

BEBE STORES INC  
Form 10-Q  
November 09, 2006

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

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

**For the quarterly period ended September 30, 2006**

**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  
(State or Jurisdiction of  
Incorporation or Organization)**

**94-2450490  
(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  
Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer (as defined in

Rule 12b-2 if the Securities Exchange Act).

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

The number of shares of registrant's common stock, par value \$0.001 per share, outstanding as of October 30, 2006 was 92,737,623

**bebe stores, inc.**  
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**Table of Contents****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 September 30, 2006	As of July 1, 2006	As of October 1, 2005
<b>Assets:</b>			
Current assets:			
Cash and equivalents	\$ 50,391	\$ 38,656	\$ 31,479
Short-term marketable securities	292,414	289,015	253,632
Receivables (net of allowance of \$935, \$897 and \$912)	8,704	5,682	8,029
Inventories	53,427	42,151	39,638
Prepaid and other	11,211	13,802	13,170
Total current assets	416,147	389,306	345,948
Property and equipment, net	96,643	95,022	78,349
Other assets	17,210	16,581	8,899
Total assets	\$ 530,000	\$ 500,909	\$ 433,196
<b>Liabilities and Shareholders Equity:</b>			
Current liabilities:			
Accounts payable	\$ 28,821	\$ 22,947	\$ 25,575
Accrued liabilities	26,672	35,841	27,369
Current portion of capital leases	237	249	168
Total current liabilities	55,730	59,037	53,112
Long term portion of capital leases	205	260	184
Deferred rent and other lease incentives	37,293	33,388	32,912
Total liabilities	93,228	92,685	86,208
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 92,621,101, 91,744,090 and 91,206,371 shares	93	92	91
Additional paid-in capital	108,523	95,768	83,606
Accumulated other comprehensive income	2,411	2,418	1,676
Retained earnings	325,745	309,946	261,615

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Total shareholders' equity	436,772	408,224	346,988
Total liabilities and shareholders' equity	\$ 530,000	\$ 500,909	\$ 433,196

See accompanying notes to condensed consolidated financial statements.

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**bebe stores, inc.**  
**CONDENSED CONSOLIDATED STATEMENTS OF INCOME**  
(In thousands, except per share data)  
(unaudited)

	Quarters Ended	
	September 30, 2006	October 1, 2005
Net sales	\$ 157,059	\$ 126,155
Cost of sales, including production and occupancy	77,773	63,952
Gross margin	79,286	62,203
Selling, general and administrative expenses	50,290	42,249
Income from operations	28,996	19,954
Interest and other income, net	3,173	2,115
Income before income taxes	32,169	22,069
Provision for income taxes	11,742	8,496
Net income	\$ 20,427	\$ 13,573
Basic earnings per share	\$ 0.22	\$ 0.15
Diluted earnings per share	\$ 0.22	\$ 0.14
Basic weighted average shares outstanding	91,980	91,147
Diluted weighted average shares outstanding	94,398	94,159

See accompanying notes to condensed consolidated financial statements.

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

	<b>Quarters Ended</b>	
	<b>September 30, 2006</b>	<b>October 1, 2005</b>
Cash flows from operating activities:		
Net income	\$ 20,427	\$ 13,573
Adjustments to reconcile net income to cash provided by operating activities:		
Non-cash compensation expense	2,364	2,309
Depreciation and amortization	4,271	3,769
Net loss on disposal of property		1
Deferred rent and other lease incentives	3,910	2,687
Deferred income taxes	(621)	(504)
Changes in operating assets and liabilities:		
Receivables	(1,675)	(915)
Inventories	(11,273)	(8,053)
Prepaid expenses and other assets	2,516	(803)
Accounts payable	5,874	4,889
Accrued liabilities	(2,754)	4,628
Net cash provided by operating activities	23,039	21,581
Cash flows from investing activities:		
Purchase of property and equipment	(7,664)	(4,950)
Purchase of marketable securities	(69,375)	(82,702)
Proceeds from sales of marketable securities	65,975	72,901
Net cash used by investing activities	(11,064)	(14,751)
Cash flows from financing activities:		
Net proceeds from issuance of common stock	5,853	551
Excess tax benefit on options exercised	4,538	256
Cash dividends paid	(9,216)	(3,648)
Other	(67)	(41)
Net cash provided (used) by financing activities	1,108	(2,882)
Net increase in cash and equivalents	13,083	3,948
Effect of exchange rate changes on cash	(1,348)	459
Cash and equivalents:		
Beginning of period	38,656	27,072

End of period	\$ 50,391	\$ 31,479
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See accompanying notes to condensed consolidated financial statements.

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**Table of Contents****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 September 30, 2006, July 1, 2006, and October 1, 2005, and the condensed consolidated statements of income and cash flows for the quarters ended September 30, 2006 and October 1, 2005 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 and footnotes 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 our Annual Report on Form 10-K for the year ended July 1, 2006.

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 earnings for the periods presented have been included. The condensed consolidated balance sheet at July 1, 2006, presented herein, was derived from the audited balance sheet included in the Form 10-K for the fiscal year ended July 1, 2006.

Our business is affected by the pattern of seasonality common to most retail apparel businesses. The results for the current and prior periods are not necessarily indicative of future financial results.

**FISCAL YEAR**

Our fiscal year is a 52 or 53 week period, each period ending on the first Saturday after June 30. The quarterly periods ending September 30, 2006 and October 1, 2005 both include 13 weeks.

**INVENTORIES**

The Company's inventories consist of:

	<b>September 30, 2006</b>	<b>As of July 1, 2006 (In thousands)</b>	<b>October 1, 2005</b>
Raw materials	\$ 11,442	\$ 10,417	\$ 6,417
Merchandise available for sale	41,985	31,734	33,221
Inventories	\$ 53,427	\$ 42,151	\$ 39,638

**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.

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

	<b>Quarters Ended</b>	
	<b>September 30, 2006</b>	<b>October 1, 2005</b>
	<b>(In thousands)</b>	
Basic weighted average number of shares outstanding	91,980	91,147
Incremental shares from the assumed issuance of stock options	2,418	3,012
Diluted weighted average number of shares outstanding	94,398	94,159

The number of incremental shares from the assumed issuance of stock options is calculated applying the treasury stock method.

Excluded from the computation of the number of diluted weighted average shares outstanding were antidilutive options of approximately 1,445,000 and 917,000, for the quarters ended September 30, 2006 and October 1, 2005, respectively.

**COMPREHENSIVE INCOME**

Comprehensive income consists of net income and other comprehensive income (income, expenses, gains and losses that bypass the income statement and are reported directly as a separate component of equity). The Company's comprehensive income consists of net income and foreign currency translation adjustments for all periods presented.

	<b>Quarters Ended</b>	
	<b>September 30, 2006</b>	<b>October 1, 2005</b>
	<b>(In thousands)</b>	
Net income	\$ 20,427	\$ 13,573
Other comprehensive income (loss)	(7)	705
Total comprehensive income	\$ 20,420	\$ 14,278

**CREDIT FACILITIES**

The Company has an unsecured commercial line of credit agreement with a bank, which provides for borrowings and issuance of letters of credit up to a combined total of \$25.0 million and expires on March 31, 2009. The outstanding balance bears interest at either the bank's reference rate (which was 8.25% as of September 30, 2006) or the LIBOR rate plus 1.75 percentage points. As of September 30, 2006, there were no outstanding cash borrowings, and there was \$9.8 million outstanding in letters of credit.

This credit facility requires the Company to comply with certain financial covenants, including amounts for minimum tangible net worth, unencumbered liquid assets and profitability, and certain restrictions on making loans and investments.

**STOCK BASED COMPENSATION**

The 1997 Stock Plan as amended (the "Stock Plan") provides for the grant of incentive stock options, non-qualified stock options, stock purchase rights, stock awards and restricted stock units. Although the Stock Plan allows for stock options and related awards to be granted at prices below fair market value, the Company has historically granted such options at the fair market value of the stock on the date of grant. Stock options and related awards have a maximum term of ten years. Options and restricted stock granted to employees and options granted to Directors generally vest over four years with 20% of the award vested in each of the first and second years, and 30% vested in



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each of the remaining two years. Restricted stock units awarded to Directors generally vest over a period of one year from the date of grant. As of September 30, 2006, the Company has reserved 19,613,750 shares of common stock for issuance under the Stock Plan and there were 1,063,799 shares available for future grant.

Effective July 3, 2005, the Company adopted the fair value recognition provisions of FASB Statement No. 123(R), Share-Based Payment, using the modified prospective transition method. Under this transition method, compensation cost in 2006 includes the portion vesting in the period for (1) all share-based payments granted prior to, but not vested as of July 2, 2005, based on the grant date fair value estimated in accordance with the original provisions of FASB Statement No. 123 and (2) all share-based payments granted subsequent to July 2, 2005, based on the grant date fair value estimated in accordance with the provisions of FASB Statement No. 123(R).

The Company recognized share-based compensation expense of \$2.4 million (\$0.02 per diluted share, after related tax benefit of \$0.9 million) and \$2.3 million (\$0.02 per diluted share, after related tax benefit of \$0.9 million) in the quarters ended September 30, 2006 and October 1, 2005, respectively, as a component of selling, general and administrative expenses. As of September 30, 2006, there was \$17.6 million (before any related tax benefit) of total unrecognized compensation cost related to nonvested share-based compensation that is expected to be recognized over a weighted-average period of 2.3 years.

The fair value of each option grant was estimated on the date of the grant using the Black-Scholes valuation model. The expected life of the options represents the period of time the options are expected to be outstanding and is based on historical trends. The expected stock price volatility is based on an average of the historical volatility of the Company's stock for a period approximating the expected life and the implied volatility based on traded options of the Company's stock. The expected dividend yield is based on the Company's most recent annual dividend payout. The risk-free interest rate is based on the U.S. Treasury yield curve in effect at the time of grant and has a term that approximates the expected life.

The following table presents the weighted-average assumptions used in the option pricing model for the first quarter 2007 and 2006 stock option grants.

	Quarters Ended	
	September 30, 2006	October 1, 2005
Expected dividend rate	0.8%	0.9%
Volatility	49.5%	54.5%
Risk-free interest rate	4.7%	4.0%
Expected lives (years)	4.1	4.4
Fair value per option granted	\$8.85	\$8.35

The following table summarizes stock option activity during the quarter ended September 30, 2006:

	Options (In thousands)	Weighted Average Exercise Price Per Share	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value (In thousands)
Outstanding, July 1, 2006	7,350	\$ 9.59		
Granted	617	21.18		
Exercised	(873)	6.66		
Cancelled	(112)	14.13		
Outstanding, September 30, 2006	6,982	\$ 10.90	7.43	\$ 97,036

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Exercisable, September 30, 2006	2,855	\$ 7.94	6.38	\$ 48,114
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Intrinsic value for stock options is defined as the difference between the current market value and the grant price. During the quarter ended September 30, 2006, the total intrinsic value of stock options exercised was \$13.2 million. Cash received from stock options exercised during the quarter was \$5.8 million and the actual tax benefit realized for tax deductions from stock options exercised totaled \$4.8 million.

The following table summarizes restricted stock unit activity during the quarter ended September 30, 2006:

	Shares (In thousands)	Weighted Average Grant Date Fair Value Per Share
Nonvested, July 1, 2006	31	\$ 15.24
Granted	17	\$ 20.60
Vested	(2)	\$ 17.58
Nonvested, September 30, 2006	46	\$ 17.15

**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 on April 28, 2005 in the United States District Court for the Northern District of California (case No. C050177) alleging violations under the Fair Labor Standards Act, specifically that the Company obligated her to buy and wear its brand clothing as a uniform, without reimbursement or credit, and the net effect of deducting the value of such required purchases from her wages would often result in her not being paid minimum wages. The plaintiff purports to bring the action also on behalf of a class of hourly, non-managerial employees who are similarly situated. The lawsuit seeks compensatory, statutory and injunctive relief. The Company has negotiated a confidential settlement in this case and has accrued an amount that management believes reasonably estimates the potential liability, which did not have a material impact on the Company's financial position or results of operations.

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. The Company believes that the claims are without merit, however it is reviewing the allegations at this early stage.

In addition to the above, the Company is also involved in various other legal proceedings arising in the normal course of business. None of these matters are expected, individually or in the aggregate, to have a material adverse effect on the Company's business, financial condition or results of operations.

The Company intends to defend itself vigorously against 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, the Company has recorded an estimate of potential liabilities that management believes are reasonable. Any estimates are revised as further information becomes available.

**RECENT ACCOUNTING PRONOUNCEMENTS**

In June 2006, the FASB issued Interpretation No. 48 ( FIN 48 ), Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 . FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes*. FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and



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measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company is in the process of determining the impact that the adoption of FIN 48 will have on its financial position and results of operations.

In June 2006, the FASB ratified the consensus reached by the Emerging Issues Task Force in Issue No. 06-3, *How Taxes Collected from Customers and Remitted to Governmental Authorities Should be Presented in the Income Statement (That is, Gross Versus Net Presentation)*. Issue No. 06-3 requires disclosure of an entity's accounting policy regarding the presentation of taxes assessed by a governmental authority that are directly imposed on a revenue-producing transaction between a seller and a customer, including sales, use, value added and some excise taxes. We present such taxes on a net basis (excluded from revenues and costs). The adoption of Issue No. 06-3, which is effective for interim and annual reporting periods beginning after December 15, 2006, will have no impact on the Company's consolidated financial statements.



**Table of Contents****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*, *estimate*, *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, miscalculation of the demand for our products, effective management of our growth, decline in comparable store sales performance, ongoing competitive pressures in the apparel industry, changes in the level of consumer spending or preferences in apparel, our ability to attract and retain key management personnel and/or other factors discussed in *Risks That May Affect Results* and elsewhere in this Form 10-Q.

**OVERVIEW**

We design, develop and produce a distinctive line of contemporary women's apparel and accessories. While we attract a broad audience, our target customer is a 21 to 35-year-old woman who seeks current fashion trends to suit her lifestyle. The *bebe* look, appeals to a hip, sexy, sophisticated, body-conscious woman who takes pride in her appearance. 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 in the following lifestyle categories: career, evening, casual, and active. 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*, *COLLECTION bebe*, *Neda by bebe*, *Neda*, *BEBE SPORT* and *bebe O* brand names through our 248 retail stores, of which 184 are *bebe* stores, 43 are *BEBE SPORT* stores, 20 are *bebe* outlet stores and 1 is a *Neda by bebe* store. These stores are located in 32 states, the District of Columbia, Puerto Rico and Canada. In addition, we have an on-line store at [www.bebe.com](http://www.bebe.com) and our licensees operate 14 international stores. During the first quarter of fiscal 2007, we opened 6 stores, including 1 *bebe* store, 4 *BEBE SPORT* stores and 1 *Neda by bebe* store and we did not close any stores. We expect to open approximately 50 stores, including approximately 28 *bebe* stores, 21 *BEBE SPORT* stores and 1 *Neda by bebe* store during the year. We also plan to renovate 12 existing stores, relocate or expand 9 existing stores and close approximately 3 stores, resulting in square footage growth of approximately 18%.

*bebe*. The Company was founded by Manny Mashouf, Chairman of the Board. We opened our first store in San Francisco, California in 1976, which was also the year we incorporated.

*BEBE SPORT*. The Company launched *BEBE SPORT* during fiscal 2003 to address the performance and active lifestyle needs of the *bebe* customer.

*bebe outlets*. The Company utilizes the outlets as a clearance vehicle for merchandise from our retail stores. In addition, the inventory includes a strong presentation of *bebe* logo merchandise and special cuts produced under the *bebe O* label exclusively for the outlet stores.

*On-line*. *bebe.com* is an extension of the *bebe* store experience and provides a complete assortment of *bebe* and *BEBE SPORT* merchandise. It is also used as an advertising vehicle to communicate with our customers.

*Neda by bebe*. In September 2006, the Company opened its first *Neda by bebe* store, a new accessory concept featuring shoes and a unique selection of fine leather goods and gift items. This boutique concept features shoes imported primarily from Italy including both branded and private label. Additionally, products manufactured under the *Neda by bebe* label will be carried in select *bebe* stores.

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*COLLECTION bebe*. In March 2006, bebe introduced COLLECTION bebe, the exclusive runway collection of better priced contemporary women's apparel. We launched our first assortment of COLLECTION bebe in 20 stores in September 2006 and plan to make the second collection available in select stores in March 2007.

**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. These accounting policies and estimates are constantly reevaluated, and adjustments are made when facts and circumstances dictate a change. Our accounting policies are more fully described in Note 1 to the consolidated financial statements in our annual report on Form 10-K for the year ended July 1, 2006.

We have identified certain critical accounting policies, which are described below:

*Revenue recognition.* We recognize revenue at the time the products are received by the customers in accordance with the provisions of Staff Accounting Bulletin (SAB) No. 101, Revenue Recognition in Financial Statements as amended by SAB No. 104, Revenue Recognition. Revenue is recognized for store sales at the point at which the customer receives and pays for the merchandise at the register with either cash or credit card. For online sales, revenue is recognized at the time the customer receives the product. We estimate and defer revenue and the related product costs for shipments that are in transit to the customer. Customers typically receive goods within one week of shipment. Amounts related to shipping billed to customers are reflected in net sales and the related costs are reflected in cost of goods sold.

We record a reserve for estimated product returns based on historical return trends. As of September 30, 2006 and October 1, 2005, the reserve was \$1,148,000 and \$868,000, respectively. If actual returns are greater than those projected, additional sales returns may be recorded in the future.

Discounts offered to customers consist primarily of point of sale markdowns and are recorded at the time of the related sale as a reduction of revenue.

The value of points and rewards earned by our loyalty program members is included as a liability and a reduction of revenue at the time the points and rewards are earned based on historical conversion and redemption rates. The associated revenue is recognized when the rewards are redeemed or expire.

Gift certificates sold are carried as a liability and revenue is recognized when the gift certificate is redeemed. Similarly, customers may receive a store credit in exchange for returned goods. Store credits are carried as a liability until redeemed.

Royalty revenue from product licensees is recorded as earned, which is based on the licensees' sales.

*Stock Based Compensation.* We account for stock options and awards issued to employees in accordance with the fair value recognition provisions of Financial Accounting Standards Board (FASB) Statement No. 123(R) (SFAS No. 123(R)), Share-Based Payment, using the modified prospective transition method. Under SFAS No. 123(R), stock-based awards to employees are required to be recognized as compensation expense, based on the calculated fair value on the date of grant. We determine the fair value using the Black Scholes option pricing model. This model requires subjective assumptions, including future stock price volatility and expected term, which affect the calculated values.

*Inventories.* Our inventories are stated at the lower of weighted average cost or market. Market is determined based on the estimated net realizable value, which is generally the merchandise selling price. To ensure that our raw material is properly valued we age the fabric inventory and record a reserve in accordance with our established policy, which is based on historical experience. To ensure our finished goods inventory is properly valued we review the age and turnover of our inventory and record a reserve if the selling price is marked down below cost. These assumptions can have an impact on current and future operating results and financial position. We estimate shrinkage for the period

between the last physical count and balance sheet date based on historic shrinkage trends.

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*Long-lived assets.* We review long-lived assets for impairment whenever events or changes in circumstances, such as store closures or poor performing stores, indicate that the carrying value of an asset may not be recoverable. If the undiscounted cash flows from the long-lived assets are less than the carrying value we record an impairment charge equal to the difference between the carrying value and the asset's fair value. In addition, at the time a decision is made to close a store, we record an impairment charge, if appropriate, or accelerate depreciation over the revised useful life of the asset. Historically, our impairment charges have been immaterial. During the quarters ended September 30, 2006 and October 1, 2005 we recorded \$0 and \$73,000, respectively, of impairment charges. We believe at this time that the long-lived assets' carrying values and useful lives continue to be appropriate.

*Accrued Litigation.* We accrue estimates of probable liabilities associated with lawsuits and claims. The results of any litigation are inherently uncertain. As information becomes available, we assess the potential liabilities related to pending litigation and may revise our estimates as necessary. Such revisions of estimates could materially impact the results of operations and financial position.

*Self-Insurance.* We use a combination of insurance and self insurance for employee related health care benefits. We record self insurance liabilities based on claims filed and an estimate of those claims incurred but not reported. Any projection of losses concerning our liability is subject to a high degree of variability. Among the causes of this variability are unpredictable external factors such as future inflation rates, changes in severity, benefit level changes, medical costs and claim settlement patterns. Should a different amount of claims occur compared to what was estimated or costs of the claims increase or decrease beyond what was anticipated, reserves may need to be adjusted in the future.

*Income Taxes.* We accrue liabilities for estimates of probable settlements of domestic and foreign tax audits. At any one time, many tax years may be subject to audit by various taxing jurisdictions. The results of these audits and negotiations with taxing authorities may affect the ultimate settlement of these issues. Our effective tax rate in a given financial statement period may be materially impacted by changes in the mix and level of earnings. We also record a valuation allowance against a portion of our deferred tax assets arising from foreign tax credit carryforwards as the utilization of these credits is not assured.

**RECENT ACCOUNTING PRONOUNCEMENTS**

In June 2006, the FASB issued Interpretation No. 48 ( FIN 48 ), Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 . FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes*. FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition. FIN 48 is effective for fiscal years beginning after December 15, 2006. The Company is in the process of determining the impact that the adoption of FIN 48 will have on its financial position and results of operations.

In June 2006, the FASB ratified the consensus reached by the Emerging Issues Task Force in Issue No. 06-3, How Taxes Collected from Customers and Remitted to Governmental Authorities Should be Presented in the Income Statement (That is, Gross Versus Net Presentation). Issue No. 06-3 requires disclosure of an entity's accounting policy regarding the presentation of taxes assessed by a governmental authority that are directly imposed on a revenue-producing transaction between a seller and a customer, including sales, use, value added and some excise taxes. We present such taxes on a net basis (excluded from revenues and costs). The adoption of Issue No. 06-3, which is effective for interim and annual reporting periods beginning after December 15, 2006, will have no impact on the Company's consolidated financial statements.

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Our fiscal year is a 52 or 53 week period, each period ending on the first Saturday after June 30. The quarterly periods ending September 30, 2006 and October 1, 2005 both include 13 weeks.

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

	<b>Quarters Ended</b>	
	<b>September 30, 2006</b>	<b>October 1, 2005</b>
<b>Statements of Operations Data:</b>		
Net sales	100.0%	100.0%
Cost of sales, including production and occupancy (1)	49.5	50.7
Gross margin	50.5	49.3
Selling, general and administrative expenses (2)	32.0	33.5
Income from operations	18.5	15.8
Interest and other income, net	2.0	1.7
Income before income taxes	20.5	17.5
Provision for income taxes	7.5	6.7
Net income	13.0%	10.8%

(1) Cost of sales includes the cost of merchandise, occupancy costs, distribution center 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 increased to \$157.1 million during the quarter ended September 30, 2006 from \$126.2 million for the quarter ended October 1, 2005, an increase of \$30.9 million, or 24.5%. During the quarter an increase in

comparable store sales of 12.8% versus the prior year contributed \$14.5 million to the increase in sales. The remaining increase in sales of \$16.4 million was generated by stores not included in the comparable store sales base and increases over the same period of the prior year in on-line sales and wholesale sales to international licensees.

	<b>Quarter Ended</b>	
	<b>September 30, 2006</b>	<b>October 1, 2005</b>
Net sales (In thousands)	\$ 157,059	\$ 126,155
Total net sales increase percentage	24.5%	22.4%
Comparable store sales increase percentage	12.8%	17.3%
Net sales per average square foot (1)	\$ 176	\$ 162
Square footage at end of period (In thousands)	898	784
Number of store locations:		
Beginning of period	242	214
New store locations	6	7
Closed store locations	0	1
Number of stores open at end of period	248	220

(1) Net sales per average square foot is calculated using net store sales and a monthly average store square footage.

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*Gross Margin.* Gross margin increased to \$79.3 million during the quarter ended September 30, 2006 from \$62.2 million for the quarter ended October 1, 2005, an increase of \$17.1 million, or 27.5%. As a percentage of net sales, gross margin increased to 50.5% for the quarter ended September 30, 2006 from 49.3% in the quarter ended October 1, 2005. The increase in gross margin as a percentage of net sales resulted primarily from higher merchandise margins due to a higher initial mark up and lower markdowns sold.

*Selling, General and Administrative Expenses.* Selling, general and administrative expenses, which primarily consist of non-occupancy store costs, corporate overhead and advertising costs, increased to \$50.3 million during the quarter ended September 30, 2006 from \$42.2 million in the quarter ended October 1, 2005, an increase of \$8.1 million, or 19.2%. As a percentage of net sales, these expenses decreased to 32.0% during the quarter from 33.5% in the comparable period of the prior year. The decrease as a percent of net sales is primarily due to a decrease in advertising expenses and lower variable expenses.

*Interest and Other Income, Net.* We generated approximately \$3.2 million of interest and other income (net of other expenses) during the quarter ended September 30, 2006 as compared to approximately \$2.1 million in the quarter ended October 1, 2005. The increase in interest income is primarily a result of higher average cash balances.

*Provision for Income Taxes.* The effective tax rate decreased to 36.5% for the quarter ended September 30, 2006 from 38.5% for the quarter ended October 1, 2005, primarily due to an increase in tax exempt interest income.

**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 its 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 in the first and second fiscal quarters. At September 30, 2006, we had approximately \$342.8 million of cash and equivalents and short-term marketable securities on hand. In addition, we had a revolving line of credit under which we could borrow or issue letters of credit up to a combined total of \$25.0 million. As of September 30, 2006, there were no cash borrowings outstanding under the line of credit and letters of credit outstanding totaled \$9.8 million.

Net cash provided by operating activities for the quarter ended September 30, 2006 was \$23.0 million. Cash provided by operating activities for the period was primarily generated by earnings adjusted for stock compensation, depreciation and deferred rent, as well as changes in working capital. The changes in working capital are primarily an increase in accounts payable and a decrease in prepaid expenses, primarily due to the timing of payments, offset by an increase in inventory due in preparation for the fall and holiday selling seasons and a decrease in accrued liabilities, also due to the timing of payments.

Net cash used by investing activities for the quarter ended September 30, 2006 was \$11.1 million due to the purchase of marketable securities and capital expenditures, primarily related to the opening of new stores. We opened six new stores in the first quarter of fiscal 2007 and expect to open a total of approximately 50 stores during fiscal 2007. We estimate that total capital expenditures will be approximately \$50 million in fiscal 2007.

Net cash provided by financing activities was \$1.1 million for the quarter ended September 30, 2006 and resulting from proceeds received from stock option exercises and the resulting tax benefit, partially offset by the payment of two (for the fourth quarter of fiscal 2006 and for the first quarter of fiscal 2007) cash dividends on our common stock.

We believe that our cash on hand, together with our cash flows from operations, 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, the size and number of new and expanded stores and/or store concepts,

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investment costs for management information systems, potential acquisitions and/or joint ventures, dividend payments, repurchase of stock and future results of operations.

**Inflation**

We do not believe that inflation has had a material effect on the results of operations in the recent past. However, we cannot assure that our business will not be affected by inflation in the future.

**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 and short-term marketable securities. Marketable securities are comprised of closed-end variable interest rate funds that invest primarily in tax-exempt municipal bonds. Due to the variable nature of these investments, their value is typically not subject to market rate changes. 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 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 marketable securities if the original maturity is between three months and twelve months, or long-term marketable securities if the original maturity is greater than twelve months. Auction rate securities have stated maturities beyond one year but are priced and traded as short-term instruments due to the liquidity provided through the interest rate reset mechanism and are classified as short-term when they represent investments of cash that are intended for use in current operations.

The following table lists our cash equivalents and short-term marketable securities at September 30, 2006:

	Book Value	Fair Value
	(Dollars in thousands)	
Cash equivalents	\$ 30,490	\$ 30,490
Weighted average interest rate (1)	2.38%	
Short-term marketable securities	292,414	292,414
Weighted average interest rate (1)	3.69%	
<b>Total</b>	<b>\$322,904</b>	<b>\$322,904</b>

(1) Represents the weighted average interest rates for tax exempt municipal bonds, municipal preferreds, corporate preferreds and taxable and tax exempt institutional money market



instruments.

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

*Foreign Currency Risks*

We enter into a significant amount of purchase obligations outside of the United States, substantially all of which are settled in U.S. Dollars and, therefore, have only minimal exposure to foreign currency exchange risks. We also operate a

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subsidiary for which the functional currency is the Canadian Dollar. Fluctuations in exchange rates therefore impact our financial condition and results of operations, as reported in U.S. Dollars. To date, we have not experienced any significant negative impact as a result of fluctuations in foreign currency markets. We do not hedge against foreign currency risks and believe that foreign currency exchange risk is immaterial.

**ITEM 4. CONTROLS AND PROCEDURES**

(a) 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.

(b) There has been no change in our internal control over financial reporting during the quarter ended September 30, 2006 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

**PART II OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS**

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 on April 28, 2005 in the United States District Court for the Northern District of California (case No. C050177) alleging violations under the Fair Labor Standards Act, specifically that the Company obligated her to buy and wear its brand clothing as a uniform, without reimbursement or credit, and the net effect of deducting the value of such required purchases from her wages would often result in her not being paid minimum wages. The plaintiff purports to bring the action also on behalf of a class of hourly, non-managerial employees who are similarly situated. The lawsuit seeks compensatory, statutory and injunctive relief. The Company has negotiated a confidential settlement in this case and has accrued an amount that management believes reasonably estimates the potential liability, which did not have a material impact on the Company's financial position or results of operations.

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. The Company believes that the claims are without merit, however it is reviewing the allegations at this early stage.

In addition to the above, the Company is also involved in various other legal proceedings arising in the normal course of business. None of these matters are expected, individually or in the aggregate, to have a material adverse effect on the Company's business, financial condition or results of operations.

The Company intends to defend itself vigorously against 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, the Company has recorded an estimate of potential liabilities that management believes are reasonable. Any estimates are revised as further information becomes available.

**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.

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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. Other than revisions to risk factors numbered three and four under the heading **Risks Relating to our Business**, which have been updated to reflect recent developments, 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 1, 2006.

**RISKS RELATING TO OUR BUSINESS:**

**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 consumer demands and fashion trends will adversely affect our sales.

**2. If we are unable to obtain raw materials, 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 may be negatively impacted.

**3. Our success depends on our ability to attract and retain key employees in order to support our existing business and future expansion.** From time to time we actively recruit qualified candidates to fill key executive positions from within the 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.

In addition, we depend on the expertise and execution of our key employees, particularly Manny Mashouf, our founder and Chairman of the Board, and Gregory Scott, our Chief Executive Officer and member of the Board of Directors. If we lose the services of Mr. Mashouf or Mr. Scott, or any key officers or employees, it could harm our business and results of operations. Proceedings have been commenced for dissolution of the marriage of Manny and Neda Mashouf and on November 8, 2006, Neda Mashouf resigned from the Company and from our Board of Directors. We previously identified Neda Mashouf as a key employee. The loss of Ms. Mashouf could have an adverse effect on our operations and as a result, our business could suffer.

**4. If we are not able to successfully develop new concepts, including BEBE SPORT, our revenue base and earnings may be impaired.** We believe that there is opportunity to expand the number of BEBE SPORT stores in new and existing markets while we continue to address the product assortment. If these stores are not successful, our financial condition may be harmed. In addition, from time to time, we may pursue other new concepts. For example, we opened the first Neda by bebe store, our boutique accessory concept, in the first quarter of fiscal 2007.

**5. There can be no assurance that future store openings will be successful and new store openings may impact existing stores.** We expect to open approximately 50 stores in fiscal 2007, of which approximately 28 will be bebe stores,

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approximately 21 will be BEBE SPORT stores and 1 will be a Neda by bebe store. In the past, we have closed stores as a result of poor performance, and there can be no assurance that the stores that we plan to open in fiscal 2007, 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 2006 we closed three stores and during fiscal 2007, we anticipate closing three stores. For fiscal 2007, we plan to grow our operations primarily through the opening of new stores. Most of our new store openings in fiscal 2007 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 results of operations.

**6. We are subject to risks associated with our online sales.** We operate an on-line store at [www.bebe.com](http://www.bebe.com) to sell our merchandise. Although our online sales encompass a relatively small percentage of our total sales, our on-line operations are subject to numerous risks, including unanticipated operating problems, reliance on third-party computer hardware and software providers, system failures and the need to invest in additional computer systems. The on-line 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 online content, credit card fraud, risks related to the failure of the computer systems that operate the website and its related support systems. In addition, given our use of a third party platform, we do not have direct control of certain aspects of our on-line business. There can be no assurance that our on-line store will continue to achieve sales and profitability growth or even remain at its current level.

**7. 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 and production facility in Los Angeles, California. Any serious disruption at these facilities whether due to construction, relocation, fire, earthquake, terrorist acts or otherwise would harm our operations and could have a harmful effect on 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.

**8. We rely on information technology, the disruption of which could adversely impact our business.** We rely on various information systems to manage our operations and regularly make investments to upgrade, enhance or replace such systems. To support our growth we initiated a three year IS&T strategic plan and we are currently in year two of this plan. In year one we completed the upgrade of our infrastructure, began the implementation of our new production management system, implemented Arthur planning, completed the conversion of our web site to a third party platform and the roll out of clubbebe. We went live with the first phase of our production management system in October 2006 and plan to be fully operational within 12 months. In addition to improving the preproduction and design processes, we should significantly improve our ability to manage the flow of paper and streamline the process. For years two and three, we have begun the process of identifying partners to replace our current point of sale system and implement a new human resources system. After both of these systems have been chosen and the implementation process has begun we will begin to evaluate our merchandising system needs. Any delays or difficulties in transitioning to new systems, or in integrating them with our current systems, or any other disruptions affecting any of our information systems, could have a material adverse impact on our business, financial condition and results of operations.

**9. 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, 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 greater financial, distribution and marketing resources

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than we do, 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.

**10. Purchases of the merchandise we sell are generally discretionary and are therefore particularly susceptible to economic conditions.** The outlook for the United States economy is uncertain and is directly affected by global factors that are beyond our control. Such factors include disposable consumer income, oil prices, recession and fears of recession, war and fears of war, terrorist attacks, inclement weather, consumer debt, interest rates, sales tax rates, consumer confidence in future economic conditions and political conditions, and consumer perceptions of personal well-being and security. Consumers are generally more willing to make discretionary purchases, including purchases of fashion products, during periods in which favorable economic conditions prevail. If economic conditions change, our business, financial condition and results of operations could be adversely affected. We cannot predict the indirect effects such as rising oil and freight prices, consumer spending or other economic factors that natural disasters will have on our results of operations.

**11. 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 customs restrictions could increase the cost or reduce the supply of merchandise available to the company and adversely affect its 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.

**12. If we are not able to successfully 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, there is no assurance 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 name or related names. We may not be able to register certain trademarks, purchase the right or obtain a license to use the bebe name 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.

**13. 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 can be held jointly liable for the wrongdoings of the manufacturers of their products. While we do not control their employees' employment conditions or the manufacturers' 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.

**RISKS RELATING TO OUR COMMON STOCK:**

**1. Our stock price may fluctuate because of the relatively low number of shares that can be publicly traded.** The vast majority of our outstanding shares of our common stock are subject to trading restrictions. As of September 30, 2006, approximately 26,000,000 shares, of the total outstanding 93,000,000 shares, of our





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common stock were available to be publicly traded, and as a result, our stock price is vulnerable to market swings due to large purchases, sales and short sales of our common stock.

**2. 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.

**3. Because Manny Mashouf and Neda Mashouf beneficially own 72% of the outstanding shares, other shareholders may not be able to influence the direction the company takes.** As of October 5, 2006, Manny Mashouf, the Chairman of the Board, and Neda Mashouf beneficially owned approximately 72% of the outstanding shares of our common stock. As a result, they 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.

**4. Failure to comply with Section 404 of the Sarbanes-Oxley Act of 2002 could negatively impact investor confidence.** In order to meet the requirements of the Sarbanes-Oxley Act of 2002 in future periods, we must continuously document, test, monitor and enhance our internal control over financial reporting. There can be no assurance that the periodic evaluation of our internal controls required by Section 404 of the Sarbanes-Oxley Act will not result in the identification of significant control deficiencies and/or material weaknesses or that our auditors will be able to attest to the effectiveness of our internal control over financial reporting. Failure to maintain the effectiveness of our internal control over financial reporting or to comply with the requirements of this Act could have a material adverse effect on our reputation, financial condition and market price of our common stock.

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

Not applicable.

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

Not applicable.

**ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

Not applicable.

**ITEM 5. OTHER INFORMATION**

On November 8, 2006, Neda Mashouf resigned from our Board of Directors and has declined to stand for re-election at the 2006 annual meeting of shareholders. Ms. Mashouf had served as the Vice Chairman of our Board. Ms. Mashouf advised the Company that her resignation was not the result of a disagreement with the Company on any matter relating to the Company's operations, policies or practices. The Board of Directors has not substituted another candidate for election as director at the 2006 annual meeting.

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**ITEM 6. EXHIBITS**

(a) Exhibits.

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

Exhibit Number	Description
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.

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**SIGNATURE**

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

Dated November 9, 2006

bebe stores, inc.

/s/ Walter Parks

Walter Parks, Chief Financial Officer

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**EXHIBIT INDEX**

Exhibit Number	Description
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