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SHOE PAVILION INC
Form 10-K
March 30, 2001

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

[X] ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES
EXCHANGE ACT OF 1934.

For the fiscal year ended December 30, 2000

Commission File Number 0-23669

SHOE PAVILION, INC.

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction
of incorporation or organization)

94-3289691
(IRS Employer
Identification Number)

3200-F Regatta Boulevard, Richmond,
California
(Address of principal executive
offices)

94804
(Zip Code)

Telephone Number: (510) 970-9775

Securities Registered Pursuant to Section 12(b) of the Act:

| Title of each class ----- | Name of each exchange on which registered ----- |
|------------------------------|---|
| None | None |

Securities Registered Pursuant to Section 12(g) of the Act:

Common Stock

(Title of Class)

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K ((S) 229.405 of this chapter) is not contained herein,

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and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. []

At March 19, 2001 the aggregate market value of the registrant's Common Stock held by non-affiliates of the registrant was approximately \$3,737,500.

At March 19, 2001 the number of shares outstanding of registrant's Common Stock was 6,800,000.

DOCUMENTS INCORPORATED BY REFERENCE

Definitive Proxy Statement for the Company's 2000 Annual Meeting of Stockholders--Part III of this Form 10-K.

Shoe Pavilion, Inc.
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For the year ended December 30, 2000

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PART I

Item 1--Business

General

Shoe Pavilion, Inc. is the largest independent off-price footwear retailer on the West Coast that offers a broad selection of women's and men's designer label and name brand merchandise. The Company was among the first footwear

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retailers on the West Coast to expand the off-price concept into the designer and name brand footwear market. As of December 30, 2000 the Company operated 80 retail stores in California, Washington, Oregon and Oklahoma, of which 79 operated under the trade name Shoe Pavilion. In addition, as of December 30, 2000, the Company operated the shoe department of 36 Gordmans, Inc. (formerly Richman Gordman 1/2 Price Stores, Inc.) department stores in Colorado, Illinois, Iowa, Kansas, Missouri, Nebraska, Oklahoma and South Dakota under a licensing agreement entered into in July 1999.

The Company offers quality designer and name brand footwear such as Clarks, Dexter, Fila, Florsheim, Naturalizer, Nickles and Rockport, typically at 30% to 70% below regular department store prices for the same shoes. Such price discounts appeal to value-oriented consumers seeking quality brand name footwear not typically found at other off-price retailers or mass merchandisers. The Company is able to offer lower prices by (i) selectively purchasing large blocks of production over-runs, over-orders, mid- and late-season deliveries and last season's stock from manufacturers and other retailers at significant discounts, (ii) sourcing in-season name brand and branded design merchandise directly from factories in Italy, Brazil, China and Spain and (iii) negotiating favorable prices with manufacturers by ordering merchandise during off-peak production periods and taking delivery at its central warehouse in Richmond, California. During 2000, the Company purchased footwear merchandise from over 100 domestic and international vendors, independent resellers, manufacturers and other retailers that frequently have excess inventory for sale.

The Company's stores utilize a self-service format that allows inventory to be stored directly under a displayed shoe, thereby eliminating the need for a stockroom and significantly increasing retail floor space. The functionality and simplicity of this format enable flexible store layouts that can be easily reconfigured to accommodate a new mix of merchandise. Moreover, this format allows customers to locate all available sizes of a particular shoe and to try them on for comfort and fit without a salesperson's assistance, thereby reducing in-store staffing needs and allowing customers to make independent, rapid purchasing decisions.

Shoe Pavilion is a standardized concept that offers a bright, clean, low maintenance and functional shopping environment to customers interested in purchasing quality men's and women's value priced footwear. The Company's stores are strategically located in strip malls, outlet centers and downtown locations, frequently in close proximity to other off-price apparel retailers that attract similar customers. Shoe Pavilion stores average approximately 8,000 square feet and offer between 5,000 and 41,000 pairs of shoes, while the Gordmans licensed shoe departments average approximately 3,100 square feet and offer between 5,000 and 10,000 pairs of shoes. The Company opened, net of closures, 5 stores (including 3 Gordmans' shoe departments) in 2000, 42 stores (including 33 Gordmans' shoe departments) in 1999, and 14 stores in 1998. During 2001, the Company intends to open 2 to 4 new stores, including licensed shoe departments, primarily in its existing markets. It also expects to close 2 to 4 stores in 2001.

The Company was incorporated in Delaware in November 1997 and is the successor to Shoe Pavilion Corporation (formerly Shoe Inn, Inc.), which was incorporated in Washington in 1983. The Company's executive offices are located at 3200-F Regatta Boulevard, Richmond, California 94804, and its telephone number is (510) 970-9775.

Operating Strategy

The Company's objective is to be the leading off-price retailer of designer label and name brand footwear in each of the markets it serves. The operating strategy is designed to allow the Company to offer its customers

quality footwear typically at 30% to 70% below department store prices for the same shoes. The following summarizes key elements of the Company's operating strategy:

- . Off-Price Concept, Premium Name Brands. The Company differentiates itself from other off-price retailers and deep discount chains by focusing on higher price point merchandise, extending the off-price concept into the designer and name brand footwear market. As a result, the Company generally does not compete with other discount stores in obtaining the majority of its merchandise. Similarly, while some department store and brand name retail chains operate discount outlets, such operations generally obtain merchandise from existing inventory of their retail affiliates rather than from external sources. Some of the Company's most successful stores have benefited from the heightened consumer awareness and preference to shop at discount malls or outlet centers, both of which typically include other off-price retailers.
- . Broad Selection of Designer Footwear. The Company offers a broad selection of quality footwear from over 75 name brands such as Skechers, New Balance, BCBG, Naturalizer, Hush Puppy, Fila and Dexter. The availability and wide variety of premium brand names distinguish Shoe Pavilion and serve to attract first time buyers and consumers who otherwise might shop at more expensive department stores. The wide variety of brand names also enables the Company to tailor its merchandise from store to store to accommodate consumer preferences that may vary by location.
- . Selective Bulk Purchases; Diverse Vendor Network. The Company is able to offer lower prices by selectively purchasing large blocks of over-runs, over-orders, mid- and late-season deliveries and last season's stock from over 100 domestic and international vendors, independent resellers, manufacturers and other retailers at significant discounts. The diversity and scope of its vendor network help to provide a constant source of quality merchandise, and the purchase of name brand, traditional styles helps to mitigate the likelihood of inventory writedowns. To augment available merchandise with the latest in-season styles, the Company purchases branded design footwear directly from factories in Italy, Brazil, China and Spain.
- . Self-Service Stores. The Company believes that the self-service format reinforces its off-price strategy and appeals to value-oriented consumers. The Company's format allows inventory to be stored directly under a displayed shoe, thereby eliminating the need for a stockroom and significantly increasing retail floor space. The functionality and simplicity of this format enable flexible store layouts that can be easily rearranged to complement the current merchandise. Moreover, this format allows customers to locate all available sizes of a particular shoe and to try them on for comfort and fit without a salesperson's assistance, thereby reducing in-store staffing needs and allowing customers to make independent, rapid purchasing decisions.

Growth Strategy

Since opening its first store in 1979 in Washington, the Company has expanded to 116 stores, including 36 licensed shoe departments, in eleven states. The Company intends to continue to expand by opening new stores and enhancing comparable store sales.

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- . Continue New Store Openings. The Company intends to increase its presence in its current markets and to enter new markets by selectively opening new stores, which can be served by the Company's business support and distribution infrastructure. When entering a new market, the Company prefers to open multiple stores, thereby creating an immediate market presence and enabling television advertising costs to be spread economically across a number of stores. The Company opened 7 stores and 3 licensed shoe departments in 2000, 17 stores and 33 licensed shoe department locations in 1999, and 16 stores in 1998. The Company closed 5 stores in 2000, 8 stores in 1999, and 2 stores in 1998. During 2001, the Company intends to open 2 to 4 new stores, including licensed shoe departments, primarily in its existing markets. Management believes that new store openings in the Company's current markets will further increase name recognition, which, in turn, will facilitate expansion into new markets.

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- . Increase Comparable Store Sales. During 2000, the Company achieved an increase of 9.4% in comparable store sales after experiencing a 1.2% downturn in 1999 and a 6.1% increase in 1998. Management intends to focus on achieving historical same store growth rates through a continuing refinement of its store locations and merchandise selection.

The Company's ability to execute its operating and growth strategy is subject to numerous risks and uncertainties. There can be no assurance that the Company will be successful in implementing its strategy or that its strategy, even if implemented, will lead to successful achievement of the Company's objectives.

Merchandising

Unlike deep-discount retailers, Shoe Pavilion offers high quality merchandise and a consistent selection of name brand dress and casual shoes for men and women. List prices generally range between \$19.99 and \$69.99 for women's shoes, and between \$39.99 and \$99.99 for men's shoes. The principal categories of footwear offered by Shoe Pavilion stores, and selected brands for each, are summarized in the following table:

| Women's | Men's | Athletic |
|--------------|------------|-------------|
| BCBG | Airwalk | Adidas |
| Caressa | Bass | Avia |
| Esprit | Dexter | Converse |
| Hush Puppies | Lugz | Fila |
| Life Stride | Nunn Bush | New Balance |
| Naturalizer | Rockport | Nike |
| Nickles | Skechers | Reebok |
| Rockport | Timberland | Saucony |

Site Selection, Opening Costs and Leases

The Company uses an exclusive broker on the West Coast to identify potential retail sites as well as possible acquisition candidates. Before entering a new market, management reviews detailed reports on demographics; spending, traffic, and consumption patterns; and other site and market related data. As of December 30, 2000, 46 of the Company's stores were located in strip malls, 11

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were located in outlet centers, 10 were located in free standing stores and 13 were located in other types of facilities.

In July 1999, the Company entered into a license agreement to operate 33 shoe departments at Gordmans, Inc., a Midwest name brand family apparel, accessories and home fashions off-price retailer. All of the shoe departments are located within Gordmans department stores, which are primarily located in strip centers or free standing locations. Because there are no leasehold improvement or equipment requirements and licensed shoe departments average approximately one-half the size of Company stores, opening costs are substantially less than Shoe Pavilion stores. Opening costs for licensed shoe departments are primarily for fixtures and inventory, and average \$125,000, consisting of approximately \$25,000 for fixtures and \$100,000 for inventory.

Opening costs for stores are typically minimal, excluding the initial stocking of inventory. The Company estimates that its total cash requirements to open a typical new store average \$400,000, consisting of approximately \$90,000 for fixtures, equipment and leasehold improvements; \$300,000 for inventory; and the balance for working capital needs. Costs vary from store to store depending on, among other things, the location, size, property condition, and the tenant improvement package offered by the landlord. The Company has been able to renegotiate some of its existing leases to be more heavily revenue-based. The Company does not own any of its real estate.

The Company actively monitors individual store performance and closes underperforming stores, including five stores in 2000, eight stores in 1999 and two stores in 1998. The relatively small investment required to open new stores affords the Company the flexibility to close stores more quickly than other retailers. During

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2001, the Company expects to close two to four stores. See "Item 7--Management's Discussion and Analysis of Financial Condition and Results of Operations--Factors Affecting Financial Performance--Risks Associated with Expansion."

Sourcing And Purchasing

Vendors. During 2000, the Company purchased its inventory from over 100 domestic and international vendors, independent resellers and other retailers who have over bought merchandise. In 2000, the Company's top ten suppliers accounted for approximately 32% of its inventory purchases. No vendor accounted for more than 10% of total inventory purchases in 2000. The Company purchases from its suppliers on an order-by-order basis and has no long-term purchase contracts or other contractual assurances of continued supply or pricing. Since the Company has locations in a number of markets along the West Coast and the Midwest, Shoe Pavilion can accommodate and distribute a wide variety of merchandise that meets the needs of customers in different geographic areas. Management believes that the strength and variety of its supplier network mitigates much of the Company's exposure to inventory supply risks. See "Item 7--Management's Discussion and Analysis of Financial Condition and Results of Operations--Factors Affecting Financial Performance--Inventory and Sourcing Risk."

Direct Sourcing. The Company purchases in-season name brand and branded design merchandise directly from factories in Italy, Brazil, China and Spain. These purchases include both labeled and non-labeled goods and provide a consistent source of in-season merchandise. Directly sourced goods accounted for approximately 13.4% and 10.8% of the Company's net sales in 2000 and 1999 respectively. The Company purchases from its manufacturing sources on an order-

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by-order basis and has no long-term purchase contracts or other contractual assurances of continued supply or pricing. See "Item 7--Management's Discussion and Analysis of Financial Condition and Results of Operations--Factors Affecting Financial Performance--International Purchasing."

Marketing

The Company believes that television advertising benefits all stores in a common viewing market. In 2000 the Company spent approximately 4.7% of net sales, or \$4.3 million, net of vendor contributions. In 1999, the amount was approximately 3.3% of net sales, or \$2.4 million, net of vendor contributions. In 1998 the amount was 5.4% of net sales, or \$3.0 million without any vendor contributions. The Company believes that advertising costs for a particular market will be more effectively and economically leveraged as the number of stores increases in that market. The Company occasionally uses print advertising, usually at the time of a new store opening; however, it has found print advertising to be less effective than television advertising. Shoe Pavilion's signage is consistent at all of its locations, with highly visible signage at the front and, when appropriate, rear of the store.

Merchandise Distribution

The Company operates a 92,000 square foot distribution facility located in Richmond, California. This distribution facility also houses the Company's executive and administrative headquarters. Vendors ship all products to this central distribution center where the merchandise is inspected, verified against the original purchase order, ticketed and repackaged for shipment to stores. The Company believes that this facility can accommodate the Company's planned growth for the foreseeable future.

Information Systems

During 1999, the Company completed an upgrade of its information systems on an enterprise-wide basis, including all critical areas of corporate office, network infrastructure and point of sale (POS). This fully integrated upgrade, uses an IBM AS 400 that is reliable and scalable, allowing simple upgrades of processing power as the business grows. In addition, the corporate network infrastructure was upgraded to a Windows NT

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environment with standardized workstations and a common set of desktop applications that may be used throughout the Company. This upgrade provided a stable networking environment as well as a foundation for future growth. As of January 1, 2000, the Company had incurred approximately \$2.8 million in total costs for implementing these new systems. These costs include approximately \$800,000 for equipment, which is being leased by the Company over 36 to 60 months. No additional implementation costs were incurred in 2000.

Competition

The retail footwear market is highly competitive, and the Company expects the level of competition to increase. The Company competes with off-price and discount retailers (e.g., Nordstrom Rack, Payless ShoeSource, Ross Dress for Less and Famous Footwear), branded retail outlets (e.g., Nine West), national retail stores (e.g., Nordstrom, Marshalls, Macy's, Sears, J.C. Penney, Loehmann's, Robinsons-May and Mervyn's), traditional shoe stores and mass merchants. Many of these competitors have stores in the markets in which the Company now operates and in which it plans to expand.

Employees

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As of December 30, 2000, the Company had approximately 326 full-time employees and 402 part-time employees. The number of part-time employees fluctuates depending upon seasonal needs. The Company's 22 warehouse employees in Richmond, CA are represented by Local 315, International Brotherhood of Teamsters. In December 1998, the Company signed a collective bargaining agreement with Local 315 that terminates on January 31, 2002. The Company generally considers its relationship with its employees to be good.

Executive Officers

Certain information regarding the executive officers of the Company is set forth below:

| Name ---- | Age --- | Position ----- |
|-----------------------|------------|---|
| Dmitry Beinus..... | 48 | Chairman of the Board and Chief Executive Officer |
| Robert R. Hall..... | 48 | Vice President and Chief Operating Officer |
| John D. Hellmann..... | 50 | Vice President of Finance, Chief Financial Officer, and Secretary |

Dmitry Beinus has served as Chairman of the Board, President and Chief Executive Officer of the Company since founding the Company in 1979. From 1976 to 1978, Mr. Beinus was employed in the shoe department of Nordstrom, Inc.

Robert R. Hall has served as Vice President and Chief Operating Officer of the Company since January 1997. Mr. Hall joined the Company as a Regional Manager in 1990, and has held various positions within the Company including Operations Manager and Vice President of Merchandising.

John D. Hellmann has served as Vice President of Finance and Chief Financial Officer of the Company since June 2000. From September 1995 until June 2000, Mr. Hellmann served as Vice President and Chief Financial Officer of The Lamaur Corporation, a manufacturer and wholesaler of hair care products. Mr. Hellmann is a Certified Public Accountant.

The Company's executive officers serve at the discretion of the Board of Directors. There is no family relationship between any of the Company's executive officers or between any executive officer and any of the Company's directors.

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Item 2--Properties

The Company's corporate offices and distribution facility are located in a 92,000 square foot facility in Richmond, California, which the Company occupies under a lease expiring in 2002. As of December 30, 2000 the Company's 80 stores occupied an aggregate of approximately 649,000 square feet of space. The 36 licensed shoe departments had an aggregate of 110,000 square feet of space as of December 30, 2000. The Company leases all of its stores, with leases expiring between 2001 and 2010. The Company has options to renew most of its leases.

Store Locations

As of December 30, 2000, the Company operated 80 retail stores in the states

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of California, Washington, Oregon and Oklahoma and 36 licensed shoe departments in Colorado, Illinois, Iowa, Kansas, Missouri, Nebraska, Oklahoma and South Dakota. The number of stores in each geographic area is set forth below:

| Location ----- | Stores at Year End | | | | |
|--------------------------|--------------------|------|------|------|------|
| | 2000 | 1999 | 1998 | 1997 | 1996 |
| Northern California..... | 32 | 31 | 27 | 24 | 22 |
| Southern California..... | 33 | 30 | 25 | 16 | 4 |
| Nevada..... | 0 | 0 | 0 | 1 | 1 |
| Oregon..... | 4 | 4 | 4 | 2 | 2 |
| Washington..... | 10 | 13 | 13 | 12 | 12 |
| Oklahoma..... | 1 | 0 | 0 | 0 | 0 |
| Total..... | 80 | 78 | 69 | 55 | 41 |

| Location ----- | Licensed Shoe Departments | |
|-------------------|------------------------------|------|
| | 2000 | 1999 |
| Colorado..... | 3 | 3 |
| Illinois..... | 3 | 1 |
| Iowa..... | 7 | 6 |
| Kansas..... | 5 | 5 |
| Missouri..... | 7 | 7 |
| Nebraska..... | 8 | 8 |
| Oklahoma..... | 2 | 2 |
| South Dakota..... | 1 | 1 |
| Total..... | 36 | 33 |

Item 3--Legal Proceedings

The Company is not a party to any material pending legal proceedings.

Item 4--Submission of Matters to a Vote of Security Holders

Inapplicable.

PART II

Item 5--Market for the Registrant's Common Equity and Related Stockholder Matters

The common stock of the Company has been traded on the Nasdaq National Market(R) under the symbol SHOE since the Company's initial public offering on

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February 23, 1998. The following table sets forth, for the periods indicated, the highest and lowest closing sale prices for the common stock, as reported by the Nasdaq National Market (R).

| | High | Low |
|---------------------|------|------|
| | ---- | ---- |
| 2000 | | |
| First Quarter..... | 2.72 | 1.75 |
| Second Quarter..... | 2.38 | 1.50 |
| Third Quarter..... | 3.38 | 2.00 |
| Fourth Quarter..... | 3.06 | 1.13 |
| 1999 | | |
| First Quarter..... | 8.50 | 5.00 |
| Second Quarter..... | 5.50 | 4.06 |
| Third Quarter..... | 6.00 | 3.53 |
| Fourth Quarter..... | 3.75 | 1.59 |

On March 1, 2001 the Company received a Nasdaq Staff Determination indicating that the Company had failed to comply with the Minimum Market Value of Public Float requirement for continued listing set forth in Marketplace Rule 4450 (a) (2) (the "Rule"), and that its shares, therefore, were subject to delisting from The Nasdaq National Market. The Company has requested a hearing before a Nasdaq Listing Qualifications Panel to review the Staff Determination. The hearing is scheduled for April 6, 2001. The hearing request has stayed the delisting of the Company's common stock pending the Panel's decision. There can be no assurance the Panel will grant the Company's request for continued listing. In order to maintain a Minimum Market Value of Public Float of \$5.0 Million and be in compliance with the Rule, the 2,300,000 shares of the Company's common stock included in the public float would need to trade at approximately \$2.17 per share for a minimum of 10 consecutive trading days. If the Panel does not grant the Company's request for continued listing on the Nasdaq National Market, the Company intends to apply for listing of its common stock on the Nasdaq SmallCap Market. The Company currently satisfies the requirements for listing on the Nasdaq SmallCap Market. No assurance can be given, however, that the Company will continue to meet the requirements for listing on the Nasdaq SmallCap Market.

As of December 30, 2000, there were approximately 13 holders of record of the Company's common stock.

From August 1988 through February 1998, the Company made distributions to its sole stockholder primarily to allow the stockholder to pay taxes on earnings of the Company included or includable in the taxable income of the stockholder as a result of the Company's S corporation status. Upon completion of its initial public offering, the Company made an S corporation distribution in the amount of \$7.8 million to its previous sole stockholder, which approximately equaled the estimated earned and previously undistributed taxable S corporation income of the Company through the day preceding the termination date of its S corporation status. Except as mentioned in the previous sentences, the Company has not paid any cash dividends in the past. The Company currently intends to retain any earnings for use in its business and does not anticipate paying any cash dividends on its Common Stock in the foreseeable future. In addition, the Company's line of credit restricts the Company's ability to pay dividends. See Note 4 of Notes to Consolidated Financial Statements.

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Item 6 -- Selected Financial Data

The selected consolidated financial and operating data set forth below should be read in conjunction with "Item 8--Financial Statements and Supplementary Data--Consolidated Financial Statements of the Company and related Notes thereto" and "Item 7--Management's Discussion and Analysis of Financial Condition and Results of Operations" included herein.

| | Year Ended | | | | |
|--|------------|----------|----------|----------|----------|
| | 2000 | 1999 | 1998 (1) | 1997 | 1996 |
| (In thousands, except per share and operating data) | | | | | |
| Statement of Operations Data: | | | | | |
| Net sales..... | \$91,058 | \$71,611 | \$55,907 | \$45,074 | \$30,315 |
| Cost of sales and related occupancy expenses..... | 61,662 | 48,076 | 35,777 | 28,922 | 20,318 |
| Gross profit..... | 29,396 | 23,535 | 20,130 | 16,152 | 9,997 |
| Selling expenses..... | 19,134 | 13,999 | 11,472 | 8,800 | 5,592 |
| General and administrative expenses..... | 7,014 | 5,655 | 3,664 | 3,106 | 2,630 |
| Income from operations..... | 3,248 | 3,881 | 4,994 | 4,246 | 1,775 |
| Interest and other expense, net..... | (1,295) | (633) | (453) | (520) | (287) |
| Income before income taxes..... | 1,953 | 3,248 | 4,541 | 3,726 | 1,488 |
| Provision for income taxes..... | (779) | (1,233) | (1,147) | (261) | (98) |
| Net income..... | \$1,174 | \$2,015 | \$3,394 | \$3,465 | \$1,390 |
| Net income per share: | | | | | |
| Basic..... | \$ 0.17 | \$ 0.30 | \$ 0.53 | \$ 0.77 | \$ 0.31 |
| Diluted..... | \$ 0.17 | \$ 0.30 | \$ 0.52 | \$ 0.77 | \$ 0.31 |
| Weighted average shares outstanding: | | | | | |
| Basic..... | 6,800 | 6,800 | 6,462 | 4,500 | 4,500 |
| Diluted..... | 6,810 | 6,801 | 6,474 | 4,500 | 4,500 |
| Pro Forma: | | | | | |
| Historical income before income taxes..... | -- | -- | \$ 4,541 | \$ 3,726 | \$ 1,488 |
| Pro forma provision for income taxes (2)..... | -- | -- | (1,748) | (1,435) | (566) |
| Pro forma net income (2)..... | -- | -- | \$ 2,793 | \$ 2,291 | \$ 922 |
| Pro forma net income per share (2)..... | | | | | |
| Pro forma weighted average shares outstanding (2)..... | -- | -- | 6,600 | -- | -- |
| Selected Operating Data: | | | | | |
| Number of stores: | | | | | |
| Opened during period (3)..... | 10 | 50 | 16 | 16 | 9 |
| Closed during period..... | 5 | 8 | 2 | 2 | 6 |
| Open at end of period..... | 116 | 111 | 69 | 55 | 41 |

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| | | | | | |
|--|------|--------|------|------|------|
| Comparable store sales increase (decrease)..... | 9.4% | (1.2)% | 6.1% | 4.6% | 8.0% |
|--|------|--------|------|------|------|

| | Year Ended | | | | |
|--|------------|----------|----------|----------|----------|
| | 2000 | 1999 | 1998 | 1997 | 1996 |
| Balance Sheet Data: | | | | | |
| Working Capital..... | \$29,890 | \$14,305 | \$13,739 | \$ 6,045 | \$ 3,783 |
| Total assets..... | 46,915 | 41,613 | 33,534 | 22,646 | 15,146 |
| Total indebtedness (including current portion)..... | 14,037 | 8,075 | 8,494 | 7,658 | 3,673 |
| Stockholders' equity..... | 20,217 | 19,043 | 17,028 | 7,328 | 4,567 |

(1) In 1998, the Company changed its year end to a 52-53 week year ending on the Saturday nearest to December 31. Due to this change, sales for the fourth quarter and year ended January 2, 1999 include two

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additional days; had these days not been included comparable store sales would have increased 5.3% for the year ended January 2, 1999. All references herein to 1998 refer to the year ended January 2, 1999.

(2) Prior to February 1998, the Company operated as an S corporation and was not subject to federal and certain state income taxes. Upon the completion of its initial public offering, the Company became subject to federal and state income taxes. Pro forma net income reflects federal and state income taxes as if the Company had not elected S corporation status for income tax purposes. Pro forma net income per share is based on the weighted average number of shares of common stock outstanding during the period plus the estimated number of shares offered by the Company (1,271,722 shares) which were necessary to fund the \$7.8 million distribution paid to the Company's stockholder upon termination of the Company's status as an S Corporation. See Note 3 of Notes to Consolidated Financial Statements.

(3) 2000 and 1999 include 3 and 33 licensed shoe departments, respectively, operated pursuant to a license agreement with Gordmans, Inc.

Item 7--Management's Discussion and Analysis of Financial Condition and Results of Operations

The statements contained in this Form 10-K which are not historical facts are forward-looking statements that are subject to risks and uncertainties that could cause actual results to differ materially from those set forth in or implied by forward-looking statements. Factors that could cause or contribute to such differences include those discussed in the Company's filings with the Securities and Exchange Commission, including, without limitation, the factors discussed in this Form 10-K under the captions-- "Factors Affecting Financial Performance" and "Liquidity and Capital Resources," as well as those discussed elsewhere in this Form 10-K.

Overview

Shoe Pavilion is the largest independent off-price footwear retailer on the West Coast that offers a broad selection of women's and men's designer label

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and name brand merchandise. The Company was among the first footwear retailers on the West Coast to expand the off-price concept into the designer and name brand footwear market. As of December 30, 2000 the Company operated 80 retail stores in California, Washington, Oregon and Oklahoma, of which 79 operated under the trade name Shoe Pavilion. In addition, as of December 30, 2000, the Company operated the shoe department of 36 Gordmans, Inc. (formerly Richman Gordman 1/2 Price Stores, Inc.) department stores in Colorado, Illinois, Iowa, Kansas, Missouri, Nebraska, Oklahoma and South Dakota under a licensing agreement entered into in July 1999.

The Company opened, net of closures, 5 stores in 2000, 42 new stores in 1999, and 14 stores in 1998. During 2001, the Company intends to open approximately 2 to 4 new stores, including leased shoe departments, primarily in its existing markets. It also expects to close 2 to 4 stores in 2001.

The Company's growth in net sales historically has resulted primarily from the opening of new stores. In 2000 and 1999 the Company also experienced growth in net sales as a result of the opening of 36 shoe departments pursuant to a licensing agreement entered into with Gordmans in 1999. The Company expects that the primary source of future sales growth will continue to be new store openings. Because the Company's comparable store sales have fluctuated widely, the Company does not expect that comparable store sales will contribute significantly to future growth in net sales. The Company defines comparable stores as those stores that have been open for at least 14 consecutive months. Stores open less than 14 consecutive months are treated as new stores, and stores closed during the period are excluded from comparable store sales. The Company's comparable store sales increased 9.4% in 2000, decreased 1.2% in 1999 and increased 6.1% in 1998. The Company believes that the decline in 1999 comparable store sales was due in part to unusual weather patterns causing delays in normal seasonal sales; the high same store sales comparisons from the prior year; the rapid expansion into the licensed stores causing delays in replenishments to the existing stores; and an overall soft footwear environment exacerbated by several prominent store liquidations which dictated more promotional activity by the Company.

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The Company seeks to acquire footwear merchandise on favorable financing terms and in quantities large enough to support future growth. This strategy causes an increase in inventory levels at various times throughout the year. As a result, similar to other off-price retailers, the Company's inventory turnover rates are typically less than full-price retailers. Because of the substantial increase in net sales, inventory levels increased from \$33.0 million at January 1, 2000 to \$38.2 million at December 30, 2000.

Prior to its initial public offering in February 1998, Shoe Pavilion was treated as an S corporation for federal and certain state income tax purposes since August 1988. As a result, the Company's earnings from August 1988 through February 22, 1998 were taxed, with certain exceptions, directly to the Company's sole stockholder rather than to the Company. The Company's S corporation status terminated on February 22, 1998, and the Company is now subject to state and federal income taxes as a C corporation. In connection with its conversion to C corporation status, the Company recorded a nonrecurring tax benefit of \$485,000. The pro forma adjustments reflect federal and state income taxes as if the Company had not elected S corporation status for income tax purposes. See Note 3 of Notes to Consolidated Financial Statements.

Results of Operations

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The following table sets forth, for the periods indicated, the relative percentages that certain income and expense items bear to net sales:

| | 2000 ----- | 1999 ----- | 1998 ----- |
|---|---------------|---------------|---------------|
| Net sales..... | 100.0% | 100.0% | 100.0% |
| Gross profit..... | 32.3 | 32.9 | 36.0 |
| Selling expenses..... | 21.0 | 19.6 | 20.5 |
| General and administrative expenses..... | 7.7 | 7.9 | 6.6 |
| ----- | | | |
| Income from operations..... | 3.6 | 5.4 | 8.9 |
| Interest and other expenses, net..... | (1.4) | (0.9) | (0.8) |
| ----- | | | |
| Income before income taxes..... | 2.2 | 4.5 | 8.1 |
| Provision for income taxes..... | (0.9) | (1.7) | -- |
| ----- | | | |
| Net income..... | 1.3% | 2.8% | -- |
| ===== | | | |
| Pro forma provision for income taxes..... | | | (3.1) |
| ----- | | | |
| Pro forma net income..... | | | 5.0% |
| ===== | | | |

2000 Compared with 1999

Net Sales. Net sales increased 27.2% to \$91.1 million for 2000 from net sales of \$71.6 million for 1999. Approximately \$18.8 million of the increase in net sales is attributable to the increase in new store sales, including sales from the new leased shoe departments. In addition, the Company's comparable store net sales increased \$4.8 million or 9.4%. These increases were partially offset by store closings.

Gross Profit. Cost of sales includes landed merchandise and occupancy costs and the license fee paid to Gordmans for the leased shoe departments. Gross profit increased 24.9% to \$29.4 million from \$23.5 million for 1999. This increase in gross profit dollars is attributable to the increase in net sales in 2000. Gross profit as a percentage of net sales decreased slightly to 32.3% for 2000 from 32.9% for 1999. This reduction in the gross profit percentage is principally due to higher merchandise cost as a percentage of sales, which was partially offset by the decrease in occupancy costs as a percentage of sales. The Company was able to reduce its occupancy costs as a percent of sales by leveraging both its increase in comparable store sales and the license fee paid for the shoe departments the Company operates.

Selling Expenses. Selling expenses consist principally of payroll and related costs, advertising and promotional expenses, freight out and credit card processing fees. Selling expenses increased by 36.7% to \$19.1 million for 2000 from \$14.0 million in 1999 and increased as a percentage of sales to 21.0% in 2000

from 19.6% in 1999. The increase in selling expenses is primarily attributable to the increase in advertising, payroll costs, freight out and credit card fees which were in part directly related to the increase in net sales in 2000. The increase in selling expenses as a percentage of net sales is principally the result of the increase in advertising costs. For 2000, advertising costs

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were \$4.3 million or 4.7% of net sales compared to \$2.4 million or 3.3% of net sales for 1999.

General and Administrative Expenses. General and administrative expenses consist primarily of corporate and administrative expenses, including payroll, employee benefits and warehousing costs. General and administrative expenses increased 24% to \$7.0 million for 2000 from \$5.7 million for 1999 and decreased slightly as a percentage of net sales to 7.7% in 2000 from 7.9% in 1999. The increase in general and administrative expenses was primarily attributable to increased administrative and warehouse payroll costs, information system costs related to the computer system installed in 1999 and increased enrollment in the Company's employee benefit plan.

Interest and Other Expense, Net. Interest and other expense, net, increased to \$1.3 million for 2000 from \$.6 million for 1999. The increase was primarily attributable to higher average borrowings on the Company's revolving line of credit to fund increased inventory levels related in part to the higher sales in 2000. In addition, the weighted average interest rate in 2000 increased to 8.4% from 6.8% in 1999.

Income Taxes. In 2000 a greater portion of the Company's business was generated in states with a higher tax rate compared with 1999. As a result the effective tax rate for 2000 increased to 39.9% from 38.0% in 1999.

1999 Compared with 1998

Net Sales. Net sales increased 28.1% to \$71.6 million for 1999 from \$55.9 million for 1998. This increase in net sales was primarily attributable to new store sales, including sales from leased shoe departments, of \$24.4 million and was offset by store closures and a 1.2% decrease in comparable store sales.

Gross Profit. Gross profit increased 16.9% to \$23.5 million for 1999 from \$20.1 million for 1998 but decreased as a percentage of net sales to 32.9% from 36.0%. The decrease in gross profit percentage was attributable to several factors including, the deleveraging of net sales as a result of higher fixed occupancy costs coupled with a decrease in comparable store sales; and generally, a more highly competitive environment.

Selling Expenses. Selling expenses increased 22.0% to \$14.0 million for 1999 from \$11.5 million for 1998, but decreased as a percentage of net sales to 19.6% from 20.5%. The increase in selling expenses was primarily attributable to increases in payroll and related expenses incurred in connection with new store openings and the costs associated with leasing new information system equipment, offset by the leveraging of advertising and promotional expenses.

General and Administrative Expenses. General and administrative expenses increased 54.3% to \$5.7 million for 1999 from \$3.6 million for 1998, and increased as a percentage of net sales to 7.9% from 6.5%. The increase in general and administrative expenses was primarily attributable to increased enrollment in new employee benefit programs, new store openings, including leased shoe departments and amortization of new information systems coupled with the costs of leasing new information system equipment.

Interest and Other Expense, Net. Interest and other expense, net, increased 39.7% to \$633,000 for 1999 from \$453,000 for 1998. The increase was attributable to higher average borrowings on the Company's revolving line of credit to fund store expansion.

Income Taxes. The effective tax rate for 1999 was 38.0% and the pro forma tax rate for 1998 was 38.5%.

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Inflation

The Company does not believe that inflation has had a material impact on its results of operations. There can be no assurance, however, that inflation will not have such an effect in future periods.

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Liquidity and Capital Resources

The Company had \$29.9 million in working capital as of December 30, 2000, compared to \$14.3 million at January 1, 2000. At December 30, 2000, borrowings under the revolving line of credit of \$14.0 million were classified as long term since the line matures in May 2002. However, in 1999 the Company's revolver of \$8.0 million was classified as short-term. The Company's capital requirements relate primarily to merchandise inventory and leasehold improvements. The Company's working capital needs are typically higher in the second and third quarters as a result of increased inventory purchases for the spring and fall selling seasons.

Historically, the Company has funded its cash requirements primarily through cash flows from operations and borrowings under its credit facility. Net cash provided by (used in) operating activities was (\$4.8) million, \$2.4 million, and (\$3.0) million for 2000, 1999, and 1998, respectively. Net cash provided by (used in) operating activities historically has been driven primarily by net income and fluctuations in inventory and accounts payable. Inventory levels have increased throughout these years due to a net increase in the number of stores and the increase in net sales. During 2000, the Company used cash primarily to purchase merchandise inventory and to a lesser extent for capital expenditures.

Capital expenditures were \$1.3 million, \$2.9 million and \$2.6 million in 2000, 1999 and 1998, respectively. Expenditures for 2000 were primarily for the build out of 7 new stores and 3 new Gordmans' shoe departments and the remodeling of twelve stores. Expenditures for 1999 were primarily for the build-out of 17 new stores, 33 new Gordmans' shoe departments and the Company's new information systems. Expenditures for 1998 were primarily for the build out of 16 new stores plus work-in-progress of the Company's new management information systems. The Company estimates that capital expenditures for 2001 will total approximately \$300,000, primarily for the build-out of approximately 2 to 4 new stores, including new Gordmans' shoe departments.

Financing activities provided (used) cash of \$6.0 million, (\$419,000) and \$7.1 million in 2000, 1999 and 1998 respectively. The cash provided by financing activities in 2000 primarily relates to the net increase in borrowings under the Company's revolving line of credit. The cash use in 1999 primarily related to paying down balances on the Company's revolving line of credit. The cash provided by financing activities for 1998 primarily reflects \$14.1 million raised in the Company's initial public offering offset by a \$7.8 million payment for an S corporation distribution and a \$1.0 million increase on the Company's line of credit. During 1997 the Company made distributions to its then sole stockholder of \$704,000. Upon completion of its initial public offering, the Company made an S corporation distribution in the amount of \$7.8 million to its previous sole stockholder, which approximately equaled the estimated earned and previously undistributed taxable S corporation income of the Company through the day preceding the termination date of its S corporation status. See Note 3 of Notes to Consolidated Financial Statements.

As of December 30, 2000, the Company had a credit agreement with a financial institution for a revolving line of credit up to \$20.0 million, including a

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\$5.0 million sublimit for the issuance of letters of credit. Borrowings are based upon eligible inventory. Borrowings under the credit facility are secured by the Company's accounts receivable, general intangibles, inventory and other rights to payment. The agreement prohibits the declaration and payment of cash or stock dividends. The agreement contained various restrictive and financial covenants including minimum EBITDA as determined on a rolling four quarters basis and minimum quarterly pre tax profit and minimum net income. At December 30, 2000, the Company was not in compliance with the minimum EBITDA, minimum quarterly pretax profit and minimum net income covenants. In conjunction with the new loan agreement entered into in February 2001, as described below, the financial institution adjusted these covenants so the Company was in compliance. The weighted average interest rate was 8.74% at December 30, 2000. As of December 30, 2000, the unused and available portion of the credit facility was approximately \$4.1 million.

In February 2001, the Company and its lender entered into a new loan agreement for a revolving line of credit up to \$20.0 million, including a \$5.0 million sublimit for the issuance of letters of credit, with a maturity date of June 1, 2002. The new agreement adjusted certain economic terms and financial covenants. Interest on

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outstanding borrowings will be at the bank's floating prime rate or Libor plus from 1.3% to 1.8%, depending on the Company's achievement of certain financial ratios. Certain adjustments were made to the financial covenants including lowering the minimum EBITDA requirement for 2001.

The Company expects that anticipated cash flow from operations and available borrowings under the Company's credit facility will satisfy its cash requirements for at least the next 12 months. The Company's capital requirements may vary significantly from anticipated needs, depending upon such factors as operating results, the number and timing of new store openings.

Recently Issued Accounting Standards

Statement of Financial Accounting Standards ("SFAS") No. 133, "Accounting for Derivative Instruments and Hedging Activities," will be effective for the Company as of December 31, 2000. SFAS 133, as amended, establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities. It requires that an entity recognize all derivatives as either assets or liabilities in the statement of financial position and measure those instruments at fair value. Additionally, under SFAS 133, certain contracts that were not formerly considered derivatives may now meet the definition of a derivative. The Company will adopt SFAS 133 effective December 31, 2000. Adoption of this new standard will not have a significant impact on the Company's financial statements.

Weather and Seasonality

The Company has experienced, and expects to continue to experience, seasonal fluctuations in its net sales and net income. Historically, net sales and net income have been weakest during the first quarter. The Company's quarterly results of operations may also fluctuate significantly as a result of a variety of factors, including timing of new store openings, the level of net sales contributed by new stores, merchandise mix, the timing and level of price markdowns, availability of inventory, store closures, advertising costs, competitive pressures and changes in the demand for off-price footwear.

Factors Affecting Financial Performance

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In addition to the other information in this Form 10-K, the following factors should be considered carefully in evaluating an investment in the shares of common stock of the Company. The statements contained in this Form 10-K which are not historical facts are forward-looking statements that are subject to risks and uncertainties that could cause actual results to differ materially from those set forth in or implied by forward-looking statements. Factors that could cause or contribute to such differences include those discussed below, as well as those discussed elsewhere in this Form 10-K.

Risks Associated with Expansion

The Company has experienced rapid and substantial growth in net sales as well as in its employee base. The Company's continued growth will depend to a significant degree on its ability to expand its operations through the opening of new stores and to operate these stores on a profitable basis. The success of the Company's planned expansion will be significantly dependent upon the Company's ability to locate suitable store sites and negotiate acceptable lease terms. In addition, several other factors could affect the Company's ability to expand, including the adequacy of the Company's capital resources, the ability to hire, train and integrate employees and the ability to adapt the Company's distribution and other operational systems. There can be no assurance that the Company will achieve its planned expansion or that any such expansion will be profitable. In addition, there can be no assurance that the Company's expansion within its existing markets will not adversely affect the individual financial performance of the Company's existing stores or its overall operating results, or that new stores will achieve net sales and profitability levels consistent with existing stores. To manage its planned expansion, the Company regularly evaluates the adequacy of its existing systems and procedures, including product distribution facilities, store management, financial controls and management information systems. However, there can be no assurance that the Company will anticipate all of the changing

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demands that expanded operations may impose on such systems. Failure to adapt its distribution capabilities or other internal systems or procedures as required could have a material adverse effect on the Company's business, financial condition and results of operations.

The Company actively monitors individual store performance and has closed underperforming stores in the past, including five in 2000 eight in 1999 and two in 1998. The Company intends to continue to close underperforming stores in the future, and if it were to close a number of stores, it could incur significant closure costs and reductions in net sales. In certain instances, the Company may be unable to close an underperforming store on a timely basis because of lease terms. A significant increase in closure costs or the inability to close one or more underperforming stores on a timely basis could have a material adverse effect on the Company's business, financial condition and results of operations.

License Agreement

In July 1999, the Company entered into a license agreement to operate the shoe department of Gordmans, Inc. department stores located in the Midwest. The initial term of the agreement shall expire, unless terminated sooner as provided by the agreement, on June 29, 2002. Upon the expiration of the initial term, the agreement shall automatically renew for an additional term of three years, expiring on July 2, 2005 unless either the Company or Gordmans gives the other party written notice on or before January 1, 2002, that they do not intend to renew the agreement. The Company operated 36 shoe departments of

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Gordmans at December 30, 2000. There can be no assurance that the agreement will not be terminated before the expiration of its initial term or that the agreement will be renewed after the expiration of its initial term. Early termination of the agreement or failure of either party to renew the agreement could adversely affect the Company's net sales, financial condition and results of operations.

Inventory and Sourcing Risk

The Company's future success will be significantly dependent on its ability to obtain merchandise that consumers want to buy, particularly name brand merchandise with long-term retail appeal, and to acquire such merchandise under favorable terms and conditions. In 2000, the Company's top ten suppliers accounted for approximately 32% of inventory purchases. The deterioration of the Company's relationship with any key vendor could result in delivery delays, merchandise shortages or less favorable terms than the Company currently enjoys. The Company deals with its suppliers on an order-by-order basis and has no long-term purchase contracts or other contractual assurances of continued supply or pricing. As the Company's operations expand, its demand for off-price inventory will continue to increase. The Company's footwear purchases typically involve manufacturing over-runs, over-orders, mid- or late-season deliveries or last season's stock. The inability of the Company to obtain a sufficient supply of readily salable, high margin inventory, to negotiate favorable discount and payment agreements with its suppliers or to sell large inventory purchases without markdowns could have a material adverse effect on the Company's business, financial condition and results of operations. See "Item 1--Business--Sourcing and Purchasing."

Reliance on Key Personnel

The Company's future success will be dependent, to a significant extent, on the efforts and abilities of its executive officers. The loss of the services of any one of the Company's executive officers could have a material adverse effect on the Company's operating results. In addition, the Company's continued growth will depend, in part, on its ability to attract, motivate and retain skilled managerial and merchandising personnel. Competition for such personnel is intense, and there can be no assurance that the Company will be able to retain a substantial percentage of its existing personnel or attract additional qualified personnel in the future.

Uncertainty of Future Operating Results; Fluctuations in Comparable Store Sales

Although the Company has been profitable, there can be no assurance that the Company will continue to remain profitable. Future operating results will depend upon many factors, including general economic

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conditions, the level of competition and the ability of the Company to acquire sufficient inventory, achieve its expansion plans and effectively monitor and control costs. There can be no assurance that the Company's recent gross margin levels will be sustainable in the future.

Although the Company achieved a substantial portion of its 1999 net sales growth through the licensing agreement with Gordmans, historically its growth in net sales has resulted primarily from new store openings. At the present time, the Company expects that the primary source of future sales growth will be from new store openings.

Historically, the Company's comparable store sales have fluctuated widely,

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and the Company does not expect that comparable store sales will contribute significantly to future growth in net sales. The Company defines comparable stores as those stores that have been open for at least 14 consecutive months. Stores open less than 14 consecutive months are treated as new stores, and stores closed during the period are excluded from comparable store sales. The Company's comparable store sales increased 9.4% in 2000, decreased 1.2% in 1999 and increased 6.1% in 1998.

Risks Associated with Possible Acquisitions

The Company may pursue the acquisition of companies and assets that complement its existing business. Acquisitions involve a number of special risks, including the diversion of management's attention to the assimilation of the operations and personnel of the acquired businesses, potential adverse short-term effects on the Company's operating results and amortization of acquired intangible assets. The Company has limited experience in identifying, completing and integrating acquisitions. The Company does not have any current plans to acquire any other companies, and there can be no assurance that the Company will identify attractive acquisition candidates, that acquisitions will be consummated on acceptable terms or that any acquired companies will be integrated successfully into the Company's operations.

Seasonality and Quarterly Fluctuations

The Company has experienced, and expects to continue to experience, seasonal fluctuations in its net sales and net income. Historically, net sales and net income have been weakest during the first quarter. The Company's quarterly results of operations may also fluctuate significantly as a result of a variety of factors, including timing of new store openings, the level of net sales contributed by new stores, merchandise mix the timing and level of price markdowns, availability of inventory, store closures, advertising costs, competitive pressures and changes in the demand for off-price footwear. Any such fluctuations could have a material adverse effect on the market price of the Company's common stock.

Dependence on Consumer Spending and Preferences

The success of the Company's operations depends upon a number of general economic factors relating to consumer spending, including employment levels, business conditions, interest rates, inflation and taxation. There can be no assurance that consumer spending will not decline in response to economic conditions, thereby adversely affecting the Company's operating results.

All of the Company's products are subject to changing consumer preferences. Consumer preferences could shift to types of footwear other than those that the Company currently offers. Any such shift could have a material adverse effect on the Company's operating results. The Company's future success will depend, in part, on its ability to anticipate and respond to changes in consumer preferences, and there can be no assurance that the Company will be able to anticipate effectively or respond to such changes on a timely basis or at all. Failure to anticipate and respond to changing consumer preferences could lead to, among other things, lower net sales, excess inventory and lower gross margins, any of which could have a material adverse effect on the Company's business, financial condition and results of operations.

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International Purchasing

The Company purchases in-season name brand and branded-design merchandise directly from factories in Italy, Brazil, China and Spain. Directly-sourced

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goods accounted for approximately 13.4% and 10.8% of net sales in 2000 and 1999, respectively. The Company has no long-term contracts with direct manufacturing sources and competes with other companies for production facilities. All of the manufacturers with which the Company conducts business are located outside of the United States, and the Company is subject to the risks generally associated with an import business, including foreign currency fluctuations, unexpected changes in foreign regulatory requirements, disruptions or delays in shipments and the risks associated with United States import laws and regulations, including quotas, duties, taxes, tariffs and other restrictions. There can be no assurance that the foregoing factors will not disrupt the Company's supply of directly-sourced goods or otherwise adversely impact the Company's business, financial condition and results of operations in the future. See "Item 1--Business--Sourcing and Purchasing."

Inventory Shrinkage

The retail industry is subject to theft by customers and employees. Because the Company uses a self-service format, where shoppers have access to both shoes of a pair, the Company must maintain substantial store security. Although the Company has implemented enhanced security procedures, there can be no assurance that the Company will not suffer from significant inventory shrinkage in the future, which could have a material adverse effect on the Company's business, financial condition and results of operations.

Competition

The retail footwear market is highly competitive, and the Company expects the level of competition to increase. The Company competes with off-price and discount retailers (e.g., Nordstrom Rack, Payless ShoeSource, Ross, Dress for Less and Famous Footwear), branded retail outlets (e.g., Nine West), national retail stores (e.g., Nordstrom, Marshalls, Macy's, Sears, J.C. Penney, Loehmann's, Robinsons-May and Mervyn's), traditional shoe stores and mass merchants. Many of these competitors have stores in the markets in which the Company now operates and in which it plans to expand. Many of the Company's competitors have significantly greater financial, marketing and other resources than the Company. In addition, there can be no assurance that in the future new participants will not enter the off-price segment of the footwear market. Competitive pressures resulting from competitors' pricing policies could materially adversely affect the Company's gross margins. There can be no assurance that the Company will not face greater competition from other national, regional or local retailers or that the Company will be able to compete successfully with existing and new competitors. The inability of the Company to respond to such competition could have a material adverse effect on the Company's business, financial condition and results of operations.

Future Capital Needs

The Company expects that anticipated cash flows from operations and available borrowings under the Company's credit facility will satisfy its cash requirements for at least the next 12 months. To the extent that the foregoing cash resources are insufficient to fund the Company's activities, including new store openings planned for 2001, additional funds will be required. There can be no assurance that additional financing will be available on reasonable terms or at all. Failure to obtain such financing could delay or prevent the Company's planned expansion, which could adversely affect the Company's business, financial condition and results of operations.

Substantial Control by Single Stockholder

Dmitry Beinus, the Company's Chairman of the Board, President and Chief Executive Officer owns approximately 66.2% of the Company's outstanding Common Stock. As a result, Mr. Beinus is able to decide all matters requiring

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stockholder approval, including the election of directors and approval of significant corporate transactions. Concentration of stock ownership could also have the effect of preventing a change in control of the Company.

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Possible Volatility of Stock Price

The Company's common stock is quoted on the Nasdaq National Market, which has experienced and is likely to experience in the future significant price and volume fluctuations, either of which could adversely affect the market price of the common stock without regard to the operating performance of the Company. In addition, the trading price of the Company's common stock could be subject to wide fluctuations in response to quarterly variations in operating results, fluctuations in the Company's comparable store sales, announcements by other footwear retailers, the failure of the Company's earnings to meet the expectations of investors, as well as other events or factors.

On March 1, 2001 the Company received a Nasdaq Staff Determination indicating that the Company had failed to comply with the Minimum Market Value of Public Float requirement for continued listing set forth in Marketplace Rule 4450 (a) (2) (the "Rule"), and that its shares, therefore, were subject to delisting from The Nasdaq National Market. The Company has requested a hearing before a Nasdaq Listing Qualifications Panel to review the Staff Determination. The hearing is scheduled for April 6, 2001. The hearing request has stayed the delisting of the Company's common stock pending the Panel's decision. There can be no assurance the Panel will grant the Company's request for continued listing. In order to maintain a Minimum Market Value of Public Float of \$5.0 Million and be in compliance with the Rule, the 2,300,000 shares of the Company's common stock included in the public float would need to trade at approximately \$2.17 per share for a minimum of 10 consecutive trading days. If the Panel does not grant the Company's request for continued listing on the Nasdaq National Market, the Company intends to apply for listing of its common stock on the Nasdaq SmallCap Market. The Company currently satisfies the requirements for listing on the Nasdaq SmallCap Market. No assurance can be given, however, that the Company will continue to meet the requirements for listing on the Nasdaq SmallCap Market.

Item 7A--Quantitative and Qualitative Disclosure about Market Risk

The Company is exposed to market risks, which include changes in U.S. interest rates and foreign exchange rates. The Company does not engage in financial transactions for trading or speculative purposes.

Interest Rate Risk. The interest payable on the Company's bank line of credit is based on variable interest rates and therefore is affected by changes in market rates. The Company does not use derivative financial instruments in its investment portfolio and believes that the market risk is insignificant.

Commodity Prices. The Company is not exposed to fluctuation in market prices for any commodities.

Foreign Currency Risks. As of December 30, 2000, the Company had two foreign exchange contracts outstanding to hedge certain purchases in Italian Lira. The purpose of the Company's foreign currency hedging activities is to protect the Company from the risk that the eventual dollar net cash outflow resulting from inventory purchases will be affected by changes in exchange rates.

As of December 30, 2000 the notional amount and fair value of the Company's

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foreign exchange contracts in U.S. dollars were \$ 397,886 and \$ 2,375, respectively.

The Company has minimal purchases outside of the United States that involve foreign currencies and, therefore, has only minimal exposure to foreign currency exchange risks. The Company does not typically hedge against foreign currency risks and believes that foreign currency exchange risk is insignificant.

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Item 8--Financial Statements and Supplementary Data

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INDEPENDENT AUDITORS' REPORT

To the Board of Directors and Stockholders of
Shoe Pavilion, Inc.

We have audited the accompanying consolidated balance sheets of Shoe Pavilion, Inc. and subsidiary (the "Company") as of December 30, 2000 and January 1, 2000, and the related consolidated statements of income, stockholders' equity, and cash flows for each of the three years in the period ended December 30, 2000. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of the Company as of December 30, 2000 and January 1, 2000, and the results of its operations and its cash flows for each of the three years in the period ended December 30, 2000 in conformity

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with accounting principles generally accepted in the United States of America.

DELOITTE & TOUCHE LLP

San Francisco, California

February 9, 2001

(February 27, 2001 as to Note 4)

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SHOE PAVILION, INC.

CONSOLIDATED BALANCE SHEETS

| | December 30, 2000 | January 1, 2000 |
|--|----------------------|--------------------|
| | ----- | ----- |
| ASSETS | | |
| CURRENT ASSETS: | | |
| Cash..... | \$ 814,228 | \$ 928,676 |
| Receivables..... | 740,460 | 578,070 |
| Inventories..... | 38,187,378 | 32,984,783 |
| Prepaid expenses and other..... | 940,636 | 609,557 |
| | ----- | ----- |
| Total current assets..... | 40,682,702 | 35,101,086 |
| FIXED ASSETS: | | |
| Store fixtures and equipment..... | 4,136,138 | 3,810,727 |
| Leasehold improvements..... | 3,296,800 | 2,917,771 |
| Information technology systems..... | 2,240,028 | 2,212,398 |
| | ----- | ----- |
| Total..... | 9,672,966 | 8,940,896 |
| Less accumulated depreciation..... | 4,389,243 | 3,400,923 |
| | ----- | ----- |
| Net fixed assets..... | 5,283,723 | 5,539,973 |
| Deferred income taxes and other..... | 948,785 | 971,485 |
| | ----- | ----- |
| TOTAL..... | \$46,915,210 | \$41,612,544 |
| | ===== | ===== |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| CURRENT LIABILITIES: | | |
| Accounts payable..... | \$ 8,750,084 | \$11,139,306 |
| Accrued expenses..... | 2,027,768 | 1,643,259 |
| Short-term borrowings..... | -- | 8,000,000 |
| Current portion of capitalized lease obligations..... | 14,754 | 13,232 |
| | ----- | ----- |
| Total current liabilities..... | 10,792,606 | 20,795,797 |
| Long-term debt..... | 13,975,231 | -- |
| Deferred rent..... | 1,883,546 | 1,712,249 |
| Capitalized lease obligations, less current portion.... | 46,759 | 61,513 |
| Commitments and contingencies..... | -- | -- |
| STOCKHOLDERS' EQUITY: | | |
| Preferred stock--\$.001 par value; 1,000,000 shares authorized; no shares issued or outstanding..... | -- | -- |
| Common stock--\$.001 par value: 15,000,000 shares authorized; 6,800,000 shares issued and outstanding..... | 6,800 | 6,800 |
| Additional paid-in capital..... | 13,967,258 | 13,967,258 |
| Retained earnings..... | 6,243,010 | 5,068,927 |

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| | | |
|---------------------------------|--------------|--------------|
| Total stockholders' equity..... | 20,217,068 | 19,042,985 |
| TOTAL..... | \$46,915,210 | \$41,612,544 |

See notes to consolidated financial statements.

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SHOE PAVILION, INC.

CONSOLIDATED STATEMENTS OF INCOME

| | December 30, 2000 | January 1, 2000 | January 2, 1999 |
|---|----------------------|--------------------|--------------------|
| Net sales..... | \$91,058,092 | \$71,611,220 | \$55,907,211 |
| Cost of sales and related occupancy expenses | 61,662,190 | 48,076,135 | 35,777,493 |
| Gross profit..... | 29,395,902 | 23,535,085 | 20,129,718 |
| Selling expenses..... | 19,134,430 | 13,999,417 | 11,472,385 |
| General and administrative expenses..... | 7,013,724 | 5,654,248 | 3,663,852 |
| Income from operations..... | 3,247,748 | 3,881,420 | 4,993,481 |
| Other expense: | | | |
| Interest..... | (1,121,904) | (618,647) | (430,359) |
| Other--net..... | (173,257) | (14,312) | (22,716) |
| Total other expense--net..... | (1,295,161) | (632,959) | (453,075) |
| Income before income taxes..... | 1,952,587 | 3,248,461 | 4,540,406 |
| Provision for income taxes..... | (778,504) | (1,233,846) | (1,146,954) |
| Net income..... | \$ 1,174,083 | \$ 2,014,615 | \$ 3,393,452 |
| Net income per share: | | | |
| Basic..... | \$ 0.17 | \$ 0.30 | \$ 0.53 |
| Diluted..... | \$ 0.17 | \$ 0.30 | \$ 0.52 |
| Weighted average shares outstanding: | | | |
| Basic..... | 6,800,000 | 6,800,000 | 6,461,580 |
| Diluted..... | 6,810,258 | 6,801,417 | 6,473,771 |
| PRO FORMA: | | | |
| Historical income before income taxes..... | -- | -- | \$ 4,540,406 |
| Pro forma provision for income taxes.. | -- | -- | (1,748,000) |
| Pro forma net income..... | -- | -- | \$ 2,792,406 |
| Pro forma net income per share: | | | |
| Basic..... | -- | -- | \$ 0.42 |
| Diluted..... | -- | -- | \$ 0.42 |
| Pro forma weighted average shares outstanding: | | | |
| Basic..... | -- | -- | 6,647,871 |

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Diluted..... -- -- 6,660,062

See notes to consolidated financial statements.

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SHOE PAVILION, INC.

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

| | Common Stock | | Additional Paid-in Capital | Retained Earnings | Total |
|--|---------------------|---------|----------------------------------|----------------------|--------------|
| | Number of Shares | Amount | | | |
| Balance at December 31, 1997..... | 4,500,000 | \$4,500 | \$ 812,033 | \$ 6,511,523 | \$ 7,328,056 |
| Issuance of stock through initial public offering..... | 2,300,000 | 2,300 | 14,104,562 | | 14,106,862 |
| Net income..... | | | | 3,393,452 | 3,393,452 |
| Distribution to previous sole stockholder..... | | | (949,337) | (6,850,663) | (7,800,000) |
| Balance at JANUARY 2, 1999..... | 6,800,000 | 6,800 | 13,967,258 | 3,054,312 | 17,028,370 |
| Net income..... | | | | 2,014,615 | 2,014,615 |
| Balance at JANUARY 1, 2000..... | 6,800,000 | 6,800 | 13,967,258 | 5,068,927 | 19,042,985 |
| Net income..... | | | | 1,174,083 | 1,174,083 |
| Balance at December 30, 2000..... | 6,800,000 | \$6,800 | \$13,967,258 | \$ 6,243,010 | \$20,217,068 |

See notes to consolidated financial statements.

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SHOE PAVILION, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

| | December 30, 2000 | January 1, 2000 | January 2, 1999 |
|-----------------------|----------------------|--------------------|--------------------|
| OPERATING ACTIVITIES: | | | |
| Net income..... | \$ 1,174,083 | \$ 2,014,615 | \$ 3,393,452 |

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| | | | |
|--|--------------|--------------|--------------|
| Adjustments to reconcile net income to net cash provided (used) by operating activities: | | | |
| Depreciation..... | 1,432,809 | 1,209,842 | 798,566 |
| Other..... | 116,863 | 17,849 | 34,965 |
| Deferred income taxes..... | (466,840) | (662,620) | (485,447) |
| Effect of changes in: | | | |
| Inventories..... | (5,202,595) | (6,092,682) | (7,096,502) |
| Receivables..... | (162,390) | (421,104) | 141,697 |
| Prepaid expenses and other..... | 158,461 | (189,940) | (160,789) |
| Accounts payable..... | (2,389,222) | 5,172,095 | 46,231 |
| Accrued expenses and deferred rent..... | 555,806 | 1,310,730 | 305,689 |
| | ----- | ----- | ----- |
| Net cash provided (used) by operating activities..... | (4,783,025) | 2,358,785 | (3,022,138) |
| | ----- | ----- | ----- |
| INVESTING ACTIVITIES: | | | |
| Purchase of fixed assets..... | (1,293,422) | (2,932,849) | (2,593,656) |
| | ----- | ----- | ----- |
| FINANCING ACTIVITIES: | | | |
| Net proceeds from initial public offering..... | -- | -- | 14,106,862 |
| Borrowings (payments) on credit facility, net..... | 5,975,231 | (407,262) | 1,020,137 |
| Principal payments on capital leases..... | (13,232) | (11,868) | (183,995) |
| Distributions paid to previous sole stockholder..... | -- | -- | (7,800,000) |
| | ----- | ----- | ----- |
| Net cash provided (used) by financing activities..... | 5,961,999 | (419,130) | 7,143,004 |
| | ----- | ----- | ----- |
| Net increase (decrease) in cash..... | (114,448) | (993,194) | 1,527,210 |
| Cash, beginning of period..... | 928,676 | 1,921,870 | 394,660 |
| | ----- | ----- | ----- |
| Cash, end of period..... | \$ 814,228 | \$ 928,676 | \$ 1,921,870 |
| | ===== | ===== | ===== |
| CASH PAID FOR: | | | |
| Interest..... | \$ 1,066,700 | \$ 573,769 | \$ 416,072 |
| Income taxes..... | \$ 1,502,792 | \$ 1,618,000 | \$ 1,826,000 |

See notes to consolidated financial statements.

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SHOE PAVILION, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. BASIS OF PRESENTATION AND OPERATIONS

General--Shoe Pavilion, Inc. (the "Company"), a Delaware corporation, operates as a single business segment of off-price shoe stores located in California, Washington, Oregon and Oklahoma, under the name Shoe Pavilion. The Company had 80 and 78 stores open as of December 30, 2000 and January 1, 2000, respectively. In July 1999, the Company entered into a licensing agreement to operate the shoe department of Gordmans, Inc. (formerly Richman Gordman 1/2 Price Stores, Inc.) department stores located in the Midwest. The initial term of the agreement shall expire, unless terminated sooner as provided by the

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agreement, on June 29, 2002. Upon the expiration of the initial term, the agreement shall automatically renew for an additional term of three years, expiring on July 2, 2005 unless either the Company or Gordmans gives the other party written notice on or before January 1, 2002, that they do not intend to renew the agreement. The Company operated 36 and 33 shoe departments of Gordmans, Inc. at December 30, 2000 and January 1, 2000, respectively. The Company purchases inventory from international and domestic vendors. For 2000, the Company's top ten suppliers accounted for approximately 32% of inventory purchases.

Public Offering--On February 27, 1998, the Company sold 2,300,000 shares of its common stock for net proceeds of \$14,107,000. In connection with the offering, on February 23, 1998, the Company terminated its status as an S corporation and recorded a deferred income tax benefit of \$485,000.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Use of Estimates--The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Consolidation Policy--The consolidated financial statements include the Company and its wholly-owned subsidiary, Shoe Pavilion Corporation. All significant intercompany balances and transactions have been eliminated.

Change of Year--In December 1998, the Company changed its year end to a 52-53 week year ending on the Saturday nearest to December 31. All references herein to 2000 and 1999 refer to the years ended December 30, 2000 and January 1, 2000, respectively.

Cash represents cash on hand and cash held in banks.

Estimated fair value of financial instruments--The carrying value of cash, accounts receivable, accounts payable and debt approximates their estimated fair values at December 30, 2000. As of December 30, 2000, the notional amount and fair value of the Company's foreign exchange contracts in U.S. dollars were \$397,886 and \$2,375, respectively.

Inventories are stated at the lower of average cost or market.

Fixed assets are stated at cost. Depreciation and amortization are provided on the straight-line method over the estimated useful lives of the assets ranging from three to five years. Leasehold improvements are amortized on the straight-line method over the shorter of the useful lives of the assets or lease term, generally five years.

Income Taxes--Effective February 23, 1998, the Company is taxed as a C corporation for federal and state income tax purposes. The income tax provisions as of December 30, 2000 and January 1, 2000 reflect this

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status. Prior to February 23, 1998, the Company was taxed as an S corporation for federal income tax and certain state reporting purposes, which provides that taxable income or loss of the Company is generally passed through to the individual stockholders. Accordingly, no provision for federal and certain state income taxes has been recorded in the accompanying financial statements prior to February 23, 1998. Upon conversion from an S corporation to a C corporation, the Company recorded a deferred tax asset of \$485,477, which reduced tax expense.

Deferred Rent--Certain of the Company's store leases provide for free or reduced rent during an initial portion of the lease term. Deferred rent consists of the aggregate obligation for lease payments under these leases amortized on a straight-line basis over the lease term, in excess of amounts paid. In addition, deferred rent includes construction allowances received from landlords, which are amortized on a straight-line basis over the initial lease term.

Preopening Costs--Store preopening costs are charged to expense as incurred.

Long-lived Assets--The Company periodically reviews long-lived assets for impairment to determine whether any events or circumstances indicate that the carrying amount of the assets may not be recoverable. Such review includes estimating expected future cash flows. No impairment loss provisions have been required to date.

Net Income Per Share--Basic income per share is computed as net income divided by the weighted average number of common shares outstanding during the period. Diluted income per share reflects the potential dilution that could occur from the exercise of outstanding stock options and is computed by dividing net income by the weighted average number of common shares outstanding for the period plus the dilutive effect of outstanding stock options.

Comprehensive Income equals net income.

Stock-Based Compensation--The Company accounts for its stock option plans in accordance with Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" and its related interpretations. Accordingly, no compensation expense has been recognized in the financial statements for stock option arrangements.

Recently Issued Accounting Standards--Statement of Financial Accounting Standards ("SFAS") No. 133, "Accounting for Derivative Instruments and Hedging Activities," will be effective for the Company as of December 31, 2000. SFAS No. 133, as amended, establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities. It requires that an entity recognize all derivatives as either assets or liabilities in the statement of financial position and measure those instruments at fair value. Additionally, under SFAS 133, certain contracts that were not formerly considered derivatives may now meet the definition of a derivative. The Company will adopt SFAS 133 effective December 31, 2000. Adoption of this new standard will not have a significant impact on the Company's financial statements.

3. PRO FORMA INFORMATION

The objective of the pro forma information is to show what the significant effects on the historical information might have been had the Company not been treated as a S corporation for tax purposes prior to February 23, 1998, the effective date of the Company's initial public offering.

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SHOE PAVILION, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS--(Continued)

3. PRO FORMA INFORMATION (Continued)

Income Taxes--The pro forma information presented in the consolidated statements of income reflects a provision for income taxes at an effective rate of 38.5% for the year ended January 2,1999.

Pro Forma Net Income Per Share--Pro forma basic net income per share is based on the weighted average number of shares of common stock outstanding during the period plus the estimated number of shares offered by the Company (1,271,722) which were necessary to fund the \$7,800,000 distribution paid to the Company's stockholder upon termination of the Company's status as a S corporation. Pro forma diluted net income per share is calculated using the number of shares used in the basic calculation plus the dilutive effect of stock options outstanding during the period.

4. FINANCING AGREEMENTS

As of December 30, 2000, the Company had a credit agreement with a financial institution for a revolving line of credit up to \$20.0 million, including a \$5.0 million sublimit for the issuance of letters of credit. Borrowings are based upon eligible inventory. Borrowings under the credit facility are secured by the Company's accounts receivable, general intangibles, inventory and other rights to payment. The agreement prohibits the declaration and payment of cash or stock dividends. The agreement contained various restrictive and financial covenants including minimum EBITDA as determined on a rolling four quarters basis and minimum quarterly pre tax profit and minimum net income. At December 30, 2000, the Company was not in compliance with the minimum EBITDA, minimum quarterly pretax profit and minimum net income covenants. In conjunction with the new loan agreement entered into in February 2001, as described below, the financial institution adjusted these covenants so the Company was in compliance. The weighted average interest rate was 8.74% at December 30, 2000. As of December 30, 2000, the unused and available portion of the credit facility was approximately \$4.1 million.

In February 2001, the Company and its lender entered into a new loan agreement for a revolving line of credit up to \$20.0 million, including a \$5.0 million sublimit for the issuance of letters of credit, with a maturity date of June 1, 2002. The new agreement adjusted certain economic terms and financial covenants. Interest on outstanding borrowings will be at the bank's floating prime rate or Libor plus from 1.3% to 1.87%, depending on the Company's achievement of certain financial ratios. Certain adjustments were made to the financial covenants including lowering the minimum EBITDA requirement for 2001.

5. COMMITMENTS AND CONTINGENCIES

Leases--The Company is obligated under operating leases for store and warehouse locations and equipment. While most of the agreements provide for minimum lease payments and include rent escalation clauses, certain of the store leases provide for additional rentals contingent upon prescribed sales volumes. Additionally, the Company is required to pay common area maintenance and other costs associated with the centers in which the stores operate. Most of the leases provide for renewal at the option of the Company.

The Company's assets under capital leases as of December 30, 2000 and

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January 1, 2000 are as follows:

| | December 30, 2000 | January 1, 2000 |
|--|----------------------|--------------------|
| | ----- | ----- |
| Total assets under capital leases..... | \$105,995 | \$295,911 |
| Less accumulated amortization..... | 47,417 | 178,136 |
| | ----- | ----- |
| | \$ 58,578 | \$117,775 |
| | ===== | ===== |

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SHOE PAVILION, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS--(Continued)

5. COMMITMENTS AND CONTINGENCIES (Continued)

Future minimum lease payments required are as follows:

| | Capital Leases | Operating Leases |
|---|-------------------|---------------------|
| | ----- | ----- |
| Year ending: | | |
| 2001..... | \$20,833 | \$ 9,828,661 |
| 2002..... | 47,613 | 8,250,800 |
| 2003..... | | 6,958,174 |
| 2004..... | | 5,374,574 |
| 2005..... | | 3,507,183 |
| Thereafter..... | | 6,295,403 |
| | ----- | ----- |
| Total minimum lease payments..... | 68,446 | \$40,214,795 |
| | | ===== |
| Less amounts representing interest..... | 6,933 | |
| | ----- | |
| Present value of capital lease obligations..... | 61,513 | |
| Less current portion..... | 14,754 | |
| | ----- | |
| Total long-term portion..... | \$46,759 | |
| | ===== | |

Rental expense for the years ended December 30, 2000, January 1, 2000 and January 2, 1999 was \$11,395,249, \$9,361,284, and \$5,934,733, respectively, including contingent rentals of \$1,584,793, \$821,863, and \$307,355, respectively.

Letters of Credit--The Company has obtained letters of credit in connection with overseas purchase arrangements. The total amount outstanding was \$1,285,408 as of December 30, 2000. The Company also has a standby letter of credit relating to a rental agreement of \$14,667 as of December 30, 2000.

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Contingencies--The Company is party to various legal proceedings arising from normal business activities. Management believes that the resolution of these matters will not have an adverse material effect on the Company's financial position or results of operations.

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SHOE PAVILION, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS--(Continued)

6. INCOME TAXES

The components of deferred tax assets (liabilities) are as follows:

| | December 30, 2000 | January 1, 2000 |
|---|----------------------|--------------------|
| | ----- | ----- |
| Current: | | |
| Uniform capitalization of inventory costs..... | \$ 662,112 | \$ 315,785 |
| Accrued vacation..... | 83,724 | 10,348 |
| Inventory reserve..... | 98,539 | 39,020 |
| Prepaid expenses..... | (4,015) | (31,714) |
| State taxes..... | (112,904) | (74,220) |
| | ----- | ----- |
| Total current (reported in prepaid expenses and other)..... | 727,456 | 259,219 |
| | ----- | ----- |
| Non-Current: | | |
| Difference in basis of fixed assets..... | 229,220 | 156,731 |
| Deferred rent and tenant improvements..... | 658,230 | 732,116 |
| | ----- | ----- |
| Total non-current..... | 887,450 | 888,847 |
| | ----- | ----- |
| Net deferred tax asset..... | \$1,614,906 | \$1,148,066 |
| | ===== | ===== |

The provision for income taxes consisted of the following:

| | December 30, 2000 | January 1, 2000 |
|----------------------|----------------------|--------------------|
| | ----- | ----- |
| Current: | | |
| Federal..... | \$1,003,195 | \$1,535,150 |
| State..... | 242,149 | 361,316 |
| | ----- | ----- |
| Total current..... | 1,245,344 | 1,896,466 |
| Deferred..... | (466,840) | (662,620) |
| | ----- | ----- |
| Total provision..... | \$ 778,504 | \$1,233,846 |
| | ===== | ===== |

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A reconciliation of the statutory federal income tax rate with the Company's effective tax rate is as follows:

| | December 30, 2000 | January 1, 2000 |
|---|----------------------|--------------------|
| | ----- | ----- |
| Statutory federal rate..... | 34.0% | 34.0% |
| State income taxes, net of federal income tax benefit..... | 5.7 | 4.6 |
| Other..... | 0.2 | (0.6) |
| | ----- | ----- |
| Effective tax rate..... | 39.9% | 38.0% |
| | ===== | ===== |

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SHOE PAVILION, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS--(Continued)

7. STOCKHOLDERS' EQUITY

Stock Options--In January 1998, the Company adopted the 1998 Equity Incentive Plan (the "1998 Plan") authorizing the issuance of 1,000,000 shares of common stock to key employees and consultants of the Company. The 1998 Plan provides for awards of incentive stock options and nonqualified stock option grants to purchase common stock at prices equal to fair market value at the date of grant. During 2000, the Company granted options under this plan for the purchase of 165,500 shares of common stock at exercise prices ranging from \$1.81 to \$1.94 per share, the fair market value of the shares at the date of grant. Such options vest from 25% to 33% each year, beginning on each anniversary date from the date of grant and expire ten years from that date. At December 30, 2000, 729,250 options were available for grants and 73,625 options were exercisable.

Directors' Stock Options--In January 1998, the Company adopted the Directors' Stock Option Plan (the "Directors' Plan") authorizing the issuance of 100,000 shares of common stock to non-employee directors of the Company. The Directors' Plan provides for awards of nonqualified stock options to purchase common stock at prices equal to fair market value at the date of grant. During 2000, the Company granted options under this plan for the purchase of 5,000 shares of common stock at an exercise price of \$1.83 per share, the fair market value of the shares at the date of grant. Such options vest 100% one year from grant date and expire six years from that date. At December 30, 2000, 75,000 options were available for grant and 20,000 options were exercisable.

The following tables summarize information about the stock options under both plans outstanding at December 30, 2000:

| | Number of Shares | Weighted Average Exercise Price |
|-----------------------------------|---------------------|---------------------------------------|
| | ----- | ----- |
| Balance at December 31, 1997..... | -- | -- |

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| | | |
|--|-----------|--------|
| Options granted..... | 334,000 | \$6.96 |
| Options canceled..... | (26,000) | 7.52 |
| | ----- | |
| Balance at January 2, 1999..... | 308,000 | 6.91 |
| Options granted..... | 86,000 | 4.36 |
| Options canceled..... | (82,750) | 6.67 |
| | ----- | |
| Balance at January 1, 2000..... | 311,250 | 6.27 |
| Options granted..... | 170,500 | 1.91 |
| Options canceled..... | (186,000) | 4.64 |
| | ----- | |
| Balance at December 30, 2000..... | 295,750 | \$4.78 |
| | ===== | |
| Weighted average fair value of options granted during 2000..... | | \$1.61 |

| Range of Exercise Prices | Number Outstanding at December 30, 2000 | Weighted Average Remaining Contractual Life (in years) | Weighted Average Exercise Price | Number Exerciseable at December 30, 2000 | Weighted Average Exercise Price |
|-----------------------------------|---|---|--|---|--|
| ----- | ----- | ----- | ----- | ----- | ----- |
| \$1.81 - \$1.94... | 125,500 | 9.28 | \$1.92 | -- | \$ -- |
| \$4.75 - \$6.75... | 27,250 | 7.31 | 5.67 | 8,625 | 5.71 |
| \$7.00 - \$10.25.. | 143,000 | 6.74 | 7.13 | 85,000 | 7.09 |
| | ----- | ---- | ----- | ----- | ----- |
| \$1.81 - \$10.25.. | 295,750 | 7.87 | \$4.78 | 93,625 | \$6.96 |
| | ===== | ===== | ===== | ===== | ===== |

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SHOE PAVILION, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS--(Continued)

7. STOCKHOLDERS' EQUITY (CONTINUED)

SFAS No. 123, "Accounting for Stock-Based Compensation," requires the disclosure of pro forma net income and net income per share as though the Company had adopted the fair value method as of the beginning of 1995. Under SFAS No. 123, the fair value of stock-based awards to employees is calculated through the use of option pricing models, even though such models were developed to estimate the fair value of freely tradable, fully transferable options without vesting restrictions, which significantly differ from the Company's stock option awards. These models also require subjective assumptions, including future stock price volatility and expected time to exercise, which greatly affect the calculated values. The Company's calculations were made using the Black-Scholes option pricing model with the following weighted average assumptions and forfeitures being recognized as they occur.

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| | Year Ended December 30, 2000 | Year Ended January 1, 2000 | Year Ended January 2, 1999 |
|---|---------------------------------|-------------------------------|-------------------------------|
| | ----- | ----- | ----- |
| Expected life in years following vesting..... | 9.2 years | 9.2 years | 5.7 years |
| Stock price volatility.. | 94.70% | 87.01% | 85.17% |
| Risk free interest rate..... | 6.0% | 6.0% | 6.0% |
| Dividends during term... | None | None | None |

If the computed fair values of all awards had been amortized over the vesting period of the awards, net income would have been reduced to the pro forma amounts indicated below.

| | Year Ended December 30, 2000 | Year Ended January 1, 2000 | Year Ended January 2, 1999 |
|------------------------|---------------------------------|-------------------------------|-------------------------------|
| | ----- | ----- | ----- |
| Net Income: | | | |
| As reported..... | \$1,174,083 | \$2,014,615 | \$3,393,452 |
| Pro forma..... | \$1,152,053 | \$1,787,608 | \$2,994,316 |
| Net Income per share: | | | |
| As reported: | | | |
| Basic..... | \$ 0.17 | \$ 0.30 | \$ 0.53 |
| Diluted..... | \$ 0.17 | \$ 0.30 | \$ 0.52 |
| Pro forma: | | | |
| Basic and diluted..... | \$ 0.17 | \$ 0.26 | \$ 0.46 |

8. EMPLOYEE BENEFIT PLAN

The Company established a 401(k) Savings Plan (the "Plan") effective January 1, 1998. An employee becomes eligible to participate in the Plan after completing one year of service and attainment of the age 21; however, all employees hired prior to January 1, 1998, regardless of length of service, were permitted to enroll in the Plan. Generally, employees may contribute up to 15% of their compensation or a maximum of \$10,500 in accordance with IRC Sections 402(g), 401(k) and 415. For every dollar contributed to the Plan, the Company will match 50 cents, up to a maximum of 3% of the employee's compensation. The Company contributed \$18,794 and \$25,041 for the years ending December 30, 2000 and January 1, 2000, respectively. The Company's contributions vest over a five-year period.

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SHOE PAVILION, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS--(Continued)

9. QUARTERLY FINANCIAL DATA (UNAUDITED)

Net Income
(loss)

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| | Sales | Gross Profit | Net Income (loss) | Per Share | |
|---------------------------------------|----------|--------------|-------------------|-----------|-----------|
| | | | | Basic | Diluted |
| (In thousands, except per share data) | | | | | |
| 2000 Quarters | | | | | |
| 4th Quarter..... | \$23,637 | \$7,137 | \$ (590) | \$ (0.09) | \$ (0.09) |
| 3rd Quarter..... | 23,148 | 7,621 | 389 | 0.06 | 0.06 |
| 2nd Quarter..... | 24,951 | 8,551 | 1,146 | 0.17 | 0.17 |
| 1st Quarter..... | 19,322 | 6,087 | 229 | 0.03 | 0.03 |
| 1999 Quarters | | | | | |
| 4th Quarter..... | \$21,699 | \$6,894 | \$ 385 | \$ 0.06 | \$ 0.06 |
| 3rd Quarter..... | 18,469 | 5,961 | 245 | 0.04 | 0.04 |
| 2nd Quarter..... | 17,190 | 6,034 | 842 | 0.12 | 0.12 |
| 1st Quarter..... | 14,253 | 4,646 | 543 | 0.08 | 0.08 |

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Item 9--Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

None.

PART III

Item 10--Directors and Executive Officers of the Registrant

The information required by this item is incorporated by reference from the Company's Definitive Proxy Statement for the Company's 2000 Annual Meeting of Stockholders under the captions "Election of Directors" and "Section 16(a) Beneficial Ownership Reporting Compliance." See also Item 1 above.

Item 11--Executive Compensation

The information required by this item is incorporated by reference from the Company's Definitive Proxy Statement for the Company's 2000 Annual Meeting of Stockholders under the caption "Executive Compensation."

Item 12--Security Ownership of Certain Beneficial Owners and Management

The information required by this item is incorporated by reference from the Company's Definitive Proxy Statement for the Company's 2000 Annual Meeting of Stockholders under the caption "Ownership of Management and Principal Stockholders."

Item 13--Certain Relationships and Related Transactions

The information required by this item is incorporated by reference from the Company's Definitive Proxy Statement for the Company's 2000 Annual Meeting of Stockholders under the captions "Compensation Committee Interlocks and Insider Participation" and "Transactions with the Company."

PART IV

Item 14--Exhibits, Financial Statement Schedules and Reports on Form 8-K

(a) The following documents are filed as part of this report:

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(1) Consolidated Financial Statements of the Company are included in Part II, Item 8:

Independent Auditors' Report
Consolidated Balance Sheets
Consolidated Statements of Income
Consolidated Statements of Cash Flows
Consolidated Statements of Shareholders' Equity
Notes to Consolidated Financial Statements

(2) Consolidated Supplementary Financial Statement Schedule for the years ended December 30, 2000 and January 1, 2000:

None.

All other schedules are omitted because of the absence of conditions under which they are required or because the required information is included in the consolidated financial statements or notes thereto.

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(3) Exhibits:

See attached Exhibit Index.

(b) The Company filed the following reports on Form 8-K during the fourth quarter of 1998:

(1) A report dated December 29, 1998 disclosing a fiscal year end change.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Date: March 27, 2001

SHOE PAVILION, INC.

/s/ Dmitry Beinus

By: _____

Dmitry Beinus
Chairman of the Board, President
and Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities indicated.

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| Signature ----- | Capacity ----- | Date ---- |
|---|--|----------------|
| /s/ Dmitry Beinus ----- Dmitry Beinus | Chairman, President and Chief Executive Officer (Principal Executive Officer) | March 27, 2001 |
| /s/ John D. Hellmann ----- John D. Hellmann | Vice President, Chief Financial Officer (Principal Financial Officer and Principal Accounting Officer) | March 27, 2001 |
| /s/ David H. Folkman ----- David H. Folkman | Director | March 27, 2001 |
| /s/ Peter G. Hanelt ----- Peter G. Hanelt | Director | March 27, 2001 |

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EXHIBIT INDEX

Set forth below is a list of exhibits that are being filed or incorporated by reference into this Form 10-K:

| Exhibit Number ----- | Exhibit ----- |
|----------------------------|---|
| 2.1 | -- Exchange Agreement dated February 23, 1998 by and among Shoe Pavilion, Inc., Shoe Inn, Inc. and Dmitry Beinus (Incorporated by reference from Exhibit 2.1 to Registration Statement No. 333-41877). |
| 3.1 | -- Certificate of Incorporation of the Registrant (Incorporated by reference from Exhibit 3.1 to Registration Statement No. 333-41877). |
| 3.2 | -- Bylaws of the Registrant (Incorporated by reference from Exhibit 3.2 to Registration Statement No. 333-41877). |
| 4.1 | -- Specimen Common Stock Certificate (Incorporated by reference from Exhibit 4.1 to Registration Statement No. 33-41877). |
| 10.1 | -- Lease Agreement between Lincoln-Whitehall Pacific, LLC and Shoe Inn, Inc. dated October 28, 1996 (Incorporated by reference from Exhibit 10.1 to Registration Statement No. 333-41877). |
| 10.2 | -- First Amendment to Lease Agreement between Lincoln-Whitehall Pacific, LLC and Shoe Pavilion Corporation dated September 17, 1998 (Incorporated by reference from Exhibit 10.2 to the Company's 10-K filed March 23, 1999). |
| 10.3 | -- Second Amendment to Lease Agreement between Lincoln-Whitehall Pacific, LLC and Shoe Pavilion Corporation dated January 11, 1999 (Incorporated by reference from Exhibit 10.3 to the Company's 10-K filed March 23, 1999). |

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- 10.4 -- 1998 Equity Incentive Plan with forms of non-qualified and incentive stock option agreements (Incorporated by reference from Exhibit 10.2 to Registration Statement No. 333-41877).
- 10.5 -- Directors' Stock Option Plan with form of stock option agreement (Incorporated by reference from Exhibit 10.3 to Registration Statement No. 333-41877).
- 10.6 -- Credit Agreement dated December 1, 1998 between Shoe Pavilion Corporation and Wells Fargo Bank, National Association (Incorporated by reference from Exhibit 10.6 to the Company's 10-K filed March 23, 1999).
- 10.7 -- Revolving Line of Credit Note dated December 1, 1998 between Shoe Pavilion Corporation and Wells Fargo Bank, National Association (Incorporated by reference from Exhibit 10.7 to the Company's 10-K filed March 23, 1999).
- 10.8 -- Continuing Guaranty dated December 1, 1998 between Shoe Pavilion, Inc. and Wells Fargo Bank, National Association (Incorporated by reference from Exhibit 10.8 to the Company's 10-K filed March 23, 1999).
- 10.9 -- Tax Allocation Agreement dated February 18, 1998 between Shoe Inn, Inc. and Dmitry Beinus (Incorporated by reference from Exhibit 10.5 to Registration Statement No. 333-41877).
- 10.10 -- Agreement of Purchase and Sale dated as of April 14, 1997 among Standard Shoe Company and Shoe Inn, Inc. (Incorporated by reference from Exhibit 10.6 to Registration Statement No. 333-41877).
- 10.11 -- Form of Indemnification Agreement between the Registrant and certain of its officers and directors (Incorporated by reference from Exhibit 10.7 to Registration Statement No. 333-41877).
- 10.12 -- License Agreement dated July 7, 1999 between Richman Gordman 1/2 Price Stores, Inc. and Shoe Pavilion, Inc. (Incorporated by reference from Exhibit 10.1 to the Company's 10-Q filed August 5, 1999).

(continued on following page)

EXHIBIT INDEX

(continued from previous page)

- | Exhibit
Number
----- | Exhibit
----- |
|----------------------------|--|
| 10.13 | -- First Amendment to License Agreement between Richman Gordman 1/2 Price Stores, Inc. and Shoe Pavilion, Inc. dated December 20, 1999 (Incorporated by reference from Exhibit 10.13 to the Company's 10-K filed March 27, 2000). |
| 10.14 | -- First Amendment to Credit Agreement between Shoe Pavilion Corporation and Wells Fargo Bank, National Association dated October 30, 1999 (Incorporated by reference from Exhibit 10.14 to the Company's 10-K filed March 27, 2000). |
| 10.15 | -- Second Amendment to Credit Agreement between Shoe Pavilion Corporation and Wells Fargo Bank, National Association dated February 8, 2000 (Incorporated by reference from Exhibit 10.15 to the Company's 10-K filed March 27, 2000). |
| 10.16 | -- Third Amendment to Credit Agreement between Shoe Pavilion Corporation and Wells Fargo Bank, National Association dated March 9, 2000 (Incorporated by reference from Exhibit 10.16 to the |

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- Company's 10-K filed March 27, 2000).
- 10.17 -- Credit Agreement dated February 27, 2001 between Shoe Pavilion Corporation and Wells Fargo Bank, National Association.
- 21 -- List of Subsidiaries
- 23 -- Independent Auditors' Consent