.

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bebe stores, inc.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)
(unaudited)

| | Six Months Ended | |
|---|---|---|
| | January 4, 2014 | December 29, 2012 |
| Cash flows from operating activities: | | |
| Net loss | $(14,619) | $(7,400) |
| Adjustments to reconcile net loss to cash used by operating activities: | | |
| Non-cash compensation expense | 1,772 | 1,206 |
| Depreciation and amortization | 10,067 | 10,404 |
| Non-cash charge for asset impairment | 904 | 1,817 |
| Net loss (gain) on disposal of property | (849) | 994 |
| Tax benefit from exercise of stock options and awards | 252 | 84 |
| Excess tax benefit from exercise of stock options and awards | (62) | (1) |
| Deferred rent and other lease incentives | (2,522) | (47) |
| Deferred income taxes | (397) | 13 |
| Changes in operating assets and liabilities: | | |
| Receivables | (736) | 761 |
| Inventories | 1,986 | (4,129) |
| Prepaid expenses and other | (334) | (4,117) |
| Accounts payable | (1,685) | (1,664) |
| Accrued liabilities | 1,157 | (984) |
| Long term income taxes payable | (166) | 44 |
| Net cash used by operating activities | (5,232) | (3,019) |
| Cash flows from investing activities: | | |
| Purchase of property and equipment | (8,372) | (14,994) |
| Purchase of marketable securities | — | (44,080) |
| Proceeds from sales of investment securities | 61,590 | 59,423 |
| Net cash provided by investing activities | 53,218 | 349 |
| Cash flows from financing activities: | | |
| Proceeds from issuance of common stock | 172 | 113 |
| Excess tax benefit from exercise of stock options and awards | 62 | 1 |
| Cash dividends paid | (3,956) | (4,219) |
| Purchase of common stock | — | (5,438) |
| Net cash used by financing activities | (3,722) | (9,543) |
| Net increase (decrease) in cash and equivalents | 44,264 | (12,213) |
| Effect of exchange rate changes on cash | (367) | (116) |
| Cash and equivalents: | | |
| Beginning of period | 86,965 | 104,982 |
| End of period | $130,862 | $92,653 |

See accompanying notes to condensed consolidated financial statements.

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bebe stores, inc.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

INTERIM FINANCIAL STATEMENTS

The accompanying condensed consolidated balance sheets of bebe stores, inc. (the "Company") as of January 4, 2014, July 6, 2013 and December 29, 2012, the condensed consolidated statements of operations and comprehensive loss for the three and six months ended January 4, 2014 and December 29, 2012 and the condensed consolidated statements of cash flows for the six months ended January 4, 2014 and December 29, 2012 have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X, without audit. Accordingly, they do not include all of the information required by accounting principles generally accepted in the United States of America for annual financial statements. Therefore, these condensed consolidated financial statements should be read in conjunction with the Company's Annual Report on Form 10-K for the fiscal year ended July 6, 2013.

In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary to present fairly the financial position at the balance sheet dates and the results of operations for the periods presented have been included. The condensed consolidated balance sheet at July 6, 2013, presented herein, was derived from the audited balance sheet included in the Company's Annual Report on Form 10-K for the fiscal year ended July 6, 2013.

The Company's business is affected by the pattern of seasonality common to most retail apparel businesses. The results for the periods presented are not necessarily indicative of future financial results.

FISCAL YEAR

The Company's fiscal year is a 52 or 53 week period, each period ending on the first Saturday after June 30. Fiscal years 2014 and 2013 include 52 weeks and 53 weeks, respectively.

The three month periods ended January 4, 2014 and December 29, 2012 each include 13 weeks. The six month periods ended January 4, 2014 and December 29, 2012 each include 26 weeks.

RECENT ACCOUNTING PRONOUNCEMENTS

Other Comprehensive Income

In February 2013, the Financial Accounting Standards Board ("FASB") issued guidance that requires enhanced disclosures around the amounts reclassified out of accumulated other comprehensive income. The amendments do not change the requirements for reporting net income or other comprehensive income. The guidance requires an entity to present information about significant reclassifications out of accumulated other comprehensive income and their corresponding effects on the respective line items in net income. The guidance is effective for annual and interim reporting periods beginning after December 15, 2012. The adoption did not have a material effect on the Company's consolidated financial statements.

INVESTMENTS

The Company's investment portfolio consists of treasury bills, certificates of deposit and auction rate securities. The Company held short term available for sale securities totaling $22.0 million as of January 4, 2014, that consisted entirely of certificates of deposit at cost which approximates fair value. The Company also holds long term available for sale securities at fair value totaling $11.1 million as of January 4, 2014, that consisted entirely of interest bearing auction rate securities ("ARS").

The Company holds a variety of interest bearing ARS consisting of federally insured student loan backed securities and insured municipal authority bonds. As of January 4, 2014, the Company's ARS portfolio totaled approximately $11.1 million classified as available for sale securities, net of a temporary impairment charge of $4.5 million. As of that date, the Company's ARS portfolio included approximately 77% federally insured student loan backed securities and 23% municipal authority bonds and consisted of approximately 36% A rated investments, 19% BBB rated investments and 45% CCC rated investments. As of July 6, 2013, the Company's ARS consisted of 21% AAA rated investments, 19% AA rated investments, 23% A rated investments, 20% BBB rated investments and 17% CCC rated investments. These ARS investments are intended to provide liquidity via an auction process that resets the applicable interest rate at predetermined calendar intervals, allowing investors to either roll over their holdings or gain immediate liquidity by selling such interests at par. The uncertainties in the credit markets

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that began in February 2008 have affected the Company's holdings in ARS investments and auctions for the Company's investments in these securities have failed to settle on their respective settlement dates. Historically the fair value of ARS investments had approximated par value due to the frequent resets through the auction process. While the Company continues to earn interest on its ARS investments at the maximum contractual rate, these investments are not currently trading and therefore do not currently have a readily determinable market value. Accordingly, the estimated fair value of ARS no longer approximates par value. Consequently, the investments are not currently liquid, and the Company will not be able to access these funds until a future auction of these investments is successful, the issuer redeems the securities or at maturity. Maturity dates for these ARS investments range from 2031 to 2033 with principal distributions occurring on certain securities prior to maturity. To date, principal distributions and maturities of the securities held by the Company have all been at par value. During the three and six months ended January 4, 2014, $15.9 million and $24.9 million, respectively, of ARS were settled at par.

The Company reviews its impairments in accordance with guidance issued by the FASB and SEC in order to determine the classification of the impairment as "temporary" or "other-than-temporary". A temporary impairment charge results in an unrealized loss being recorded in the accumulated other comprehensive income component of shareholders' equity. Such an unrealized loss does not affect net income for the applicable accounting period. An other-than-temporary impairment charge is recorded as a loss in the condensed consolidated statements of operations and comprehensive loss for the applicable accounting period. When evaluating the investments for other-than-temporary impairment, the Company estimates the expected cash flows of the underlying collateral by reviewing factors such as the length of time and extent to which fair value has been below cost basis, the financial condition of the issuer and any changes thereto, and the Company's intent to sell, or whether it is more likely than not it will be required to sell, the investment before recovery of the investment's amortized cost basis. The Company has not recorded any impairment loss from its available for sale investments as other-than-temporary based on such analysis.

The valuation of the Company's investment portfolio is subject to uncertainties that are difficult to predict. Factors that may impact its valuation include changes to credit ratings of the securities as well as to the underlying assets supporting those securities, rates of default of the underlying assets, underlying collateral value, discount rates and ongoing strength and quality of market credit and liquidity.

The following is a summary of our available for sale securities:

| | As of January 4, 2014 | | | |
|---|---|---|---|---|
| | Cost | Unrealized Losses Less Than 12 Months | Unrealized Losses 12 Months or Greater | Estimated Fair Value |
| | (In thousands) | | | |
| Short term treasury bills | $— | $— | $— | $— |
| Short term certificates of deposit | 21,977 | — | — | 21,977 |
| | $21,977 | $— | $— | $21,977 |
| Long term treasury bills | $— | $— | $— | $— |
| Long term auction rate securities | 15,575 | — | 4,451 | 11,124 |
| | $15,575 | $— | $4,451 | $11,124 |

| | As of July 6, 2013 | | | |
|---|---|---|---|---|
| | Cost | Unrealized Losses Less Than 12 Months | Unrealized Losses 12 Months or Greater | Estimated Fair Value |
| | (In thousands) | | | |

| | | | | |
|---|---|---|---|---|
| Short term treasury bills | $11,990 | $— | $— | $11,990 |
| Short term certificates of deposit | 26,955 | — | — | 26,955 |
| | $38,945 | $— | $— | $38,945 |
| Long term treasury bills | $19,950 | $— | $— | $19,950 |
| Long term auction rate securities | 40,475 | — | 6,244 | 34,231 |
| | $60,425 | $— | $6,244 | $54,181 |

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| | As of December 29, 2012 | | | |
|---|---|---|---|---|
| | Cost | Unrealized Losses Less Than 12 Months | Unrealized Losses 12 Months or Greater | Estimated Fair Value |
| | (In thousands) | | | |
| Short term treasury bills | $36,941 | $— | $— | $36,941 |
| Short term certificates of deposit | 27,145 | — | — | 27,145 |
| | $64,086 | $— | $— | $64,086 |
| Long term treasury bills | $19,950 | $— | $— | $19,950 |
| Long term auction rate securities | 45,550 | — | 6,260 | 39,290 |
| | $65,500 | $— | $6,260 | $59,240 |

FAIR VALUE MEASUREMENTS

The FASB has established a three-tier fair value hierarchy, which prioritizes the inputs used in measuring fair value. These tiers include: Level 1, defined as observable inputs such as quoted prices in active markets; Level 2, defined as inputs other than quoted prices in active markets that are either directly or indirectly observable; and Level 3, defined as unobservable inputs in which little or no market data exists, therefore requiring an entity to develop its own assumptions.

As of January 4, 2014, the Company held financial instruments that are measured at fair value on a recurring basis. These included cash equivalents and available for sale securities. Cash equivalents consist of money market funds. Short term available for sale securities consist of government treasury bills and certificates of deposit. Long term available for sale securities consist of government treasury bills and ARS. These ARS consist of federally insured student loan backed securities and insured municipal authority bonds.

The Company determined the estimated fair value of its investment in ARS as of January 4, 2014 by reviewing trading activity for similar securities in secondary markets as well as by using a discounted cash flow model. The assumptions used in preparing the discounted cash flow model include estimates for liquidity (average of LIBOR +5.45%), interest rates (weighted average of 0.3%), timing (range from 10 – 14 years), credit ratings and amount of cash flows and expected holding periods of the ARS and recent trading activity in the secondary marketplace.

The following items are measured at fair value on a recurring basis as of January 4, 2014:

| Description | January 4, 2014 | Using Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|---|---|---|---|---|
| | Fair value measurements at reporting date (In thousands) | | | |
| Cash equivalents | $46,409 | $46,409 | $— | $— |
| Current available for sale securities | 21,977 | — | 21,977 | — |
| Non-current available for sale securities | 11,124 | — | — | 11,124 |
| Total | $79,510 | $46,409 | $21,977 | $11,124 |

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The following items are measured at fair value on a recurring basis as of December 29, 2012:

| Description | December 29, 2012 | Using Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|---|---|---|---|---|
| | Fair value measurements at reporting date (In thousands) | | | |
| Cash equivalents | $46,393 | $46,393 | $— | $— |
| Current available for sale securities | 64,086 | 36,941 | 27,145 | — |
| Non-current available for sale securities | 59,240 | 19,950 | — | 39,290 |
| Total | $169,719 | $103,284 | $27,145 | $39,290 |

During the quarter ended January 4, 2014, there were no transfers of assets and liabilities between Level 1 (quoted prices in active markets for identical assets) and Level 2 (significant other observable inputs) of the fair value measurement hierarchy. An impairment charge has been recorded in accumulated other comprehensive income that reduces the carrying amount of the applicable non-current assets of $15.6 million to their fair value of $11.1 million as of January 4, 2014.
The following table presents the Company's activity for assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the three and six months ended January 4, 2014:

| | Three months ended January 4, 2014 | Six Months Ended January 4, 2014 |
|---|---|---|
| | (In thousands) | |
| Balance at beginning of period | $26,977 | $34,231 |
| Total gains or (losses) (realized or unrealized) | | |
| Included in net loss | — | — |
| Included in accumulated other comprehensive income | 3 | (1,793) |
| Settlements | (15,850) | (24,900) |
| Balance at January 4, 2014 | $11,124 | $11,124 |

Non-Financial Assets:
The Company measures certain non-financial assets and liabilities, including long-lived assets, at fair value on a non-recurring basis. During the three months ended January 4, 2014 and December 29, 2012, the Company recorded impairment charges of approximately $0.7 million and $1.7 million, respectively, related to under-performing stores. During the six months ended January 4, 2014 and December 29, 2012, the Company recorded impairment charges of approximately $0.9 million and $1.8 million, respectively, related to under-performing stores.
The following table presents the Company's considerations of at-risk assets for the three and six month periods ended January 4, 2014 and December 29, 2012, respectively:

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| | Three Months Ended | | | | Six Months Ended | | | |
|---|---|---|---|---|---|---|---|---|
| | January 4, 2014 | | December 29, 2012 | | January 4, 2014 | | December 29, 2012 | |
| Number of stores identified as at risk and evaluated for impairment | 24 | | 16 | | 26 | | 17 | |
| Total carrying amount of stores identified as at risk prior to any impairment charges taken | $4.1 | million | $2.8 | million | $4.3 | million | $2.9 | million |
| Less: impairment charges recorded during the period | $0.7 | million | $1.7 | million | $0.9 | million | $1.8 | million |
| Remaining carrying amount of stores identified as at risk after impairment charges taken | $3.4 | million | $1.1 | million | $3.4 | million | $1.1 | million |
| Number of stores considered at risk, but not impaired | 18 | | 3 | | 19 | | 3 | |
| Total carrying amount of stores identified as at risk, but not impaired | $3.3 | million | $0.8 | million | $3.3 | million | $0.8 | million |

The fair market value of these assets was determined using the income approach and level 3 inputs, which required management to make significant estimates about future operating plans and projected cash flows. Management estimates the amount and timing of future cash flows based on its experience and knowledge of the retail market in which each store operates. The assumptions used in preparing the discounted cash flow model and the related sensitivity analysis around the discounted cash flow model include estimates for weighted average cost of capital 11.0% and annual revenue growth rates (range from 1.4% – 6.0%). The stores not impaired had undiscounted cash flows that exceeded their net carrying amount at a weighted average of 145% for the three month period ended January 4, 2014. For the six month period ended January 4, 2014, the stores not impaired had undiscounted cash flows that exceeded their net carrying amount at a weighted average of 154%. For the three and six months ended December 29, 2012, the stores not impaired had undiscounted cash flows that exceeded their net carrying amount at a weighted average of 602%.

The impairment charge is included in selling, general and administrative expenses (“SG&A”) in the accompanying condensed consolidated statements of operations and comprehensive loss. The Company was not required to measure any other significant non-financial assets and liabilities at fair value.

INVENTORIES

The Company’s inventories consisted of:

| | As of | | |
|---|---|---|---|
| | January 4, 2014 | July 6, 2013 | December 29, 2012 |
| | (In thousands) | | |
| Raw materials | $1,048 | $1,965 | $999 |
| Merchandise available for sale | 30,829 | 31,897 | 36,422 |
| Inventories, net | $31,877 | $33,862 | $37,421 |

CREDIT FACILITIES

The Company has an unsecured commercial line of credit agreement which provides for borrowings and issuance of letters of credit of up to a combined total of $10.0 million. This agreement was amended on February 5, 2014 to reduce the minimum tangible net worth within the financial covenants. This agreement expires on January 31, 2015. The outstanding balance bears interest at either the bank’s reference rate (which was 3.25% as of January 4, 2014) or the LIBOR rate (which was 0.17% as of January 4, 2014) plus 1.75 percentage points. As of January 4, 2014, there were no outstanding cash borrowings or trade letters of credit outstanding and a $3.0 million outstanding stand-by letter of credit. During the three and six months ended January 4, 2014 there were no cash borrowings under the line of credit and to date, no beneficiary has drawn upon the stand-by letter of credit.

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As amended, this credit facility requires the Company to comply with certain financial covenants, including minimum tangible net worth and unencumbered liquid assets, and contains certain restrictions on making loans and investments. The Company is in compliance with all covenants in the credit agreement.

INCOME TAXES

Deferred income taxes arise from temporary differences between the tax and financial statement recognition of revenue and expenses. The Company regularly assesses the need for a valuation allowance against its deferred tax assets. In evaluating whether it is more likely than not that some or all of the Company's deferred tax assets will not be realized, it considers all available positive and negative evidence, including recent year's operational results which is objectively verifiable evidence. As a result of its evaluation of the realizability of its deferred tax assets as of January 4, 2014, the Company continues to believe, based upon all available evidence, that it is more likely than not that the majority of its deferred tax assets will continue to not be realized. Accordingly, the majority of the tax benefit related to the current quarter losses is not recognized. As a result, the Company's effective tax rate for the second quarter of fiscal 2014 is not comparable to the effective tax rate for the second quarter of fiscal 2013. The Company will continue to maintain a valuation allowance against its deferred tax assets until the Company believes it is more likely than not that these assets will be realized in the future. If sufficient positive evidence arises in the future indicating that all or a portion of the deferred tax assets meet the more likely than not standard, the valuation allowance will be reversed accordingly in the period that such determination is made.

EARNINGS PER SHARE

Basic earnings per share is computed as net earnings divided by the weighted average number of common shares outstanding for the period. Diluted earnings per share reflects the potential dilution that could occur from common shares issuable through the exercise of dilutive stock options.

The following is a reconciliation of the number of shares used in the basic and diluted earnings per share computations:

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | January 4, 2014 | December 29, 2012 | January 4, 2014 | December 29, 2012 |
| | (In thousands) | | | |
| Basic weighted average number of shares outstanding | 79,119 | 84,054 | 79,087 | 84,216 |
| Incremental shares from the assumed issuance of stock options | — | — | — | — |
| Diluted weighted average number of shares outstanding | 79,119 | 84,054 | 79,087 | 84,216 |

Excluded from the computation of the number of diluted weighted average shares outstanding were options to purchase 5,293,313 and 5,201,743 shares of common stock for the three months ended January 4, 2014 and December 29, 2012, respectively, and 4,947,432 and 5,047,859 for the six months ended January 4, 2014 and December 29, 2012, respectively, which would have been anti-dilutive. The decrease in the number of weighted shares outstanding for the six months ended January 4, 2014 from the comparable period of fiscal 2013 primarily relates to the common stock repurchases made in the second and third quarters of fiscal 2013.

COMMON STOCK PURCHASES

In November 2012, the board of directors authorized a program to repurchase up to $30 million of the Company's common stock. The Company intends, from time to time, as business conditions warrant, to purchase stock in the open market or through private transactions. Purchases may be increased, decreased or discontinued at any time without prior notice. The plan does not obligate the Company to repurchase any specific number of shares and may be suspended at any time at the Company's discretion. No shares were repurchased during the three or the six months ended January 4, 2014. During the three and six months ended December 29, 2012, the Company repurchased approximately 1.8 million shares at an average price per share of $3.81 for an aggregate purchase price of approximately $6.8 million. Of the repurchases made in the three and six month periods ending December 29, 2012, $1.4 million of cash settlement was made after December 29, 2012.

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STOCK BASED COMPENSATION

The following table summarizes the stock based compensation expense recognized under the Company's stock plan during the three and the six months ended January 4, 2014 and December 29, 2012:

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | January 4, 2014 | December 29, 2012 | January 4, 2014 | December 29, 2012 |
| | (In thousands) | | | |
| Stock options | $352 | $342 | $859 | $968 |
| Nonvested stock awards/units | 512 | 112 | 913 | 238 |
| Total stock based compensation expense | $864 | $454 | $1,772 | $1,206 |

Unrecognized compensation cost related to nonvested stock options and nonvested stock awards/units totaled approximately $2.0 million and $2.2 million, respectively, as of January 4, 2014. This cost is expected to be recognized over a weighted average period of 2.7 years. There were no stock options granted during the three months ended January 4, 2014. The weighted average fair value of stock options at their grant date during the three months ended December 29, 2012 was $1.23. During the six month periods ended January 4, 2014 and December 29, 2012, the weighted average fair value of stock options at their grant date was $1.79 and $1.39, respectively.

During the six month period ended January 4, 2014, as part of the total long term executive incentive plan, the Company's Board of Directors granted a target performance award of 132,138 restricted stock units ("RSU") to certain members of its senior executive team that contained a market-based performance condition in addition to a service component. These RSUs vest after three years from the date of grant and the grants ultimately awarded will be based upon the performance percentage, which can range from 0 – 200% of the target performance award grant. The RSUs ultimately awarded upon vesting are based on the Company's performance relative to peer group companies' two year compound annual growth rate of total shareholder return. Total shareholder return is measured based on a comparison of the closing price on June 30, 2013, the day prior to the performance period beginning, and the closing price on June 30, 2015, the last day of the performance period. Total shareholder return will include the effect of dividends paid during the performance period. The fair value of these RSUs at their grant date was $6.83 and was estimated on the date of grant using a Monte Carlo simulation model that included valuation inputs for expected volatility 41%, risk free interest rate 0.38%, dividend yield 1.8% and correlation to peer group companies of 22%.

LEGAL MATTERS

As of the date of this filing, the Company is involved in ongoing legal proceedings as described below.

A former employee sued the Company in a complaint filed July 27, 2006 in the Superior Court of California, San Mateo County (Case No. CIV 456550) alleging a failure to pay all wages, failure to pay overtime wages, failure to pay minimum wages, failure to provide meal periods, violation of Labor Code §450, violation of Labor Code §2802 and California Code of Regulations §11040(9)(A), statutory wage violations (late payment of wages), unlawful business practices under Business and Professions Code §16720 and §17200, conversion of wages and violation of Civil Code §52.1. The plaintiff purports to bring the action also on behalf of current and former California bebe employees who are similarly situated. The lawsuit seeks compensatory, statutory, punitive, restitution and injunctive relief. In September 2011, the Court certified a class of store managers who allege they were required to buy and wear our product as a condition of employment and denied certification relating to claims of missed meal periods and rest breaks. Accordingly, the Court directed for a trial only on the claim that the employees were required to buy and wear our product. The Court has not yet set a trial date.

A customer named Melita Meyer sued the Company in a complaint filed January 16, 2014 in the United States District Court for the Northern District of California (Civil Action No. C14-267 DMR) alleging negligent violations of the Telephone Consumer Protection Act (47 U.S.C. §§227 et seq.), knowing and/or willful violations of the Telephone Consumer Protection Act (47 U.S.C. §§227 et seq.) and violations of California's unfair competition law (California Business and Professions Code §§ 17200, et seq.) The plaintiff purports to bring the action also on behalf of all others similarly situated. The lawsuit seeks statutory and injunctive relief. The Company was served with the lawsuit on

January 31, 2014.  The Company is investigating the allegations and preparing a response.

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The Company is also involved in various other legal proceedings arising in the normal course of business. Regarding such legal proceedings, and including the matter(s) discussed in the paragraph(s) above, the Company accrues where appropriate an amount it believe reflects the aggregate liability deemed probable and estimable. Any such estimate may be revised as further information becomes available. The amounts accrued as of this filing, individually and in the aggregate, have not had a material adverse effect on our business, financial condition or results of operations. Because of the preliminary nature of these proceedings, the difficulty in ascertaining the applicable facts relating to many of these proceedings, the inconsistent treatment of claims made in many of these proceedings and the difficulty of predicting the settlement value of many of these proceedings, the Company is unable to estimate an amount or range of any reasonable possible additional losses. However, based on its historical experience, the resolution of these proceedings is not expected to have a material effect on its business, financial condition or results of operations.
The Company intends to defend itself vigorously against each of these claims. However, the results of any litigation are inherently uncertain. The Company cannot assure you that it will be able to successfully defend itself in these lawsuits. Where required, and/or otherwise appropriate and determinable, the Company has recorded an estimate of potential liabilities that it believes is reasonable. Any estimates are revised as further information becomes available.

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

The following Management's Discussion and Analysis of Financial Condition and Results of Operations contains forward-looking statements, which involve risks and uncertainties. Our actual results may differ materially from those anticipated in these forward-looking statements. Statements that are predictive in nature, that depend upon or refer to future events or conditions or that include words such as "expects," "anticipates," "intends," "plans," "believes," "estimates," "thinks" and similar expressions are forward-looking statements. Forward-looking statements include statements about our expected results of operations, capital expenditures and store openings. Although we believe that these statements are based upon reasonable assumptions, we cannot assure you that our goals will be achieved. These forward-looking statements are made as of the date of this Form 10-Q, and we assume no obligation to update or revise them or provide reasons why actual results may differ. Factors that might cause such a difference include, but are not limited to, our ability to respond to changing fashion trends, obtain raw materials and find manufacturing facilities, attract and retain key management personnel, develop new concepts, successfully open future stores, successfully manage our online business, maintain and protect information technology, respond effectively to competitive pressures in the apparel industry and adverse economic conditions and protect our intellectual property as well as declines in comparable store sales performance, changes in the level of consumer spending or preferences in apparel and/or other factors discussed in "Risk Factors" and elsewhere in this Form 10-Q.

### OVERVIEW

We are a global specialty retailer who designs, develops and produces a distinctive line of contemporary women's apparel and accessories. We are a global fashion brand that believes feeling sexy and looking great are the cornerstones of confidence for today's sophisticated woman. Our expert designs and personal retail experience aim to help our clients look and feel their sexiest. The bebe customer expects value in the form of current fashion and high quality at a competitive price.

Our distinctive product offering includes a full range of separates, tops, dresses, active wear and accessories to satisfy her every day wardrobe needs across all occasions. We design and develop the majority of our merchandise in-house, which is manufactured to our specifications. The remainder of our merchandise is sourced directly from third-party manufacturers.

We market our products under the bebe, BEBE SPORT, bbsp and 2b bebe brand names through our 232 retail stores, of which 182 are bebe stores, including an e-commerce store at www.bebe.com, and 50 are 2b bebe stores, including an e-commerce store at www.2bstores.com, as of January 4, 2014. These stores are located in 34 states, the District of Columbia, Puerto Rico, the U.S. Virgin Islands and Canada. In addition, our licensees operate 109 international point-of-sale locations in 26 countries as of January 4, 2014. During the six months ended January 4, 2014, we opened 1 2b bebe store and closed 8 bebe and 3 2b bebe stores.

bebe stores. We were founded by Manny Mashouf, our Chairman of the Board. We opened our first store in San Francisco, California in 1976, which was also the year we incorporated. www.bebe.com is our bebe e-commerce retail store and an extension of the bebe store experience that provides a complete assortment of bebe and BEBE SPORT merchandise and is used as a vehicle to communicate with our customers.

2b bebe stores. Our 2b bebe stores focus on fun and flirty everyday lifestyle offerings for our aspirational buyers. As of January 4, 2014, we operated a total of 50 2b bebe stores, including an e-commerce store at www.2bstores.com. Of these, 17 are mall based stores that sell 2b bebe merchandise only and 32 are outlet stores that sell a mix of 2b bebe, bebe logo and bebe retail markdown merchandise. We plan to convert all outlet signs from 2b to bebe outlet by the end of May 2014 and will start to introduce made for outlet products in the fourth quarter of fiscal 2014. www.2bstores.com is our 2b bebe e-commerce retail store and an extension of the 2b bebe store experience that provides a complete assortment of 2b bebe merchandise and is also used as a vehicle to communicate with our customers.

### CRITICAL ACCOUNTING POLICIES

Management's Discussion and Analysis of Financial Condition and Results of Operations are based upon our consolidated financial statements, which have been prepared in conformity with accounting principles generally accepted in the United States of America.

The preparation of these financial statements requires the appropriate application of certain accounting policies, many of which require us to make estimates and assumptions about future events and their impact on amounts reported in our financial statements and related notes. Since future events and their impact cannot be determined with certainty, the actual results will inevitably differ from our estimates. Such differences could be material to the financial statements. We believe our application of accounting policies, and the estimates inherently required therein, are reasonable. Our most critical accounting policies are

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those related to revenue recognition, stock based compensation, inventories, marketable securities, impairment of long lived assets and income taxes. We continually evaluate these accounting policies and estimates, and we make adjustments when facts and circumstances dictate a change. Our accounting policies are described in Note 1 to the consolidated financial statements in our annual report on Form 10-K for the fiscal year ended July 6, 2013. This discussion and analysis should be read in conjunction with such discussion and with our condensed consolidated financial statements and related notes included in Part 1, Item 1 of this quarterly report.

RESULTS OF OPERATIONS

Our fiscal year is a 52 or 53 week period, each period ending on the first Saturday after June 30. Fiscal 2014 includes 52 weeks and fiscal 2013 includes 53 weeks. The three months ended January 4, 2014 and December 29, 2012 each include 13 weeks. The six months ended January 4, 2014 and December 29, 2012 each include 26 weeks.

The following table sets forth certain financial data as a percentage of net sales for the periods indicated:

| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | January 4, 2014 | December 29, 2012 | January 4, 2014 | December 29, 2012 |
| Net sales | 100.0 % | 100.0 % | 100.0 % | 100.0 % |
| Cost of sales, including production and occupancy (1) | 66.4 | 66.1 | 65.5 | 65.1 |
| Gross margin | 33.6 | 33.9 | 34.5 | 34.9 |
| Selling, general and administrative expenses (2) | 37.9 | 39.4 | 40.7 | 39.4 |
| Operating loss | (4.3 ) | (5.5 ) | (6.2 ) | (4.5 ) |
| Interest and other income, net | 0.1 | 0.2 | 0.1 | 0.2 |
| Loss before income taxes | (4.2 ) | (5.3 ) | (6.1 ) | (4.3 ) |
| Income tax benefit | — | (1.8 ) | (0.1 ) | (1.4 ) |
| Net loss | (4.2 )% | (3.5 )% | (6.0 )% | (2.9 )% |

(1) Cost of sales includes the cost of merchandise, occupancy costs, distribution center costs and production costs.

(2) Selling, general and administrative expenses primarily consist of non-occupancy store costs, corporate overhead and advertising costs.

Net Sales. Net sales decreased to $130.0 million during the three months ended January 4, 2014 from $135.5 million for the comparable period of the prior year, a decrease of $5.6 million, or 4.1%. The decrease in net sales was primarily due to a decrease in comparable store sales during the quarter coupled with store closures during the quarter. E-commerce store sales increased 16.3% for the quarter. The increase in e-commerce sales was driven by increases in both traffic and merchandise acceptance. Comparable store sales for the quarter ended January 4, 2014 decreased 1.9% compared to a decrease of 10.5% in the second quarter of the prior year and a decrease of 2.8% in the first quarter of fiscal 2014. The sequential improvement in comparable store sales was driven by improvement in both traffic and conversion.

For the six months ended January 4, 2014, net sales decreased to $244.1 million from $252.6 million for the comparable period of the prior year, a decrease of $8.5 million, or 3.4%. The decrease in net sales was primarily due to a 2.3% decrease in comparable store sales coupled with store closures. E-commerce store sales increased 17.0% for the six month period. The increase in e-commerce sales was driven by increases in both traffic and merchandise acceptance.

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| | Three Months Ended | | Six Months Ended | |
|---|---|---|---|---|
| | January 4, 2014 | December 29, 2012 | January 4, 2014 | December 29, 2012 |
| Net sales (In thousands) | $129,974 | $135,535 | $244,101 | $252,626 |
| Total net sales decrease percentage | (4.1)% | (10.9)% | (3.4)% | (9.2)% |
| Comparable store decrease percentage (1) | (1.9)% | (10.5)% | (2.3)% | (9.7)% |
| Net sales per average square foot (2) | $107 | $108 | $199 | $202 |
| Square footage at end of period (In thousands) | 927 | 1,002 | 927 | 1,002 |
| Number of store locations: | | | | |
| Beginning of period | 235 | 250 | 242 | 252 |
| New store locations | — | 1 | 1 | 6 |
| Closed store locations | 3 | 1 | 11 | 8 |
| Number of stores open at end of period | 232 | 250 | 232 | 250 |

(1) We calculate comparable store sales by including the net sales of stores that have been open at least one year. Therefore, a store is included in the comparable store sales base beginning with its thirteenth month. Stores that have been expanded or remodeled by 15 percent or more or have been permanently relocated are excluded from the comparable store sales base. In addition, we calculate comparable store sales using a same day sales comparison. Our e-commerce store sales are also included in our comparable store sales base. The inclusion of our e-commerce store sales increased the comparable store sales percentage by 2.8% and 1.9% for the three months ended January 4, 2014 and December 29, 2012, respectively. For the six months ended January 4, 2014 and December 29, 2012, the inclusion of our e-commerce store sales increased the comparable store sales 2.7% and 1.1%, respectively.

(2) We calculate net sales per average square foot using net store sales less e-commerce net sales and monthly average store square footage.

Gross Margin. Gross margin decreased to $43.7 million during the three months ended January 4, 2014 from $45.9 million for the comparable period of the prior year, a decrease of $2.3 million, or 4.9%. As a percentage of net sales, gross margin decreased to 33.6% for the three months ended January 4, 2014 from 33.9% in the comparable period of the prior year. The decrease in gross margin as a percentage of net sales was primarily due to an increase in markdowns to clear through legacy products as well as heightened promotional activities throughout the holiday season.

For the six months ended January 4, 2014, gross margin decreased to $84.3 million from $88.2 million for the comparable period of the prior year, a decrease of $3.9 million, or 4.5%. As a percentage of net sales, gross margin decreased to 34.5% for the six months ended January 4, 2014 from 34.9% in the comparable period of the prior year. The decrease in gross margin as a percentage of net sales was primarily due to an increase in markdowns to clear through legacy products as well as heightened promotional activities throughout the holiday season.

Selling, General and Administrative Expenses. Selling, general and administrative expenses decreased to $49.3 million during the three months ended January 4, 2014 from $53.4 million for the comparable period of the prior year, a decrease of $4.1 million, or 7.7%. As a percentage of net sales, selling, general and administrative expenses decreased to 37.9% during the three months ended January 4, 2014 from 39.4% in the comparable period of the prior year. The decrease in selling, general and administrative expenses in the second quarter of fiscal 2014 is a result of gains on disposal of property, lower store impairment charges, decreases in contractor and professional fees costs and a legal settlement benefit, offset in part by planned increases in advertising expenses.

For the six months ended January 4, 2014, selling, general and administrative expenses decreased to $99.3 million from $99.6 million for the comparable period of the prior year, a decrease of $0.2 million or 0.2%. As a percentage of net sales, selling, general, and administrative expenses increased to 40.7% from 39.4% in the comparable period in the prior year. The decrease in dollars of selling, general and administrative expenses in fiscal 2014 is a result of gains on disposal of property, decreases in contractor and professional fees costs, lower store impairment charges and a legal settlement benefit, offset in part by planned increases in advertising expenses.

Provision for Income Taxes. The tax rate for the second quarter of fiscal 2014 was 1.06% compared to 33.5% for the comparable period of the prior year. Due to the existence of the valuation allowance, the majority of the tax benefit related to the current quarter losses is not recognized. As a result, the Company's effective tax rate for the second quarter of fiscal 2014 is not comparable to the effective tax rate for the second quarter of fiscal 2013.

For the six months ended January 4, 2014, our effective tax rate was 1.37% compared to 32.3% for the comparable period of the prior year. Due to the existence of the valuation allowance, the majority of the tax benefit related to the current fiscal year to date losses is not recognized. As a result, the Company's effective tax rate for the six months ended January 4, 2014 is not comparable to the effective tax rate for the six months ended December 29, 2012.

SEASONALITY OF BUSINESS AND QUARTERLY RESULTS

Our business varies with general seasonal trends that are characteristic of the retail and apparel industries. As a result, our typical store generates a higher percentage of our annual net sales and profitability in the second quarter of our fiscal year, which includes the holiday selling season, compared to the other quarters of our fiscal year. If for any reason our sales were below seasonal norms during the second quarter of our fiscal year, our annual operating results would be negatively impacted. Because of the seasonality of our business, results for any quarter are not necessarily indicative of results that may be achieved for a full fiscal year.

LIQUIDITY AND CAPITAL RESOURCES

Our working capital requirements vary widely throughout the year and generally peak during the first and second fiscal quarters. As of January 4, 2014, we had approximately $164.0 million of cash and equivalents and investments on hand of which $130.9 million were cash and equivalents, approximately $22.0 million were invested in certificates of deposit and approximately $11.1 million, net of temporary impairment charges of $4.5 million, were invested in auction rate securities ("ARS"). We do not anticipate the lack of liquidity in the ARS to impact our ability to fund our operations in the foreseeable future and believe we have sufficient cash and equivalents to fund ongoing operations. In addition, we have a revolving line of credit, under which we may borrow or issue letters of credit up to a combined total of $10 million. As of January 4, 2014, there were no cash borrowings outstanding under the line of credit, no trade letters of credit outstanding and a $3.0 million stand-by letter of credit outstanding. This credit facility requires us to comply with certain financial covenants, including minimum tangible net worth and unencumbered liquid assets, and certain restrictions on making loans and investments. We are in compliance with all covenants under the credit facility.

As of January 4, 2014, we had cash and equivalents of $130.9 million held in accounts managed by third-party financial institutions consisting of invested cash and cash in our operating accounts. The invested cash is invested in interest bearing funds managed by third-party financial institutions. These funds invest in direct obligations of the government of the United States. To date, we have experienced no loss or lack of access to our invested cash or equivalents; however, we can provide no assurances that access to our invested cash and equivalents will not be impacted by adverse conditions in the financial markets.

We hold our operating and invested cash in accounts that are with third-party financial institutions. These balances exceed the Federal Deposit Insurance Corporation insurance limits. While we monitor daily the cash balances in our operating accounts and adjust the cash balances as appropriate, these cash balances could be impacted if the underlying financial institutions fail or could be subject to other adverse conditions in the financial markets. To date, we have experienced no loss or lack of access to invested cash or cash in our operating accounts.

Net cash used by operating activities for the six months ended January 4, 2014 was $5.2 million compared to net cash used by operating activities of $3.0 million for the six months ended December 29, 2012. The increase of $2.2 million from the comparable period was due to lower overall net income offset by a change in working capital. The decrease of $10.3 million in working capital was primarily related to decreased inventory expenditures.

Net cash provided by investing activities for the six months ended January 4, 2014 was $53.2 million compared to $0.3 million provided by investing activities for the six months ended December 29, 2012. The increase of $52.9 million versus the prior year comparable period was primarily due to proceeds from sale of investment securities combined with decreased investments in property and equipment. We expect that total capital expenditures will be approximately $25 million in fiscal 2014, which will include capital expenditures for new stores, remodels, store expansions, information technology systems and office improvements.

Net cash used by financing activities was $3.7 million for the six months ended January 4, 2014 compared to $9.5 million used by financing activities for the six months ended December 29, 2012. The decrease of $5.8 million from the prior year comparable period was primarily due to repurchases of our common stock made in the prior year.

We hold a variety of interest bearing ARS consisting of federally insured student loan backed securities and insured municipal authority bonds. As of January 4, 2014, our ARS portfolio totaled approximately $11.1 million classified as available

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for sale securities. As of that date, our ARS portfolio included approximately77% federally insured student loan backed securities and 23% municipal authority bonds and consisted of approximately 36% A rated investments, 19% BBB rated investments and 45% CCC rated investments. As of July 6, 2013, the Company's ARS consisted of 21% AAA rated investments, 19% AA rated investments, 23% A rated investments, 20% BBB rated investments and 17% CCC rated investments. These ARS investments are intended to provide liquidity via an auction process that resets the applicable interest rate at predetermined calendar intervals, allowing investors to either roll over their holdings or gain immediate liquidity by selling such interests at par. The uncertainties in the credit markets that began in February 2008 have affected our holdings in ARS investments and auctions for our investments in these securities have failed to settle on their respective settlement dates. Historically the fair value of ARS investments had approximated par value due to the frequent resets through the auction process. While we continue to earn interest on our ARS investments at the maximum contractual rate, these investments are not currently trading and therefore do not currently have a readily determinable market value. Accordingly, the estimated fair value of ARS no longer approximates par value. Consequently, the investments are not currently liquid, and we will not be able to access these funds until a future auction of these investments is successful, the issuer redeems the securities, or at maturity. Maturity dates for these ARS investments range from 2031 to 2033 with principal distributions occurring on certain securities prior to maturity. During the three and six months ended January 4, 2014, $15.9 million and $24.9 million, respectively, of ARS were settled at par.

We also hold short-term available for sale securities totaling $22.0 million at January 4, 2014 that consist of certificates of deposit as well as long-term available for sale securities totaling $11.1 million that consist of ARS.

In November 2012, our board of directors authorized a program to repurchase up to $30 million of our common stock. We intend, from time to time, as business conditions warrant, to purchase stock in the open market or through private transactions. Purchases may be increased, decreased or discontinued at any time without prior notice. The plan does not obligate us to repurchase any specific number of shares and may be suspended at any time at our discretion. No shares were repurchased during the three and six months ended January 4, 2014. During the three and six months ended December 29, 2012, the Company repurchased approximately 1.8 million shares at an average pricer per share of $3.81 for an aggregate purchase price of approximately $6.8 million. Of the repurchases made in the three and six month periods ending December 29, 2012, $1.4 million of cash settlement was made after December 29, 2012.

We believe that our cash and cash equivalents on hand will be sufficient to meet our capital and operating requirements for at least the next twelve months. Our future capital requirements, however, will depend on numerous factors, including without limitation, liquidity of our auction rate securities, the size and number of new and expanded stores and/or store concepts, investment costs for management information systems, potential acquisitions and/or joint ventures, repurchase of stock and future results of operations.

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

We are exposed to market risks, which include changes in U.S. interest rates and, to a lesser extent, foreign exchange rates. We do not engage in financial transactions for trading or speculative purposes.

### Interest Rate Risk

We currently maintain a portfolio of variable interest rate investments consisting of cash equivalents, government treasury bills, guaranteed investment certificates and both short term and long term investments consisting of ARS. According to our investment policy, we may invest in taxable and tax-exempt instruments. In addition, the policy establishes limits on credit quality, maturity, issuer and type of instrument. Marketable securities are classified as "trading" or "available for sale". We do not use derivative financial instruments in our investment portfolio.

All highly liquid investments with a maturity of three months or less at the date of purchase are considered to be cash equivalents. Investments are considered short-term available for sale securities if the original maturity is between three months and twelve months, or long term investments if the original maturity is greater than twelve months. Historically the fair value of ARS investments had approximated par value due to the frequent resets through the auction process. While we continue to earn interest on our ARS investments at the maximum contractual rate, these investments are not currently trading and therefore do not currently have a readily determinable market value.

Accordingly, the estimated fair value of ARS no longer approximates par value. We determined the estimated fair value of our investment in ARS as of January 4, 2014 by reviewing trading activity for similar securities in secondary markets as well as by using a discounted cash flow model to estimate the fair value of our investments in ARS. The assumptions used in preparing the discounted cash flow model include estimates for interest rates, timing and amount of cash flows and expected holding periods of the ARS. We have modified our investment strategy and increased our investments in more liquid money market investments.

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The following table lists our cash, cash equivalents and investments as of January 4, 2014:

| | Fair Value (Dollars in thousands) | |
|---|---|---|
| Cash | $ 84,453 | |
| Weighted average interest rate | 0.00 | % |
| Cash equivalents | $ 46,409 | |
| Weighted average interest rate | 0.10 | % |
| Current available for sale securities | $ 21,977 | |
| Weighted average interest rate | 1.51 | % |
| Non-current available for sale securities | $ 11,124 | |
| Weighted average interest rate | 0.27 | % |
| Total | $ 163,963 | |

The interest payable on outstanding cash borrowings under our bank line of credit is based on variable interest rates and is therefore affected by changes in market interest rates. If interest rates rose significantly, our results from operations and cash flows would not be materially affected since we have no outstanding borrowings.

Foreign Currency Risks

We enter into a significant amount of purchase obligations outside of the United States, substantially all of which are negotiated and settled in U.S. Dollars and, therefore, have only minimal exposure to foreign currency exchange risks. We also operate a subsidiary for which the functional currency is the Canadian Dollar. We translate assets and liabilities of Canada's operations into U.S. dollars at month-end rates, while we translate income and expenses at the weighted average exchange rates for the month. We record the related translation adjustments in accumulated other comprehensive income as a separate component of shareholders' equity. Fluctuations in exchange rates therefore impact our financial condition and results of operations, as reported in U.S. Dollars. We do not hedge against foreign currency risks and believe that foreign currency exchange risk is immaterial.

## ITEM 4. CONTROLS AND PROCEDURES

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our Exchange Act reports is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer as appropriate, to allow for timely decisions regarding required disclosure. In designing and evaluating our disclosure controls and procedures, our management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and our management is required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

Under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, we evaluated the effectiveness of our disclosure controls and procedures, as such term is defined under Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934, as amended. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of the end of the period covered by this quarterly report at the reasonable assurance level.

There has been no change in our internal control over financial reporting during the quarter ended January 4, 2014 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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PART II OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

See the Legal Matters section of the Notes to the Condensed Consolidated Financial Statements for a discussion of legal proceedings.

ITEM 1A. RISK FACTORS

Our past performance may not be a reliable indicator of future performance because actual future results and trends may differ materially depending on a variety of factors, including, but not limited to, the risks and uncertainties discussed below. In addition, historical trends should not be used to anticipate results or trends in future periods. Factors that might cause our actual results to differ materially from the forward looking statements discussed elsewhere in this report, as well as affect our ability to achieve our financial and other goals, include, but are not limited to, those set forth below. Except for the addition of the security risk factor, there have been no material changes in our risk factors from those disclosed in Part I, Item 1A of our Annual Report on Form 10-K for the fiscal year ended July 6, 2013.

1. The success of our business depends in large part on our ability to identify fashion trends as well as to react to changing customer demand in a timely manner. Consequently, we depend in part upon the customer response to the creative efforts of our merchandising, design and marketing teams and their ability to anticipate trends and fashions that will appeal to our consumer base. If we miscalculate our customers' product preferences or the demand for our products, we may be faced with excess inventory. Historically, this type of occurrence has resulted in excess fabric for some products and markdowns and/or write-offs, which has impaired our profitability, and may do so in the future. Similarly, any failure on our part to anticipate, identify and respond effectively to changing customer demands and fashion trends will adversely affect our sales. In addition, from time to time, we may pursue new concepts, and if the new concepts are not successful, our financial condition may be harmed.

2. We face increasing product costs from our manufacturing partners, which could result in margin erosion. Worldwide prices for raw materials have increased year-over-year. We currently estimate that these increasing product costs could result in margin erosion. Additionally, a significant percentage of our apparel products are manufactured in China. Manufacturers in that country are currently experiencing increased costs due to shortages of labor and the fluctuation of the Chinese Yuan in relation to the U.S. dollar. In addition, our business and operating results may be affected by changes in the political, social or economic environment in China. If we are unable to successfully mitigate a significant portion of such product costs, our results of operations may be materially adversely affected.

3. If we are unable to obtain raw materials or unable to find manufacturing facilities or our manufacturers perform unacceptably, our sales may be negatively affected and our financial condition may be harmed. We do not own any manufacturing facilities and therefore depend on contractors and third parties to manufacture our products. We place all of our orders for production of merchandise and raw materials by purchase order and do not have any long-term contracts with any manufacturer or supplier. If we fail to maintain favorable relationships with our manufacturers and suppliers or are unable to obtain sufficient quantities of quality raw materials on commercially reasonable terms, it could harm our business and results of operations.

We cannot assure you that contractors and third-party manufacturers (1) will not supply similar products to our competitors, (2) will not stop supplying products to us completely or (3) will supply products in a timely manner. Untimely receipt of products may result in lower than anticipated sales and markdowns which would have a negative impact on earnings. Furthermore, we have received in the past, and may receive in the future, shipments of products from manufacturers that fail to conform to our quality control standards. In such event, unless we are able to obtain replacement products in a timely manner, we may lose sales. Certain of our third-party manufacturers store our raw materials. In the event our inventory was damaged or destroyed and we were unable to obtain replacement raw materials, our earnings could be negatively impacted.

4. We face significant competition in the retail and apparel industry, which could harm our sales and profitability. The retail and apparel industries are highly competitive and are characterized by low barriers to entry. We expect

competition in our markets to increase. The primary competitive factors in our markets are: brand name recognition, sourcing, product styling, quality, presentation and pricing, timeliness of product development and delivery, store ambiance, customer service and convenience. We compete with traditional department stores, specialty store retailers, lower price point retailers, business to consumer websites, off-price retailers and direct marketers for, among other things, raw materials, market share, retail space, finished goods, sourcing and personnel. Because many of these competitors are larger and have substantially

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greater financial, distribution and marketing resources than we do or maintain comparatively lower cost of operations, we may lack the resources to adequately compete with them. If we fail to remain competitive in any way, it could harm our business, financial condition and results of operations.

5. General economic conditions, including increases in energy and commodity prices, that are largely out of our control may adversely affect our financial condition and results of operations. We are sensitive to changes in general economic conditions, both nationally and locally. Recessionary economic cycles, higher interest rates, higher fuel and other energy costs, inflation, deflation, increases in commodity prices, higher levels of unemployment, higher consumer debt levels, higher tax rates and other changes in tax laws or other economic factors that may affect consumer spending or buying habits could adversely affect the demand for products we sell in our stores. In addition, the recent turmoil in the financial markets may have an adverse effect on the U.S. and world economy, which could negatively impact consumer spending patterns. We cannot assure you that government responses to the disruptions in the financial markets will restore consumer confidence.

Furthermore, we could experience reduced traffic in our stores or limitations on the prices we can charge for our products, either of which could reduce our sales and profit margins and have a material adverse effect on our financial condition and results of operations. Also, economic factors such as those listed above and increased transportation costs, inflation, higher costs of labor, insurance and healthcare, and changes in other laws and regulations may increase our cost of sales and our operating, selling, general and administrative expenses, and otherwise adversely affect our financial condition and results of operations.

6. We cannot assure that future store openings will be successful and new store openings may impact existing stores. We expect to open approximately one 2b bebe store in fiscal 2014 as well as up to 20 international licensee operated point-of-sale locations. In the past, we have closed stores as a result of poor performance, and we cannot assure that the stores that we plan to open in fiscal 2014, or any other stores that we might open in the future, will be successful or that our overall operating profit will increase as a result of opening these stores. During fiscal 2013, we closed 20 stores, and during fiscal 2014, we anticipate closing approximately 14 bebe stores and 4 2b bebe stores and have closed 32 unproductive and immaterial international shop-in-shop locations in Israel. Most of our domestic new store openings in fiscal 2014 will be in existing markets. These openings may affect the existing stores' net sales and profitability. Our failure to predict accurately the demographic or retail environment at any future store location could have a material adverse effect on our business, financial condition and results of operations.

Our ability to effectively obtain real estate to open new stores depends upon the availability of real estate that meets our criteria, including traffic, square footage, co-tenancies, average sales per square foot, lease economics, demographics, and other factors, and our ability to negotiate terms that meet our financial targets. In addition, we must be able to effectively renew our existing store leases. Failure to secure real estate locations adequate to meet annual targets as well as effectively managing the profitability of our existing fleet of stores could have a material adverse effect on our business, financial condition and results of operations.

7. Our sales, margins and operating results are subject to seasonal and quarterly fluctuations. Our business varies with general seasonal trends that are characteristic of the retail and apparel industries, such as the timing of seasonal wholesale shipments and other events affecting retail sales. As a result, our stores typically generate a higher percentage of our annual net sales and profitability in the second quarter of our fiscal year (which includes the holiday selling season) compared to other quarters.

In addition, our comparable store sales have fluctuated significantly in the past, and we expect that they will continue to fluctuate in the future. A variety of factors affect comparable store sales, including fashion trends, competition, current economic conditions, the timing of release of new merchandise and promotional events, changes in our merchandise mix, the success of marketing programs and weather conditions. Our ability to deliver strong comparable store sales results and margins depends in large part on accurately forecasting demand and fashion trends, selecting effective marketing techniques, providing an appropriate mix of merchandise for our customer base, managing inventory effectively, and optimizing store performance by closing under-performing stores. Such fluctuations may adversely affect the market price of our common stock.

8. Our success depends on our ability to attract and retain key employees in order to support our existing businesses and future expansion. From time to time we actively recruit qualified candidates to fill key executive positions from within our company. There is substantial competition for experienced personnel, which we expect will continue. We compete for experienced personnel with companies who have greater financial resources than we do. In the past, we have experienced significant turnover of our executive management team and retail store personnel. We are also exposed to employment practice litigation due to the large number of employees and high turnover of our sales associates. If we fail to attract, motivate and retain qualified personnel, it could harm our business and limit our ability to expand.

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In addition, we depend upon the expertise and execution of our key employees, particularly: Steve Birkhold, our Chief Executive Officer and member of the Board of Directors. If we lose the services of Mr. Birkhold or any key officers or employees, it could harm our business and results of operations.

9. Because Manny Mashouf beneficially owns a substantial portion of the outstanding shares, other shareholders may not be able to influence the direction the company takes. As of January 31, 2014, Manny Mashouf, our founder and Chairman of the Board, beneficially owned approximately 59% of the outstanding shares of our common stock. As a result, he can control the election of directors and the outcome of all issues submitted to the shareholders. This may make it more difficult for a third party to acquire shares, may discourage acquisition bids, and could limit the price that certain investors might be willing to pay for shares of common stock. This concentration of stock ownership may have the effect of delaying, deferring or preventing a change in control of our company.

10. We rely on information technology, the disruption of which could adversely impact our business. We rely on various information systems to help manage our operations and regularly assess the cost-benefit analysis associated with making additional investments to upgrade, enhance or replace such systems. If at any time we do not have adequate systems in place, or should we experience any delays or difficulties in transitioning to these or other new systems, or in integrating these systems with our current systems, or we experience any other disruptions affecting our information systems, we could experience a material adverse impact on our business. Should we experience unauthorized access, disclosure or use of any of our systems, or if our security controls, computer assets and sensitive data, including client data, are breached, this could also damage our reputation with our clients. Further, with increased technology and other patent litigation hitting the industry, and especially given our reliance on our vendor's purported ownership of third party software we license, we face the potential of receiving claims that the technology we use or license infringes on another's proprietary rights. Should this occur, and while we may secure indemnification rights in certain transactions, we may be subject to having to defend ourselves from such claims and/or be subject to unanticipated license fees or the necessity to transition away from technology we are using or abandon such use altogether.

11. We are subject to risks associated with our e-commerce sales. We operate e-commerce stores at www.bebe.com and www.2bstores.com to sell our merchandise. Although our e-commerce sales encompass a relatively small percentage of our total sales, our e-commerce operations are subject to numerous risks, including unanticipated operating problems, reliance on third-party computer software providers and system failures. The e-commerce operations also involve other risks that could have an impact on our results of operations including but not limited to diversion of sales from our other stores, rapid technological change, liability for on-line content, credit card fraud and loss of sensitive data. We cannot assure that our e-commerce stores will continue to achieve sales and profitability growth or even remain at their current level.

12. We are subject to cyber-security risks and may incur increasing costs in an effort to minimize those risks and to respond to cyber incidents. There is an increased dependence on digital technologies by public companies and an increasing frequency and severity of cyber incidents. Our business involves the storage and transmission of customers' personal information, consumer preferences and credit card information. We also use mobile devices, social networking and other e-commerce activities to connect with our customers. We have a program in place to detect and respond to data security incidents. To date, all incidents we have experienced have been insignificant. If we experience a significant data security breach or fail to detect and appropriately respond to a significant data security breach, we could be exposed to government enforcement actions and private litigation. In addition, our customers could lose confidence in our ability to protect their personal information, which could cause them to discontinue usage of our clubbebe loyalty program, or stop shopping with us altogether. The loss of confidence from a significant data security breach involving team members could hurt our reputation, cause team member recruiting and retention challenges, increase our labor costs and affect how we operate our business.

13. Any serious disruption at our major facilities could have a harmful effect on our business. We currently operate a corporate office in Brisbane, California, a distribution facility in Benicia, California, and a design studio in Los Angeles, California. Any serious disruption at these facilities whether due to construction, relocation, fire, earthquake, terrorist acts or otherwise could harm our operations and could negatively affect our business and results of operations. Furthermore, we have little experience operating essential functions away from our main corporate offices

and are uncertain what effect operating such satellite facilities might have on business, personnel and results of operations.
14. Our business could be adversely impacted by unfavorable international political conditions. Due to our international operations, our sales and operating results are, and will continue to be, affected by international social, political, legal and economic conditions. In particular, our business could be adversely impacted by instability or changes resulting in the disruption of trade with the countries in which our contractors, suppliers or customers are located, significant fluctuations in the value of the dollar against foreign currencies or restrictions on the transfer of funds, or additional trade restrictions imposed by the United States and other foreign governments. Trade restrictions, including increased tariffs or quotas, embargoes and

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customs restrictions could increase the cost or reduce the supply of merchandise available to us and adversely affect our financial condition and results of operations. In addition, we purchase a substantial amount of our raw materials from China and our business and operating results may be affected by changes in the political, social or economic environment in China.

15. If we are not able to protect our intellectual property our ability to capitalize on the value of our brand name may be impaired. Even though we take actions to establish, register and protect our trademarks and other proprietary rights, we cannot assure you that we will be successful or that others will not imitate our products or infringe upon our intellectual property rights. In addition, we cannot assure that others will not resist or seek to block the sale of our products as infringements of their trademark and proprietary rights.

We are seeking to register our trademarks domestically and internationally. Obstacles may exist that may prevent us from obtaining a trademark for the bebe, BEBE SPORT, bbsp and 2b bebe names or related names. We may not be able to register certain trademarks, purchase the right or obtain a license to use these names or related names on commercially reasonable terms. If we fail to obtain trademark, ownership or license the requisite rights, it would limit our ability to expand. In some jurisdictions, despite successful registration of our trademarks, third parties may allege infringement and bring actions against us. In addition, if our licensees fail to use our intellectual property correctly, the reputation and value associated with our trademarks may be diluted. Furthermore, if we do not demonstrate use of our trademarks, our trademark rights may lapse over time.

16. If an independent manufacturer violates labor or other laws, or is accused of violating any such laws, or if their labor practices diverge from those generally accepted as ethical, it could harm our business and brand image. While we maintain a policy to monitor the operations of our independent manufacturers by having an independent firm inspect these manufacturing sites, and all manufacturers are contractually required to comply with such labor practices, we cannot control the actions or the public’s perceptions of such manufacturers, nor can we assure that these manufacturers will conduct their businesses using ethical or legal labor practices. Apparel companies, in certain conditions, may be held jointly liable for the wrongdoings of the manufacturers of their products. While we do not control our manufacturers’ employment conditions or business practices, and the manufacturers act in their own interest, they may act in a manner that results in negative public perceptions of us and/or employee allegations or court determinations that we are jointly liable.

17. We may be required to record losses in future quarters as a result of the decline in value of our investments in auction rates securities or as a result of a change in our ability to hold our investments in auction rate securities. We hold a variety of interest bearing ARS comprised of federally insured student loan backed securities and insured municipal authority bonds. These ARS investments are intended to provide liquidity via an auction process that resets the applicable interest rate at predetermined calendar intervals, allowing investors to either roll over their holdings or gain immediate liquidity by selling such interests at par. The recent uncertainties in the credit markets that began in February 2008 have affected our holdings in ARS investments and the majority of auctions for our investments in these securities have failed to settle on their respective settlement dates. Consequently, $11.1 million of our ARS are not currently liquid and we will not be able to access these funds until a future auction of these investments is successful or securities are purchased or redeemed outside of the auction process. Maturity dates for these ARS investments range from 2031 to 2033, with principal distributions occurring on certain securities prior to maturity. The valuation of our investment portfolio is subject to uncertainties that are difficult to predict. Factors that may impact its valuation include changes to credit ratings of the securities as well as to the underlying assets supporting those securities, rates of default of the underlying assets, underlying collateral value, discount rates and ongoing strength and quality of market credit and liquidity. If the current market conditions deteriorate further, or the anticipated recovery in market values does not occur, we may be required to record additional losses in other comprehensive income or losses in net income in future quarters.

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ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

Not applicable.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

Not applicable.

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

ITEM 5. OTHER INFORMATION

Not applicable.

ITEM 6. EXHIBITS

(a) Exhibits. The following is a list of exhibits filed as part of this Report on Form 10-Q.

| Exhibit | Description |
|---|---|
| 10.31 | Fifth Amendment to Credit Agreement and Revolving Line of Credit Note between Registrant and Wells Fargo dated February 5, 2014. |
| 31.1 | Section 302 Certification of Chief Executive Officer. |
| 31.2 | Section 302 Certification of Chief Financial Officer. |
| 32.1 | Section 906 Certification of Chief Executive Officer. |
| 32.2 | Section 906 Certification of Chief Financial Officer. |
| 101.INS | XBRL Instance Document |
| 101.SCH | XBRL Taxonomy Extension Schema |
| 101.CAL | XBRL Taxonomy Calculation Linkbase |
| 101.DEF | XBRL Taxonomy Extension Definition Linkbase |
| 101.LAB | XBRL Taxonomy Extension Label Linkbase |
| 101.PRE | XBRL Taxonomy Presentation Linkbase |

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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.

Date February 13, 2014

bebe stores, inc.

/s/ Liyuan Woo
Liyuan Woo, Chief Financial Officer and Principal
Accounting Officer

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