bebe stores, inc.
Form 10-Q
November 10, 2016
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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 October 1, 2016
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	94-2450490
(State or Jurisdiction of Incorporation or Organization)	(IRS Employer 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 ¨ No x
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 ¨
Non-accelerated filer ¨ (Do not check if a smaller reporting company)	Smaller reporting company x

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 October 31, 2016 was 80,079,919

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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 October 1, 2016	As of July 2, 2016	As of October 3, 2015
Assets:			
Current assets:			
Cash and equivalents	$47,278	$55,525	$26,542
Available for sale securities	—	—	15,454
Receivables	8,956	8,502	6,351
Inventories, net	28,321	28,736	34,931
Prepaid and other	11,493	10,498	13,830
Total current assets	96,048	103,261	97,108
Available for sale securities	—	—	5,290
Property and equipment, net	67,516	72,623	89,804
Other assets	3,448	3,561	3,861
Total assets	$167,012	$179,445	$196,063
Liabilities and Shareholders' Equity:			
Current liabilities:			
Accounts payable	$10,864	$11,263	$13,936
Accrued liabilities	17,905	21,510	25,588
Total current liabilities	28,769	32,773	39,524
Deferred rent and other lease incentives	16,927	17,983	22,300
Uncertain tax positions	85	85	82
Total liabilities	45,781	50,841	61,906
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 80,079,919, 80,051,155 and 79,871,705 shares	80	80	80
Additional paid-in capital	147,988	147,513	146,228
Accumulated other comprehensive income (loss)	659	728	(2,775)
Accumulated deficit	(27,496)	(19,717)	(9,376)
Total shareholders' equity	121,231	128,604	134,157
Total liabilities and shareholders' equity	$167,012	$179,445	$196,063

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	
	October 1, 2016	October 3, 2015
Net sales	$87,238	$96,283
Cost of sales, including production and occupancy	59,743	68,420
Gross margin	27,495	27,863
Selling, general and administrative expenses	35,720	44,890
Operating loss	(8,225)	(17,027)
Interest and other income (loss), net	14	(87)
Loss from operations, before income taxes	(8,211)	(17,114)
Income tax provision	17	27
Earnings in equity method investment	450	—
Net loss	$(7,778)	$(17,141)
Net loss per share amounts:		
Basic	$(0.10)	$(0.22)
Diluted	$(0.10)	$(0.22)
Basic weighted average shares outstanding	80,068	79,722
Diluted weighted average shares outstanding	80,068	79,722
Other comprehensive income (loss)		
Gain on available for sale securities	$—	$48
Foreign currency translation adjustments	69	(1,047)
Other comprehensive income (loss)	69	(999)
Comprehensive loss	$(7,709)	$(18,140)

See accompanying notes to condensed consolidated financial statements.

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

	Three Months Ended	
	October 1, 2016	October 3, 2015
Cash flows from operating activities:		
Net loss	$(7,778)	$(17,141)
Adjustments to reconcile net loss to cash used by operating activities:		
Non-cash compensation expense	472	725
Depreciation and amortization	4,268	4,510
Non-cash charge for asset impairment	764	1,517
Earnings in equity method investment	(450)	—
Cash receipt from equity method investment	600	—
Other	(91)	51
Changes in operating assets and liabilities:		
Receivables	(454)	765
Inventories	406	(3,645)
Prepaid expenses and other	(1,052)	(3,008)
Accounts payable	(312)	1,202
Deferred rent and other lease incentives	(1,047)	(1,570)
Accrued liabilities	(3,091)	(2,535)
Net cash used by operating activities	(7,765)	(19,129)
Cash flows from investing activities:		
Purchase of property and equipment and store construction deposits	(376)	(2,740)
Proceeds from sales of investment securities	—	1,509
Net cash used by investing activities	(376)	(1,231)
Cash flows from financing activities:		
Proceeds from issuance of common stock	3	4
Net cash provided by financing activities	3	4
Net decrease in cash and equivalents	(8,138)	(20,356)
Effect of exchange rate changes on cash	(109)	(49)
Cash and equivalents:		
Beginning of period	55,525	46,947
End of period	$47,278	$26,542

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 October 1, 2016 and October 3, 2015, the condensed consolidated statements of operations and comprehensive loss for the three months ended October 1, 2016 and October 3, 2015 and the condensed consolidated statements of cash flows for the three months ended October 1, 2016 and October 3, 2015 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 2, 2016.
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 2, 2016, 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 2, 2016.
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.

The Company has incurred net losses and cash used in operating activities in fiscal 2016, 2015 and 2014. Cash and equivalents were $55.5 million as of July 2, 2016. During the three months ended October 1, 2016, net loss and net cash used in operating activities were $7.8 million and $7.8 million, respectively. As a result, cash and equivalents were $47.3 million as of October 1, 2016.

We used $7.8 million, $38.6 million, $25.0 million and $30.3 million net of our cash in operating activities in the first quarter of fiscal 2017 and in the fiscal years 2016, 2015 and 2014 respectively. Our liquidity is dependent upon our ability to generate cash from operations along with usage of our existing cash and cash equivalents. Our strategic focus for the remainder of fiscal 2017 is to close unprofitable stores or negotiate rent reductions for stores with kickout rights or where the store lease is up for renewal. In addition, we continue to limit the size of the investment in inventory and capital expenditures. We are also expecting significant savings in selling, general and administrative expenses as compared with the prior year from the corporate restructuring activities which occurred in fiscal 2016 including headcount reductions. We believe our cash and equivalents, together with our cash flows from operations, will be sufficient to meet our operating and capital requirements for at least the next twelve months. Our future operating and capital requirements, however, will depend on numerous factors, including without limitation, investment costs for management information systems, potential investments and/or licensing arrangements, and future results of operations. The inability to generate positive cash flow from operations could have a material adverse effect on our business and financial conditions.
FISCAL YEAR
The Company’s fiscal year is a 52 or 53 week period, each period ending on the first Saturday on or after June 30. Fiscal years 2017 and 2016 both include 52 weeks.
The three month periods ended October 1, 2016 and October 3, 2015 each include 13 weeks.
RECENT ACCOUNTING PRONOUNCEMENTS

Stock Compensation
In March 2016, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2016-09, "Compensation - Stock Compensation (Topic 718)", which is part of the FASB's Simplification Initiative. The updated guidance simplifies the accounting for share-based payment transactions. The amended guidance is effective for fiscal years, and interim periods within those years, beginning with fiscal 2018, with early adoption permitted. The Company is currently evaluating the impact of the adoption of this standard on its

consolidated financial statements.

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Leases

In February 2016 the FASB issued ASU 2016-02, "Leases". This standard requires lessees to put most leases on their balance sheets as a right-to-use asset and a lease liability, but to continue to recognize expenses in the statements of operations in a manner similar to current accounting. The Company will adopt this standard at the beginning of fiscal year 2020 and is currently assessing the impact to the consolidated financial statements.

Revenue Recognition

In May 2014, the FASB issued ASU No. 2014-09, "Revenue from Contracts with Customers", or ASU 2014-09, which states that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. To achieve this, an entity will need to: identify the contract with a customer; identify the separate performance obligations in the contract; determine the transaction price; allocate the transaction price to the separate performance obligation in the contract; and recognize revenue when (or as) the entity satisfies each performance obligation. ASU No. 2014-09 will be effective beginning with fiscal year 2019. The Company is currently assessing its approach to the adoption of this standard and the impact on the results of operations and financial position.

Inventory

In July 2015, the FASB issued ASU No. 2015-11, "Simplifying the Measurement of Inventory". The new standard amends the guidelines for the measurement of inventory from lower of cost or market to the lower of cost and net realizable value (NRV). NRV is defined as the estimated selling prices in the ordinary course of business less reasonably predictable costs of completion, disposal and transportation. Under existing standards, inventory is measured at lower of cost or market, which requires the consideration of replacement cost, NRV and NRV less an amount that approximates a normal profit margin. This ASU eliminates the requirement to determine and consider replacement cost or NRV less an approximately normal profit margin for inventory measurement. The new standard is effective prospectively at the beginning of fiscal year 2018. The Company is currently evaluating the impact, if any, of adopting this new accounting guidance on its results of operations and financial position.

INVESTMENTS

As of October 1, 2016, the Company held no investments in auction rate securities nor any other marketable securities. As of October 3, 2015, the Company's investment portfolio consisted of certificates of deposit and auction rate securities. The Company held short term available for sale securities totaling $15.5 million as of October 3, 2015, that consisted entirely of certificates of deposit at cost which approximates fair value. The Company also held long term available for sale securities at fair value totaling $5.3 million as of October 3, 2015, that consisted entirely of interest bearing auction rate securities ("ARS").

The Company held interest bearing ARS consisting of federally insured student loan backed securities. As of October 3, 2015, the Company's ARS portfolio totaled approximately $9.0 million and was classified as available for sale securities, net of a temporary impairment charge of $3.7 million. As of that date, the Company's ARS portfolio consisted of approximately 22% A rated investments and 78% CCC rated investments. The Company's ARS were sold during the third quarter of fiscal 2016.

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 Company had no available for sale securities as of October 1, 2016. The following is a summary of our available for sale securities as of October 3, 2015:

	Cost	Unrealized Losses Less Than 12 Months	Unrealized Losses 12 Months or Greater	Estimated Fair Value
	(In thousands)			
Short term certificates of deposit	$15,454	$ —	$ —	$ 15,454

Long term auction rate securities	$9,000	$ —	$ 3,710	$ 5,290

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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 October 1, 2016, the Company held financial instruments that are measured at fair value on a recurring basis. These included cash equivalents consisting of money market funds.

The Company determined the estimated fair value of its investment in ARS as of October 3, 2015 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 +5.64%), interest rates (weighted average of 0.2%), 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 October 1, 2016:

Description	October 1, 2016	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	$ 236	$ 236	$ —	$ —
Total	$ 236	$ 236	$ —	$ —

The following items are measured at fair value on a recurring basis as of July 2, 2016:

Description	July 2, 2016	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	$ 236	$ 236	$ —	$ —
Total	$ 236	$ 236	$ —	$ —

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The following items are measured at fair value on a recurring basis as of October 3, 2015:

Description	October 3, 2015	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	$ 426	$ 426	$ —	$ —
Current available for sale securities	15,454	—	15,454	—
Long term auction rate securities	5,290	—	—	5,290
Total	$ 21,170	$ 426	$ 15,454	$ 5,290

An impairment charge was recorded in accumulated other comprehensive income that reduced the carrying amount of the applicable non-current assets of $9.0 million to their fair value of $5.3 million as of October 3, 2015.

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 October 1, 2016 and October 3, 2015, the Company recorded impairment charges of approximately $0.8 million and $1.5 million, respectively, related to under-performing stores.

The following table presents the Company’s considerations of at-risk assets for the three month periods ended October 1, 2016 and October 3, 2015, respectively:

	Three Months Ended October 1, 2016	October 3, 2015
	(dollar amounts in millions)	
Number of stores identified as at risk and evaluated for impairment	7	11
Number of stores identified as at risk, but not impaired	(3)	(5)
Number of stores identified as at risk with impairment	4	6
Total carrying amount of stores identified as at risk prior to any impairment charges taken	$1.7	$ 2.3
Total carrying amount of stores identified as at risk, but not impaired	(0.9)	(0.8)
Total carrying amount of stores identified for impairment	0.8	1.5
Impairment charges recorded during the period	$0.8	$ 1.5

The fair market value of these assets was determined using the income approach and Level 3 inputs, which require 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 0.0% – 5.0%). The stores not impaired had undiscounted cash flows that exceeded their net carrying amount at a weighted average of 126% for the three month period ended October 1, 2016. For the three months ended October 3, 2015, the stores not impaired had undiscounted cash flows that exceeded their net carrying amount at a weighted average of 52%.

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.

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INVENTORIES

The Company's inventories consisted of:

	As of October 1, 2016	July 2, 2016	October 3, 2015
	(In thousands)		
Raw materials	$717	$903	$773
Merchandise available for sale	27,604	27,833	34,158
Inventories, net	$28,321	$28,736	$34,931

CREDIT FACILITIES

On May 14, 2014, the Company entered into a secured stand-by letter of credit agreement which provides for issuance of one or more stand-by letters of credit. As of October 1, 2016, the Company had $5.0 million outstanding, related to four stand-by letters of credit and $0.2 million outstanding related to one commercial letter of credit. To date, no beneficiary has drawn upon any stand-by letter of credit.

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 October 1, 2016, 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 tax benefit related to the current quarter losses is not recognized. 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 (LOSS) PER SHARE

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

There is no difference between the number of shares used in the basic and diluted earnings per share computations. Excluded from the computation of the number of diluted weighted average shares outstanding were options to purchase 2,368,874 and 3,799,152 shares of common stock for the three months ended October 1, 2016 and October 3, 2015, respectively, which would have been anti-dilutive.

STOCK BASED COMPENSATION

The following table summarizes the stock based compensation expense recognized under the Company's stock plan during the three months ended October 1, 2016 and October 3, 2015:

	Three Months Ended	
	October 1, 2016	October 3, 2015
	(In thousands)	
Stock options	$ 86	$ 336
Nonvested stock awards/units	386	389
Total stock based compensation expense	$ 472	$ 725

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Unrecognized compensation cost related to nonvested stock options and nonvested stock awards/units totaled approximately $0.0 million and $0.8 million, respectively, as of October 1, 2016. This cost is expected to be recognized over a weighted average period of 1.0 years and 2.1 years respectively.

LEGAL PROCEEDINGS

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

A former employee filed a complaint against the Company on November 2, 2010, in the Superior Court of California, San Bernardino County (Case No. CIVRS1011823) alleging failure to pay wages, failure to provide meal and rest periods, and other violations of the California Labor Code and Business & Professions Code §17200 et. seq. The plaintiff purported to bring the action on behalf of current and former California bebe stylists and sales associates who are similarly situated. The complaint sought damages, civil penalties, and injunctive relief among other remedies. The Company continues to defend itself against the claims. The parties are conducting discovery. The trial date is set for April 10, 2017. The Company is unable to estimate an amount or range of any reasonably possible losses.

A customer served the Company with a complaint on January 31, 2014, in the United States District Court for the Northern District of California (Civil Action No. C14-267 DMR) alleging various 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.) stemming from an alleged failure to obtain customer consent prior to sending text messages. The plaintiff purported to bring the action on behalf of others similarly situated. The complaint sought damages and injunctive relief among other remedies. The parties are conducting discovery. There is no trial date set. The Company continues to defend itself against the claims. The Company is unable to estimate an amount or range of any reasonably possible losses. A companion proceeding, previously reported, in the United States District Court for the Northern District of California (Civil Action No. 3:14-CV-01968)) was consolidated with this action.

The Company is subject to various other legal proceedings and claims arising in the ordinary course of business. Regarding all matters referenced herein, the Company intends to defend itself vigorously and has accrued estimated amounts of liability where required, appropriate and determinable. Any such estimates may be revised as further information becomes available. The results of any litigation are inherently uncertain and as such the Company cannot assure that it will be able to successfully defend itself in these lawsuits nor that any amounts accrued are sufficient. The Company believes that the legal proceedings referenced herein, as well as the amounts accrued as of this filing, either individually or in the aggregate, will not have a material adverse effect on our business, financial condition or results of operations.

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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 design, develop and produce a distinctive line of contemporary women's apparel and accessories that is unique, sophisticated and timelessly sexy. Today bebe continues to define next-generation chic while staying true to its assertive, provocative origins. Inspired by Shakespeare's immortal words "To be, or not to be", the brand is, at its essence, about living, standing out and truly existing.

Our distinctive product offering includes a full range of separates, tops, dresses, active wear and accessories to satisfy our customers' every day wardrobe needs for a variety of occasions. We design and develop the majority of our merchandise in-house, which is manufactured to our specifications. However, we also source directly from third-party manufacturers. In fiscal 2017, we began to start selling co-branded and third-party labeled product as well, although we expect the majority of our product to continue to have the bebe brand. We also sell licensed product through a strategic partnership.

We market our products under the bebe and BEBE SPORT brand names through our 182 retail stores, of which 144 are bebe stores, including an on-line store at www.bebe.com, and 38 are bebe outlet stores. Our 82 international licensees operated stores in 23 countries and, pursuant to our product licensing arrangements, through certain select domestic and international retailers. During the three months ended October 1, 2016, we closed 3 bebe stores and 1 outlet store. Continuing our previous efforts to rightsize our store fleet, we anticipate closing up to 24 stores during the remainder of fiscal 2017.

bebe. We were founded by Manny Mashouf, our Chief Executive Officer and Chairman of the Board. We opened our first store in San Francisco, California in 1976, which was also the year we incorporated in California. As of October 1, 2016, we operated 143 bebe stores in 31 states, Puerto Rico, Canada and on-line. www.bebe.com is our bebe on-line 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.

bebe outlet. Our bebe outlet stores are an extension of the full-price bebe store and provide everyday lifestyle offerings for our aspirational buyers. As of October 1, 2016, we operated a total of 38 bebe outlet stores.

Strategic partnership During the fourth quarter of fiscal 2016, we entered into a strategic joint venture arrangement with Bluestar Alliance LLC (Bluestar). Under this partnership, bebe contributed all of its trademarks, trademark license arrangements (described in the next paragraph) and related intellectual property, including certain domain names, to a newly formed joint venture (the Joint Venture) and received just over 50% ownership interest in the joint venture. Bluestar contributed $35 million to the newly formed joint venture that was then paid to bebe and received just under 50% ownership interest in the joint venture. Bluestar will leverage its existing brand management organization and infrastructure to develop a wholesale domestic and international lifestyle licensing business for the joint venture and will manage its day-to-day operations. During fiscal 2017 and in future years, the Joint Venture will aggressively pursue a licensing strategy designed to capitalize on the value of our brand in all categories and channels on a global scale. We expect the Joint Venture to generate long-term, committed royalties from prospective licensees of the bebe brand name. In connection with this initiative, bebe retained a royalty-free perpetual license to utilize the bebe brand and trademarks within the United States, including its territories and possessions, and Canada which enables us to continue our existing business.

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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 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 2, 2016. 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 on or after June 30. Both fiscal 2017 and fiscal 2016 include 52 weeks. The three months ended October 1, 2016 and October 3, 2015 include 13 weeks respectively.

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

	Three Months Ended	
	October 1, 2016	October 3, 2015
Net sales	100.0 %	100.0 %
Cost of sales, including production and occupancy (1)	68.5	71.1
Gross margin	31.5	28.9
Selling, general and administrative expenses (2)	40.9	46.6
Operating loss	(9.4)	(17.7)
Interest and other income (loss), net	—	(0.1)
Loss from operations before income taxes	(9.4)	(17.8)
Income tax provision	—	0.1
Earnings in equity method investment	0.5	—
Net loss	(8.9)%	(17.8)%

(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 $87.2 million during the three months ended October 1, 2016 from $96.3 million for the comparable period of the prior year, a decrease of $9.0 million, or 9.4%. The decrease in net sales was primarily due to the effects of negative comparable store sales in the first quarter of fiscal 2017 compared with the same period in the prior year. Comparable store sales for the quarter ended October 1, 2016 decreased 3.2% compared to a decrease of 4.1% in the first quarter of the prior fiscal year coupled with a reduction in total number of stores. The decrease in comparable store sales was primarily the result of decreased store traffic.

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	Three Months Ended	
	October 1, 2016	October 3, 2015
Net sales (In thousands)	$87,238	$96,283
Net sales (decrease) percentage	(9.4)%	(5.7)%
Comparable store percentage (1)	(3.2)%	(4.1)%
Net sales per average square foot (2)	$89	$92
Square footage at end of period (in thousands)	711	787
Number of store locations:		
Beginning of period	186	201
New store locations	—	1
Closed store locations	4	1
Number of stores open at end of period	182	201

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(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. For the three months ended October 1, 2016 and October 3, 2015, the inclusion of our e-commerce store sales increased the comparable store sales 2.5% and 3.5%, 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 $27.5 million during the three months ended October 1, 2016 from $27.9 million for the comparable period of the prior year, a decrease of $0.4 million, or 1.3%. As a percentage of net sales, gross margin increased to 31.5% for the three months ended October 1, 2016 from 28.9% in the comparable period of the prior year. The increase in gross margin as a percentage of net sales was primarily due to the effect of lower promotional activity and improved occupancy leverage during the quarter.

Selling, General and Administrative Expenses. Selling, general and administrative expenses decreased to $35.7 million during the three months ended October 1, 2016 from $44.9 million for the comparable period of the prior year, a decrease of $9.2 million, or 20.4%. As a percentage of net sales, selling, general and administrative expenses decreased to 40.9% during the three months ended October 1, 2016 from 46.6% in the comparable period of the prior year. The decrease in selling, general and administrative expenses in the first quarter of fiscal 2017 was primarily driven by the effects of severance charges of $2.2 million incurred during the first quarter of fiscal 2016 and higher impairment charges and professional fees in that same quarter. The first quarter of fiscal 2017 also benefited from reduced compensation expense reflecting the effects of the workforce reductions that occurred in fiscal 2016.

Provision for Income Taxes. The tax rate for the first quarter of fiscal 2017 was (0.2)% compared to (0.2)% for the comparable period of the prior year. The current quarter effective tax rate reflects the continuing impact of maintaining a valuation allowance against net deferred tax assets. Therefore, our effective tax rate for both fiscal year 2017 and 2016 continues to approximate 0%.

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 or for any other fiscal quarter.

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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 October 1, 2016, we had approximately $47.3 million of cash and equivalents on hand.

As of October 1, 2016, all cash and equivalents were 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 three months ended October 1, 2016 was $7.8 million compared to net cash used by operating activities of $19.1 million for the three months ended October 3, 2015. The decrease in cash usage of $11.4 million from the comparable period was primarily the result of the decrease in net loss for the three months ended October 1, 2016 as compared to the same period in the prior year. The decrease of $3.2 million