RH
Form 10-Q
December 06, 2017

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended October 28, 2017

or

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from to

Commission file number: 001-35720

(Exact name of registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation or organization)	45-3052669 (I.R.S. Employer Identification Number)
15 Koch Road, Suite K	
Corte Madera, CA (Address of principal executive offices)	94925 (Zip Code)

Registrant’s telephone number, including area code: (415) 924-1005

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).   Yes   No

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

Large accelerated filer		Accelerated filer
Non-accelerated filer	(Do not check if a smaller reporting company)	Smaller reporting company
		Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

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

As of December 1, 2017, 21,309,941 shares of registrant’s common stock were outstanding.

RH

INDEX TO FORM 10-Q

PART I

Item 1. Financial Statements

RH

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except share amounts)

(Unaudited)

	October 28, 2017	January 28, 2017
ASSETS		
Current assets:		
Cash and cash equivalents	$22,162	$87,023
Short-term investments	—	142,677
Accounts receivable—net	34,447	34,191
Merchandise inventories	557,345	752,304
Asset held for sale	—	4,900
Prepaid expense and other current assets	75,041	117,162
Total current assets	688,995	1,138,257
Long-term investments	—	33,212
Property and equipment—net	778,320	682,056
Goodwill	175,553	173,603
Trademarks and other intangible assets	100,726	100,757
Deferred tax assets	29,214	28,466
Other non-current assets	28,758	36,169
Total assets	$1,801,566	$2,192,520
LIABILITIES AND STOCKHOLDERS' EQUITY (DEFICIT)		
Current liabilities:		
Accounts payable and accrued expenses	$252,569	$226,980
Deferred revenue and customer deposits	166,579	145,918
Other current liabilities	50,609	43,271
Total current liabilities	469,757	416,169
Asset based credit facility	341,000	—
Term loan—net	79,471	—
Convertible senior notes due 2019—net	323,828	312,379
Convertible senior notes due 2020—net	248,633	235,965
Financing obligations under build-to-suit lease transactions	230,259	203,015
Deferred rent and lease incentives	63,499	60,439
Other non-current obligations	70,395	44,684
Total liabilities	1,826,842	1,272,651
Commitments and contingencies (Note 17)	—	—
Stockholders' equity (deficit):		
Preferred stock, $0.0001 par value per share, 10,000,000 shares authorized, no shares	—	—

issued or outstanding as of October 28, 2017 and January 28, 2017		
Common stock, $0.0001 par value per share, 180,000,000 shares authorized,		
41,525,393 shares issued and 21,305,261 shares outstanding as of October 28, 2017;		
41,123,521 shares issued and 40,828,633 shares outstanding as of January 28, 2017	2	4
Additional paid-in capital	843,965	790,866
Accumulated other comprehensive loss	(1,527)	(1,692)
Retained earnings	152,133	150,214
Treasury stock—at cost, 20,220,132 shares as of October 28, 2017 and 294,888 shares		
as of January 28, 2017	(1,019,849)	(19,523)
Total stockholders' equity (deficit)	(25,276)	919,869
Total liabilities and stockholders' equity (deficit)	$1,801,566	$2,192,520

The accompanying notes are an integral part of these unaudited Condensed Consolidated Financial Statements.

RH

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except share and per share amounts)

(Unaudited)

	Three Months Ended		Nine Months Ended	
	October 28, 2017	October 29, 2016	October 28, 2017	October 29, 2016
Net revenues	$592,473	$549,328	$1,769,879	$1,548,165
Cost of goods sold	378,148	373,509	1,179,485	1,065,032
Gross profit	214,325	175,819	590,394	483,133
Selling, general and administrative expenses	171,163	160,433	528,213	457,207
Income from operations	43,162	15,386	62,181	25,926
Other expenses				
Interest expense—net	18,915	11,091	45,496	32,528
Loss on extinguishment of debt	4,880	—	4,880	—
Total other expenses	23,795	11,091	50,376	32,528
Income (loss) before income taxes	19,367	4,295	11,805	(6,602)
Income tax expense (benefit)	6,216	1,778	9,886	(2,567)
Net income (loss)	$13,151	$2,517	$1,919	$(4,035)
Weighted-average shares used in computing basic net income (loss) per share	21,221,848	40,730,059	29,076,556	40,653,091
Basic net income (loss) per share	$0.62	$0.06	$0.07	$(0.10)
Weighted-average shares used in computing diluted net income (loss) per share	23,535,617	40,926,450	30,593,382	40,653,091
Diluted net income (loss) per share	$0.56	$0.06	$0.06	$(0.10)

The accompanying notes are an integral part of these unaudited Condensed Consolidated Financial Statements.

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CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

(In thousands)

(Unaudited)

	Three Months Ended		Nine Months Ended	
	October 28, 2017	October 29, 2016	October 28, 2017	October 29, 2016
Net income (loss)	$ 13,151	$ 2,517	$ 1,919	$ (4,035)
Net gains (losses) from foreign currency translation	(723)	(915)	154	485
Net unrealized holding gains (losses) on available-for-sale investments	—	(59)	11	84
Total comprehensive income (loss)	$ 12,428	$ 1,543	$ 2,084	$ (3,466)

The accompanying notes are an integral part of these unaudited Condensed Consolidated Financial Statements.

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CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(Unaudited)

	Nine Months Ended	
	October 28, 2017	October 29, 2016 As Revised
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income (loss)	$1,919	$(4,035)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation and amortization	51,092	41,248
Non-cash charges resulting from inventory step-up	2,108	5,187
Amortization of debt discount	22,685	21,467
Excess tax shortfall from exercise of stock options	—	2,275
Stock-based compensation expense	42,929	21,711
Non-cash loss on extinguishment of debt	1,880	—
Other non-cash interest expense	4,914	2,971
Change in assets and liabilities—net of acquisition:		
Accounts receivable	(319)	(1,445)
Merchandise inventories	190,620	(23,261)
Prepaid expense and other assets	38,419	(30,378)
Accounts payable and accrued expenses	10,491	(63,435)
Deferred revenue and customer deposits	20,617	22,652
Other current liabilities	448	(25,372)
Deferred rent and lease incentives	846	2,953
Other non-current obligations	(1,887)	8,477
Net cash provided by (used in) operating activities	386,762	(18,985)
CASH FLOWS FROM INVESTING ACTIVITIES		
Capital expenditures	(76,789)	(104,152)
Construction related deposits	(12,772)	(3,829)
Purchase of trademarks and domain names	(39)	(164)
Proceeds from sale of assets held for sale—net	15,123	—
Purchase of investments	(16,109)	(186,967)
Maturities of investments	46,890	115,938
Sales of investments	145,020	31,896
Acquisition of business—net of cash acquired	—	(116,100)
Net cash provided by (used in) investing activities	101,324	(263,378)
CASH FLOWS FROM FINANCING ACTIVITIES		
Borrowing under asset based credit facility	446,000	—
Repayments under asset based credit facility	(105,000)	—
Borrowings under term loans	180,000	—

Repayments under term loans	(100,000)	—
Borrowing under promissory and equipment security notes	34,000	—
Repayments under promissory and equipment security notes	(841)	—
Debt issuance costs	(8,298)	—
Repurchases of common stock—including commissions	(1,000,326)	—
Payments on build-to-suit lease transactions	(8,734)	—
Proceeds from exercise of stock options	15,369	1,591
Excess tax shortfall from exercise of stock options	—	(2,275)
Tax withholdings related to issuance of stock-based awards	(4,881)	(1,365)
Payments on capital leases	(258)	(262)
Net cash used in financing activities	(552,969)	(2,311)
Effects of foreign currency exchange rate translation	22	342
Net decrease in cash and cash equivalents	(64,861)	(284,332)
Cash and cash equivalents		
Beginning of period	87,023	331,467
End of period	$22,162	$47,135
Non-cash transactions:		
Property and equipment additions due to build-to-suit lease transactions	$35,463	$46,193
Property and equipment additions from use of construction related deposits	$27,077	$3,965
Property and equipment additions in accounts payable and accrued expenses at period-end	$24,081	$23,440
Property and equipment acquired under capital lease	$753	$—

The accompanying notes are an integral part of these unaudited Condensed Consolidated Financial Statements.

RH

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

NOTE 1—THE COMPANY

Nature of Business

RH, a Delaware corporation, together with its subsidiaries (collectively, the "Company"), is a luxury home furnishings retailer that offers a growing number of categories including furniture, lighting, textiles, bathware, décor, outdoor and garden, tableware, and child and teen furnishings. These products are sold through the Company's stores, catalogs and websites.

On May 27, 2016, the Company acquired a controlling interest in Design Investors WW Acquisition Company, LLC, which owns the business operating under the name "Waterworks". Refer to Note 3—Business Combination.

As of October 28, 2017, the Company operated a total of 84 retail Galleries and 31 outlet stores in 32 states, the District of Columbia and Canada, and includes 15 Waterworks showrooms in the United States and in the U.K., and had sourcing operations in Shanghai and Hong Kong.

Basis of Presentation

The accompanying unaudited interim condensed consolidated financial statements have been prepared from the Company's records and, in management's opinion, include all adjustments, consisting of normal recurring adjustments, necessary to fairly state the Company's financial position as of October 28, 2017, and the results of operations for the three and nine months ended October 28, 2017 and October 29, 2016. The Company's current fiscal year, which consists of 53 weeks, ends on February 3, 2018 ("fiscal 2017").

Certain information and disclosures normally included in the notes to annual consolidated financial statements prepared in accordance with generally accepted accounting principles in the United States ("GAAP") have been condensed or omitted for purposes of these interim condensed consolidated financial statements.

These unaudited interim condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and related notes included in the Company's Annual Report on Form 10-K for the fiscal year ended January 28, 2017 (the "2016 Form 10-K"). Certain prior year amounts have been reclassified for consistency with the current period presentation. Refer to "Revision" below.

The results of operations for the three and nine months ended October 28, 2017 presented herein are not necessarily indicative of the results to be expected for the full fiscal year.

Revision

During the fourth quarter of fiscal 2016, management determined that the Company had incorrectly reported negative cash balances due to outstanding checks in the accounts payable and accrued expenses financial statement line item in its condensed consolidated balance sheets without properly applying the limited right of offset against cash and cash equivalents in accordance with ASC 210—Balance Sheet. This resulted in an overstatement of cash and cash equivalents and an overstatement of accounts payable and accrued expenses on its condensed consolidated balance sheets, as well as a misstatement of the cash provided by operating activities on the condensed consolidated statements of cash flows. There was no impact on the condensed consolidated statements of income or stockholders' equity related to these misstatements.

The Company assessed the materiality of these misstatements on prior periods' financial statements in accordance with SEC Staff Accounting Bulletin ("SAB") No. 99—Materiality, codified in Accounting Standards Codification ("ASC") 250—Presentation of Financial Statements, and concluded that these misstatements were not material to any prior annual or interim periods. Accordingly, in accordance with ASC 250 (SAB No. 108—Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements), the amounts have been revised in the condensed consolidated statements of cash flows.

The following are selected line items from the Company's unaudited condensed consolidated statements of cash flows illustrating the effect of the corrections (in thousands):

	Nine Months Ended October 29, 2016		
	As Reported	Adjustment	As Revised
Cash flows from operating activities:			
Change in accounts payable and accrued expenses	$(73,574)	$ 10,139	$(63,435)
Net cash used in operating activities	$(29,124)	$ 10,139	$(18,985)
Cash and cash equivalents:			
Beginning of period	$349,897	$ (18,430)	$331,467
End of period	$55,426	$ (8,291)	$47,135

NOTE 2—RECENTLY ISSUED ACCOUNTING STANDARDS

Stock-Based Compensation

In March 2016, the Financial Accounting Standards Board ("FASB") issued Accounting Standard Update No. 2016-09—Improvements to Employee Share Based Payment Accounting ("ASU 2016-09"). The new guidance simplifies several aspects of the accounting for employee share-based payment transactions including the accounting for income taxes, forfeitures, and statutory tax withholding requirements, as well as classification in the statement of cash flows. One provision requires that the excess income tax benefits and tax deficiencies related to share-based payments be recognized within income tax expense in the statement of operations, rather than within additional paid-in capital on the balance sheet. The new guidance was effective for the Company beginning on January 29, 2017. As a result of the adoption of this new guidance, the Company recognized an excess tax benefit of $1.9 million and $4.3 million in the provision for income taxes as a discrete item during the three and nine months ended October 28, 2017, respectively. These amounts may not necessarily be indicative of future amounts that may be recognized as any excess tax benefits recognized would be dependent on future stock price, employee exercise behavior and applicable tax rates. As permitted, the Company elected to classify excess tax benefits (shortfalls) as an operating activity in the condensed consolidated statements of cash flows instead of as a financing activity on a prospective basis and did not retrospectively adjust prior periods.

In May 2017, the FASB issued Accounting Standard Update No. 2017-09—Compensation—Stock Compensation (Topic 718): Scope of Modification Accounting. The new guidance clarifies when modification accounting should be applied for changes to terms or conditions of a share-based payment award. The new guidance is effective for fiscal years beginning after December 15, 2017, including interim periods within that reporting period, with early adoption permitted. The standard will be applied prospectively. The Company is evaluating the impact of adopting this new accounting standard on its consolidated financial statements.

Revenue from Contracts with Customers

In May 2014, the FASB and International Accounting Standards Board issued their converged accounting standard update on revenue recognition, Accounting Standards Update 2014-09—Revenue from Contracts with Customers (Topic 606). This guidance outlines a single comprehensive model for companies to use in accounting for revenue arising from contracts with customers and supersedes most current revenue recognition guidance, including industry-specific guidance. The core principle of the revenue model is that revenue is recognized when a customer obtains control of a good or service. A customer obtains control when it has the ability to direct the use of and obtain the benefits from the good or service. Under the new guidance, transfer of control is no longer the same as transfer of risks and rewards as indicated in the prior guidance. The FASB deferred the effective date for the new revenue reporting standard for entities reporting under GAAP for one year from the original effective date. In 2016, the FASB issued several amendments to the standard, including principal versus agent considerations when another party is involved in providing goods or services to a customer, the application of identifying performance obligations, and the recognition of expected breakage amounts.

The Company continues to assess all potential impacts of the standard. In applying the guidance under Topic 606, specifically related to the indicators of transfer of control, the Company continues to assess the guidance and has not yet concluded how such guidance will be applied to its revenue streams. The Company plans to elect to adopt the practical expedient related to shipping and handling activities. The Company has concluded that the new standard will have an impact related to the accounting for gift card breakage. Under Topic 606 the Company expects to recognize breakage, which is currently recorded as a reduction to selling, general and administrative expenses, as revenue and breakage will be recognized proportional to actual gift card redemptions.

Topic 606 is effective for fiscal years beginning after December 15, 2017, including interim periods within that reporting period, with early adoption permitted for annual reporting periods beginning after December 15, 2016. The Company will adopt Topic 606 in the first quarter of fiscal 2018. The Company has elected to adopt using a modified retrospective approach with the cumulative effect of initially applying the new standard recognized in retained earnings at the date of adoption.

Accounting for Leases

In February 2016, the FASB issued Accounting Standards Update 2016-02—Leases, which, for operating leases, requires a lessee to recognize a right-of-use asset and a lease liability, initially measured at the present value of the lease payments, in its balance sheet. The standard also requires a lessee to recognize a single lease cost, calculated so that the cost of the lease is allocated over the lease term, on a generally straight-line basis. The ASU is effective for public companies for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early adoption is permitted. The Company is currently evaluating the effects that the adoption of ASU 2016-02 will have on its consolidated financial statements and anticipates the new guidance will significantly impact its consolidated financial statements given the Company has a significant number of leases.

Financial Instruments

In January 2016, the FASB issued Accounting Standards Update 2016-01—Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities, which amends various aspects of the recognition, measurement, presentation and disclosure for financial instruments. The new standard is effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. Early adoption is permitted only for certain provisions. The Company is evaluating the impact of adopting this new accounting standard on its consolidated financial statements.

Cash Flow Classification

In August 2016, the FASB issued Accounting Standard Update No. 2016-15—Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments. The new guidance addresses eight specific cash flow issues with the objective of reducing an existing diversity in practices regarding the matter in which certain cash receipts and payments are presented and classified in the consolidated statements of cash flows. The new guidance is effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. Early adoption is permitted. The Company is evaluating the impact of adopting this new accounting standard on its consolidated financial statements.

Income Taxes: Intra-Entity Asset Transfers

In October 2016, the FASB issued Accounting Standard Update No. 2016-16—Income Taxes (Topic 740): Intra-Entity Transfers of Assets Other Than Inventory. The new guidance requires the recognition of the income tax consequences of an intercompany asset transfer, other than transfers of inventory, when the transfer occurs. For intercompany transfers of inventory, the income tax effects will continue to be deferred until the inventory has been sold to a third party. The new guidance is effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. Early adoption is permitted. The Company is evaluating the impact of adopting this new accounting standard on its consolidated financial statements.

Goodwill and Intangibles

In January 2017, the FASB issued Accounting Standard Update No. 2017-04—Intangibles—Goodwill and Other (Topic 350). The updated guidance simplifies the measurement of goodwill impairment by removing step two of the goodwill impairment test, which requires the determination of the fair value of individual assets and liabilities of a reporting unit. The new guidance requires goodwill impairment to be measured as the amount by which a reporting unit's carrying value exceeds its fair value; however, the loss recognized should not exceed the total amount of goodwill allocated to that reporting unit. The amendments should be applied on a prospective basis. The new standard is effective for fiscal years beginning after December 15, 2019 with early adoption permitted for interim or annual goodwill impairment tests performed after January 1, 2017. The Company is evaluating the impact of adopting this new accounting standard on its consolidated financial statements.

NOTE 3—BUSINESS COMBINATION

On May 27, 2016, the Company acquired a controlling interest in Design Investors WW Acquisition Company, LLC, which owns the business operating under the name "Waterworks". The purchase price of the acquisition was approximately $119.9 million consisting of $118.4 million funded with available cash and $1.5 million representing the fair value of rollover units, which amount is subject to adjustment for changes in working capital and other items. The rollover units, which are classified as a liability, are included in non-current liabilities on the condensed consolidated balance sheets (refer to Note 15—Stock-Based Compensation). After the transaction, and giving effect to equity interests acquired by management in the business, the Company owns in excess of 90% of the total equity interest in Waterworks, and owns 100% of the voting equity interest.

During the nine months ended October 29, 2016, the Company incurred $2.8 million, of acquisition-related costs associated with the transaction. The Company did not incur any acquisition-related costs during the three months ended October 29, 2016. These costs and expenses include fees associated with financial, legal and accounting advisors, and employment related costs, and are included in selling, general and administrative expenses on the condensed consolidated statements of operations.

The Company recorded a purchase price allocation adjustment of $1.9 million during the first half of 2017. The adjustment primarily related to a subset of inventory acquired for which the Company completed a fair value analysis based on the facts and circumstances that existed as of the acquisition date. Subsequent to the acquisition date, only a small portion of such inventory had been sold and therefore the impact on the Company's results of operations for historical periods since the acquisition was insignificant. The following table summarizes the purchase price allocation based on the estimated fair value of the acquired assets and assumed liabilities, prior to and after the purchase price allocation adjustments (in thousands):

	January 28, 2017	Purchase Price Allocation Adjustments	October 28, 2017
Tangible assets acquired and liabilities assumed	$18,615	$ (1,916)	$16,699
Trademarks	52,100	—	52,100
Goodwill	49,229	1,916	51,145
Total	$119,944	$ —	$119,944

Any future changes to the purchase price will be recorded directly to the consolidated statements of operations and will not impact the goodwill recorded as a result of this acquisition.

Under purchase accounting rules, the Company valued the acquired finished goods inventory to fair value, which is defined as the estimated selling price less the sum of (a) costs of disposal and (b) a reasonable profit allowance for the Company's selling effort. This valuation resulted in an increase in inventory carrying value of approximately $9.7 million for marketable inventory.

Trademarks have been assigned an indefinite life and therefore are not subject to amortization. The goodwill is representative of the benefits and expected synergies from the integration of Waterworks products and Waterworks' management and employees, which do not qualify for separate recognition as an intangible asset. A portion of the trademarks and goodwill are not deductible for tax purposes.

Results of operations of Waterworks have been included in the Company's condensed consolidated statements of operations since the May 27, 2016 acquisition date. Pro forma results of the acquired business have not been presented as the results were not considered material to the Company's condensed consolidated financial statements for all periods presented and would not have been material had the acquisition occurred at the beginning of fiscal 2016.

NOTE 4—ASSET HELD FOR SALE

Building and Land

During the first quarter of fiscal 2017, the Company committed to a plan to sell the building and land at one of its owned retail Galleries, resulting in a reclassification of building and land of $8.2 million from property and equipment to asset held for sale on the condensed consolidated balance sheets as of April 29, 2017. In May 2017, the Company completed the sale of the building and land for approximately $10.2 million and entered into a short-term five month lease agreement to lease the property. As a result, the gain associated with the sale of this property was amortized over a five month period. During the three and nine months ended October 28, 2017, the Company recorded a gain of $0.8 million and $2.1 million, respectively, which is included as a reduction of selling, general and administrative expenses on the condensed consolidated statements of operations. No additional gain associated with this transaction will be recognized in future periods.

Aircraft

During the fourth quarter of fiscal 2016, the Company committed to a plan to sell an aircraft, which resulted in a reclassification of such aircraft from property and equipment to asset held for sale on the condensed consolidated balance sheets as of January 28, 2017. The asset held for sale had a carrying value of $4.9 million as of January 28, 2017. In April 2017, the sale of the aircraft was completed for a purchase price of $5.2 million and the Company incurred costs of $0.3 million to dispose of the asset.

NOTE 5—PREPAID EXPENSE AND OTHER ASSETS

Prepaid expense and other current assets consist of the following (in thousands):

	October 28, 2017	January 28, 2017
Capitalized catalog costs	$44,252	$61,258
Vendor deposits	8,374	13,276
Federal and state tax receivable	5,598	13,124
Prepaid expense and other current assets	16,817	29,504
Total prepaid expense and other current assets	$75,041	$117,162

Other non-current assets consist of the following (in thousands):

	October 28, 2017	January 28, 2017
Construction related deposits	$13,739	$28,044
Other deposits	4,926	4,706
Deferred financing fees	4,698	1,530
Other non-current assets	5,395	1,889
Total other non-current assets	$28,758	$36,169

NOTE 6—GOODWILL AND INTANGIBLE ASSETS

The following sets forth the goodwill and intangible assets as of October 28, 2017 (in thousands):

	Gross Carrying Amount	Accumulated Amortization	Foreign Currency Translation	Net Book Value
Intangible assets subject to amortization				
Fair value of leases (1)				
Fair market write-up	$1,925	$ (1,862)	$ —	$63
Fair market write-down (2)	(1,467)	1,393	—	(74)
Total intangible assets subject to amortization	$458	$ (469)	$ —	$(11)
Intangible assets not subject to amortization				
Goodwill (3)(4)	$175,605	$ —	$ (52)	$175,553
Trademarks and domain names (4)	$100,663	$ —	$ —	$100,663

(1) The fair value of each lease is amortized over the life of the respective lease.
(2) The fair market write-down of leases is included in other non-current obligations on the condensed consolidated balance sheets.
(3) Waterworks goodwill increased $1.9 million during the nine months ended October 28, 2017 due to purchase price accounting adjustments. Refer to Note 3—Business Combination.
(4) Refer to Note 18—Segment Reporting for goodwill and trademarks and domain names by reportable segment.

The following sets forth the goodwill and intangible assets as of January 28, 2017 (in thousands):

	Gross Carrying Amount	Accumulated Amortization	Foreign Currency Translation	Net Book Value
Intangible assets subject to amortization				
Fair value of leases [1]				
Fair market write-up	$1,925	$ (1,792)	$ —	$133
Fair market write-down [2]	(1,467)	1,350	—	(117)
Total intangible assets subject to amortization	$458	$ (442)	$ —	$16
Intangible assets not subject to amortization				
Goodwill [3][4]	$173,690	$ —	$ (87)	$173,603
Trademarks and domain names [3][4]	$100,624	$ —	$ —	$100,624

(1) The fair value of each lease is amortized over the life of the respective lease.
(2) The fair market write-down of leases is included in other non-current obligations on the condensed consolidated balance sheets.
(3) The Company recorded goodwill and trademarks of $49.2 million and $52.1 million, respectively, in fiscal 2016 related to its acquisition of Waterworks. Refer to Note 3—Business Combination.
(4) Refer to Note 18—Segment Reporting for goodwill and trademarks and domain names by reportable segment.

NOTE 7—ACCOUNTS PAYABLE, ACCRUED EXPENSES AND OTHER CURRENT LIABILITIES

Accounts payable and accrued expenses consist of the following (in thousands):

	October 28, 2017	January 28, 2017
Accounts payable	$130,902	$134,720
Accrued compensation	43,697	26,886
Accrued freight and duty	21,952	27,955
Accrued sales taxes	15,517	14,908
Accrued catalog costs	13,296	3,874
Accrued occupancy	11,422	8,137
Accrued professional fees	3,801	2,082
Other accrued expenses	11,982	8,418
Total accounts payable and accrued expenses	$252,569	$226,980

Other current liabilities consist of the following (in thousands):

	October 28, 2017	January 28, 2017
Unredeemed gift card and merchandise credit liability	$27,448	$24,524
Allowance for sales returns	10,999	10,077
Current portion of non-current debt	5,986	—
Product recall reserves	2,218	4,324
Other current liabilities	3,958	4,346
Total other current liabilities	$50,609	$43,271

NOTE 8—OTHER NON-CURRENT OBLIGATIONS

Other non-current obligations consist of the following (in thousands):

	October 28, 2017	January 28, 2017
Notes payable for share repurchases	$19,390	$19,390
Equipment security notes (1)	15,040	—
Promissory note (2)	11,968	—
Capital lease obligations—non-current	7,553	7,242
Deferred contract incentive (3)	5,953	7,739
Unrecognized tax benefits	2,617	2,508
Rollover units and profit interests (4)	2,104	1,784
Other non-current obligations	5,770	6,021
Total other non-current obligations	$70,395	$44,684

(1) Represents the non-current portion of equipment security notes secured by certain of the Company's distribution center property and equipment.

(2) Represents the non-current portion of a promissory note secured by the Company's aircraft.

(3) Represents the non-current portion of an incentive payment received in relation to a 5-year service agreement. The amount will be amortized over the term of the agreement.

(4) Represents rollover units and profit interests associated with the acquisition of Waterworks. Refer to Note 15—Stock-Based Compensation.

NOTE 9—CONVERTIBLE SENIOR NOTES

0.00% Convertible Senior Notes due 2020

In June 2015, the Company issued in a private offering $250 million principal amount of 0.00% convertible senior notes due 2020 and, in July 2015, the Company issued an additional $50 million principal amount pursuant to the exercise of the overallotment option granted to the initial purchasers as part of its June 2015 offering (collectively, the "2020 Notes"). The 2020 Notes are governed by the terms of an indenture between the Company and U.S. Bank National Association, as the Trustee. The 2020 Notes will mature on July 15, 2020, unless earlier purchased by the Company or converted. The 2020 Notes will not bear interest, except that the 2020 Notes will be subject to "special interest" in certain limited circumstances in the event of the failure of the Company to perform certain of its obligations under the indenture governing the 2020 Notes. The 2020 Notes are unsecured obligations and do not contain any financial covenants or restrictions on the payments of dividends, the incurrence of indebtedness or the issuance or repurchase of securities by the Company or any of its subsidiaries. Certain events are also considered "events of default" under the 2020 Notes, which may result in the acceleration of the maturity of the 2020 Notes, as described in the indenture governing the 2020 Notes. The 2020 Notes are guaranteed by the Company's primary operating subsidiary, Restoration Hardware, Inc., as Guarantor. The guarantee is the unsecured obligation of the Guarantor and is subordinated to the Guarantor's obligations from time to time with respect to its credit agreement and ranks equal in right of payment with respect to Guarantor's other obligations.

The initial conversion rate applicable to the 2020 Notes is 8.4656 shares of common stock per $1,000 principal amount of 2020 Notes, which is equivalent to an initial conversion price of approximately $118.13 per share. The conversion rate will be subject to adjustment upon the occurrence of certain specified events, but will not be adjusted for any accrued and unpaid special interest. In addition, upon the occurrence of a "make-whole fundamental change" as defined in the indenture, the Company will, in certain circumstances, increase the conversion rate by a number of additional shares for a holder that elects to convert its 2020 Notes in connection with such make-whole fundamental change.

Prior to March 15, 2020, the 2020 Notes will be convertible only under the following circumstances: (1) during any calendar quarter commencing after September 30, 2015, if, for at least 20 trading days (whether or not consecutive) during the 30 consecutive trading day period ending on the last trading day of the immediately preceding fiscal quarter, the last reported sale price of the Company's common stock on such trading day is greater than or equal to 130% of the applicable conversion price on such trading day; (2) during the five consecutive business day period after any ten consecutive trading day period in which, for each day of that period, the trading price per $1,000 principal amount of 2020 Notes for such trading day was less than 98% of the product of the last reported sale price of the Company's common stock and the applicable conversion rate on such trading day; or (3) upon the occurrence of specified corporate transactions. As of October 28, 2017, none of these conditions have occurred and, as a result, the 2020 Notes are not convertible as of October 28, 2017. On and after March 15, 2020, until the close of business on the second scheduled trading day immediately preceding the maturity date, holders may convert all or a portion of their 2020 Notes at any time, regardless of the foregoing circumstances. Upon conversion, the 2020 Notes will be settled, at the Company's election, in cash, shares of the Company's common stock, or a combination of cash and shares of the Company's common stock. If the Company has not delivered a notice of its election of settlement method prior to the final conversion period it will be deemed to have elected combination settlement with a dollar amount per note to be received upon conversion of $1,000.

The Company may not redeem the 2020 Notes; however, upon the occurrence of a fundamental change (as defined in the indenture governing the notes), holders may require the Company to purchase all or a portion of their 2020 Notes for cash at a price equal to 100% of the principal amount of the 2020 Notes to be purchased plus any accrued and unpaid special interest to, but excluding, the fundamental change purchase date.

Under GAAP, certain convertible debt instruments that may be settled in cash on conversion are required to be separately accounted for as liability and equity components of the instrument in a manner that reflects the issuer's non-convertible debt borrowing rate. Accordingly, in accounting for the issuance of the 2020 Notes, the Company separated the 2020 Notes into liability and equity components. The carrying amount of the liability component was calculated by measuring the fair value of a similar liability that does not have an associated convertible feature. The carrying amount of the equity component, which is recognized as a debt discount, represents the difference between the proceeds from the issuance of the 2020 Notes and the fair value of the liability component of the 2020 Notes. The excess of the principal amount of the liability component over its carrying amount ("debt discount") will be amortized to interest expense using an effective interest rate of 6.47% over the expected life of the 2020 Notes. The equity component is not remeasured as long as it continues to meet the conditions for equity classification.

In accounting for the debt issuance costs related to the issuance of the 2020 Notes, the Company allocated the total amount incurred to the liability and equity components based on their relative values. Debt issuance costs attributable to the liability component are amortized to interest expense using the effective interest method over the expected life of the 2020 Notes, and debt issuance costs attributable to the equity component are netted with the equity component in stockholders' equity.

Debt issuance costs related to the 2020 Notes were comprised of discounts upon original issuance of $3.8 million and third party offering costs of $2.3 million. Discounts and third party offering costs attributable to the liability component are recorded as a contra-liability and are presented net against the convertible senior notes due 2020 balance on the condensed consolidated balance sheets. During the three months ended October 28, 2017 and October 29, 2016, the Company recorded $0.3 million and $0.2 million, respectively, related to the amortization of debt issuance costs. During the nine months ended October 28, 2017 and October 29, 2016, the Company recorded $0.8 million and $0.7 million, respectively, related to the amortization of debt issuance costs.

The carrying values of the 2020 Notes, excluding the discounts upon original issuance and third party offering costs, are as follows (in thousands):

	October 28, 2017	January 28, 2017
Liability component		
Principal	$300,000	$300,000
Less: Debt discount	(48,229)	(60,124)
Net carrying amount	$251,771	$239,876
Equity component (1)	$84,003	$84,003

(1) Included in additional paid-in capital on the condensed consolidated balance sheets.

The Company recorded interest expense of $4.0 million and $3.8 million for the amortization of the debt discount related to the 2020 Notes during the three months ended October 28, 2017 and October 29, 2016, respectively. The Company recorded interest expense of $11.9 million and $11.2 million for the amortization of the debt discount related to the 2020 Notes during the nine months ended October 28, 2017 and October 29, 2016, respectively.

2020 Notes—Convertible Bond Hedge and Warrant Transactions

In connection with the offering of the 2020 Notes in June 2015 and the exercise in full of the overallotment option in July 2015, the Company entered into convertible note hedge transactions whereby the Company has the option to purchase a total of approximately 2.5 million shares of its common stock at a price of approximately $118.13 per share. The total cost of the convertible note hedge transactions was $68.3 million. In addition, the Company sold warrants whereby the holders of the warrants have the option to purchase a total of approximately 2.5 million shares of the Company's common stock at a price of $189.00 per share. The warrants contain certain adjustment mechanisms whereby the total number of shares to be purchased under such warrants may be increased up to a cap of 5.1 million shares of common stock (which cap may also be subject to adjustment). The Company received $30.4 million in cash proceeds from the sale of these warrants. Taken together, the purchase of the convertible note hedges and sale of the warrants are intended to offset any actual earnings dilution from the conversion of the 2020 Notes until the Company's common stock is above approximately $189.00 per share. As these transactions meet certain accounting criteria, the convertible note hedges and warrants are recorded in stockholders' equity, are not accounted for as derivatives and are not remeasured each reporting period. The net costs incurred in connection with the convertible note hedge and warrant transactions were recorded as a reduction to additional paid-in capital on the condensed consolidated balance sheets.

The Company recorded a deferred tax liability of $32.8 million in connection with the debt discount associated with the 2020 Notes and recorded a deferred tax asset of $26.6 million in connection with the convertible note hedge transactions. The deferred tax liability and deferred tax asset are recorded in deferred tax assets on the condensed consolidated balance sheets.

0.00% Convertible Senior Notes due 2019

In June 2014, the Company issued $350 million principal amount of 0.00% convertible senior notes due 2019 (the "2019 Notes") in a private offering. The 2019 Notes are governed by the terms of an indenture between the Company and U.S. Bank National Association, as the Trustee. The 2019 Notes will mature on June 15, 2019, unless earlier purchased by the Company or converted. The 2019 Notes will not bear interest, except that the 2019 Notes will be subject to "special interest" in certain limited circumstances in the event of the failure of the Company to perform certain of its obligations under the indenture governing the 2019 Notes. The 2019 Notes are unsecured obligations and do not contain any financial covenants or restrictions on the payments of dividends, the incurrence of indebtedness or the issuance or repurchase of securities by the Company or any of its subsidiaries. Certain events are also considered "events of default" under the 2019 Notes, which may result in the acceleration of the maturity of the 2019 Notes, as described in the indenture governing the 2019 Notes.

The initial conversion rate applicable to the 2019 Notes is 8.6143 shares of common stock per $1,000 principal amount of 2019 Notes, which is equivalent to an initial conversion price of approximately $116.09 per share. The conversion rate will be subject to adjustment upon the occurrence of certain specified events, but will not be adjusted for any accrued and unpaid special interest. In addition, upon the occurrence of a "make-whole fundamental change," the Company will, in certain circumstances, increase the conversion rate by a number of additional shares for a holder that elects to convert its 2019 Notes in connection with such make-whole fundamental change.

Prior to March 15, 2019, the 2019 Notes will be convertible only under the following circumstances: (1) during any calendar quarter commencing after September 30, 2014, if, for at least 20 trading days (whether or not consecutive) during the 30 consecutive trading day period ending on the last trading day of the immediately preceding fiscal quarter, the last reported sale price of the Company's common stock on such trading day is greater than or equal to 130% of the applicable conversion price on such trading day; (2) during the five consecutive business day period after any ten consecutive trading day period in which, for each day of that period, the trading price per $1,000 principal amount of 2019 Notes for such trading day was less than 98% of the product of the last reported sale price of the Company's common stock and the applicable conversion rate on such trading day; or (3) upon the occurrence of specified corporate transactions. As of October 28, 2017, none of these conditions have occurred and, as a result, the 2019 Notes are not convertible as of October 28, 2017. On and after March 15, 2019, until the close of business on the second scheduled trading day immediately preceding the maturity date, holders may convert all or a portion of their 2019 Notes at any time, regardless of the foregoing circumstances. Upon conversion, the 2019 Notes will be settled, at the Company's election, in cash, shares of the Company's common stock, or a combination of cash and shares of the Company's common stock. If the Company has not delivered a notice of its election of settlement method prior to the final conversion period it will be deemed to have elected combination settlement with a dollar amount of $1,000.

The Company may not redeem the 2019 Notes; however, upon the occurrence of a fundamental change (as defined in the indenture governing the notes), holders may require the Company to purchase all or a portion of their 2019 Notes for cash at a price equal to 100% of the principal amount of the 2019 Notes to be purchased plus any accrued and unpaid special interest to, but excluding, the fundamental change purchase date.

Under GAAP, certain convertible debt instruments that may be settled in cash on conversion are required to be separately accounted for as liability and equity components of the instrument in a manner that reflects the issuer's non-convertible debt borrowing rate. Accordingly, in accounting for the issuance of the 2019 Notes, the Company separated the 2019 Notes into liability and equity components. The carrying amount of the liability component was calculated by measuring the fair value of a similar liability that does not have an associated convertible feature. The carrying amount of the equity component, which is recognized as a debt discount, represents the difference between the proceeds from the issuance of the 2019 Notes and the fair value of the liability component of the 2019 Notes. The excess of the principal amount of the liability component over its carrying amount ("debt discount") will be amortized to interest expense using an effective interest rate of 4.51% over the expected life of the 2019 Notes. The equity component is not remeasured as long as it continues to meet the conditions for equity classification.

In accounting for the debt issuance costs related to the issuance of the 2019 Notes, the Company allocated the total amount incurred to the liability and equity components based on their relative values. Debt issuance costs attributable to the liability component are amortized to interest expense using the effective interest method over the expected life of the 2019 Notes, and debt issuance costs attributable to the equity component are netted with the equity component in stockholders' equity.

Debt issuance costs related to the 2019 Notes were comprised of discounts and commissions payable to the initial purchasers of $4.4 million and third party offering costs of $1.0 million. Discounts, commissions payable to the initial purchasers and third party offering costs attributable to the liability component are recorded as a contra-liability and are presented net against the convertible senior notes due 2019 balance on the condensed consolidated balance sheets. During both the three months ended October 28, 2017 and October 29, 2016, the Company recorded $0.2 million related to the amortization of debt issuance costs. During both the nine months ended October 28, 2017 and October 29, 2016, the Company recorded $0.6 million related to the amortization of debt issuance costs.

The carrying values of the 2019 Notes, excluding the discounts and commissions payable to the initial purchasers and third party offering costs, are as follows (in thousands):

	October 28, 2017	January 28, 2017
Liability component		
Principal	$350,000	$350,000
Less: Debt discount	(24,666)	(35,457)
Net carrying amount	$325,334	$314,543
Equity component (1)	$70,482	$70,482

(1) Included in additional paid-in capital on the condensed consolidated balance sheets.

The Company recorded interest expense of $3.6 million and $3.5 million for the amortization of the debt discount related to the 2019 Notes during the three months ended October 28, 2017 and October 29, 2016, respectively. The Company recorded interest expense of $10.8 million and $10.3 million for the amortization of the debt discount related to the 2019 Notes during the nine months ended October 28, 2017 and October 29, 2016, respectively.

2019 Notes—Convertible Bond Hedge and Warrant Transactions

In connection with the offering of the 2019 Notes, the Company entered into convertible note hedge transactions whereby the Company has the option to purchase a total of approximately 3.0 million shares of its common stock at a price of approximately $116.09 per share. The total cost of the convertible note hedge transactions was $73.3 million. In addition, the Company sold warrants whereby the holders of the warrants have the option to purchase a total of approximately 3.0 million shares of the Company's common stock at a price of $171.98 per share. The warrants contain certain adjustment mechanisms whereby the total number of shares to be purchased under such warrants may be increased up to a cap of 6.0 million shares of common stock (which cap may also be subject to adjustment). The Company received $40.4 million in cash proceeds from the sale of these warrants. Taken together, the purchase of the convertible note hedges and sale of the warrants are intended to offset any actual dilution from the conversion of the 2019 Notes and to effectively increase the overall conversion price from $116.09 per share to $171.98 per share. As these transactions meet certain accounting criteria, the convertible note hedges and warrants are recorded in stockholders' equity, are not accounted for as derivatives and are not remeasured each reporting period. The net costs incurred in connection with the convertible note hedge and warrant transactions were recorded as a reduction to additional paid-in capital on the condensed consolidated balance sheets.

The Company recorded a deferred tax liability of $27.5 million in connection with the debt discount associated with the 2019 Notes and recorded a deferred tax asset of $28.6 million in connection with the convertible note hedge transactions. The deferred tax liability and deferred tax assets are included in deferred tax assets on the condensed consolidated balance sheets.

NOTE 10—CREDIT FACILITIES

The following credit facilities were outstanding as of October 28, 2017 (in thousands):

	Outstanding Amount	Unamortized Debt Issuance Costs	Net Carrying Amount
Asset based credit facility	$ 341,000	$ —	$ 341,000
LILO term loan	80,000	(529)	79,471
Total credit facilities	$ 421,000	$ (529)	$ 420,471

16

There were no amounts outstanding under any credit facilities as of January 28, 2017.

Asset Based Credit Facility & LILO Term Loan

In August 2011, Restoration Hardware, Inc., along with its Canadian subsidiary, Restoration Hardware Canada, Inc., entered into a credit agreement with Bank of America, N.A., as administrative agent, and certain other lenders.

On June 28, 2017, Restoration Hardware, Inc. entered into an eleventh amended and restated credit agreement among Restoration Hardware, Inc., Restoration Hardware Canada, Inc., various subsidiaries of RH named therein as borrowers or guarantors, the lenders party thereto and Bank of America, N.A. as administrative agent and collateral agent (the “credit agreement”). The credit agreement has a revolving line of credit with availability of up to $600.0 million, of which $10.0 million is available to Restoration Hardware Canada, Inc., and includes a $200.0 million accordion feature under which the revolving line of credit may be expanded by agreement of the parties from $600.0 million to up to $800 million if and to the extent the lenders revise their credit commitments to encompass a larger facility. In addition, the credit agreement establishes an up to $80.0 million LILO term loan facility.

The Company incurred $3.9 million of deferred financing fees related to the credit agreement, which are included in other non-current assets on the condensed consolidated balance sheets, and will be amortized on a straight line basis over the life of the revolving line of credit, which has a maturity date of June 28, 2022. As a result of the credit agreement, unamortized deferred financing fees of $0.1 million related to the previous facility were expensed during the nine months ended October 28, 2017 and $1.1 million related to the previous facility will be amortized over the life of the new revolving line of credit.

The Company incurred $0.6 million of debt issuance costs related to the LILO term loan facility, which are presented net against the term loans balance on the condensed consolidated balance sheets, and will be amortized over the life of the revolving line of credit.

Borrowings under the revolving line of credit and LILO term loan facility are subject to interest, at the borrowers' option, at either the bank's reference rate or LIBOR (or, in the case of the revolving line of credit, the Bank of America “BA” Rate or the Canadian Prime Rate, as such terms are defined in the credit agreement, for Canadian borrowings denominated in Canadian dollars or the United States Index Rate or LIBOR for Canadian borrowings denominated in United States dollars) plus an applicable margin rate, in each case.

The credit agreement contains various restrictive covenants, including, among others, limitations on the ability to incur liens, make loans or other investments, incur additional debt, issue additional equity, merge or consolidate with or into another person, sell assets, pay dividends or make other distributions, or enter into transactions with affiliates, along with other restrictions and limitations typical to credit agreements of this type and size. As of October 28, 2017, Restoration Hardware, Inc. was in compliance with all applicable covenants of the credit agreement.

As of October 28, 2017, the Company had $341.0 million in outstanding borrowings and $189.0 million of availability under the revolving line of credit, net of $27.7 million in outstanding letters of credit. As of October 28, 2017, the Company had $80.0 million outstanding borrowings under the LILO term loan facility. As a result of the consolidated fixed-charge coverage ratio (“FCCR”) restriction that limits the last 10% of borrowing availability, actual incremental borrowing available to the Company and the other affiliated parties under the revolving line of credit is approximately $125.2 million as of October 28, 2017.

Second Lien Credit Agreement

On July 7, 2017, Restoration Hardware, Inc., a wholly-owned subsidiary of RH, entered into a credit agreement (the "second lien credit agreement"), dated as of July 7, 2017, among Restoration Hardware, Inc., as lead borrower, the guarantors party thereto, the lenders party thereto, each of whom are funds and accounts managed or advised by Apollo Capital Management, L.P., and its affiliated investment managers, and Wilmington Trust, National Association as administrative agent and collateral agent with respect to an initial term loan in an aggregate principal amount equal to $100.0 million with a maturity date of January 7, 2023 (the "second lien term loan"). The second lien term loan of $100.0 million was repaid in full on October 10, 2017. As a result of the repayment, the Company incurred a $4.9 million loss on extinguishment of debt, which includes a prepayment penalty of $3.0 million and acceleration of amortization of debt issuance costs of $1.9 million.

The Company incurred $3.6 million of debt issuance costs related to the second lien credit agreement.

The second lien term loan bore interest at an annual rate generally based on LIBOR plus 8.25%. This rate was a floating rate that reset periodically based upon changes in LIBOR rates during the life of the second lien term loan. At the date of borrowing, the rate was set at one month LIBOR plus 8.25%.

All obligations under the second lien term loan were secured by a second lien security interest in assets of the loan parties including inventory, receivables and certain types of intellectual property. The second lien security interest was granted with respect to substantially the same collateral that secures the credit agreement. The second lien ranked junior in priority and is subordinated to the first lien in favor of the lenders with respect to the credit agreement.

The second lien credit agreement contained various restrictive and affirmative covenants generally in line with the covenants and restrictions contained in the credit agreement including required financial reporting, limitations on the ability to incur liens, make loans or other investments, incur additional debt, make certain restricted payments, or enter into transactions with affiliates, along with other restrictions and limitations typical to credit agreements of this type and size.

The second lien credit agreement also contained a financial ratio covenant not found in the credit agreement based upon a senior secured leverage ratio of consolidated secured debt to consolidated earnings before interest, taxes, depreciation and amortization (“EBITDA”).

The second lien credit agreement also contained a consolidated fixed charge coverage ratio generally based on the same formulation set forth in the credit agreement such that the borrower may not make certain “restricted payments” in the event that certain ratios were not met and contained certain events of default and other customary terms and conditions for a second lien credit agreement.

Intercreditor Agreement

On July 7, 2017, in connection with the second lien credit agreement, Restoration Hardware, Inc. entered into an intercreditor agreement (the “intercreditor agreement”) with the administrative agent and collateral agent under the credit agreement and the administrative agent and collateral agent under the second lien credit agreement. The intercreditor agreement established various customary inter-lender terms, including, without limitation, with respect to priority of liens, permitted actions by each party, application of proceeds, exercise of remedies in case of default, releases of liens and certain limitations on the amendment of the credit agreement and the second lien credit agreement without the consent of the other party. The intercreditor agreement was terminated upon repayment of the second lien term loan on October 10, 2017.

NOTE 11—FAIR VALUE OF FINANCIAL INSTRUMENTS

Financial Assets and Liabilities

Certain financial assets and liabilities are required to be carried at fair value. Fair value is the price that would be received to sell an asset, or paid to transfer a liability, in an orderly transaction between market participants at the measurement date. In determining the fair value, the Company utilizes market data or assumptions that it believes market participants would use in pricing the asset or liability, which would maximize the use of observable inputs and minimize the use of unobservable inputs to the extent possible, including assumptions about risk and the risks inherent in the inputs of the valuation technique.

The degree of judgment used in measuring the fair value of financial instruments generally correlates to the level of pricing observability. Pricing observability is impacted by a number of factors, including the type of financial instrument, whether the financial instrument is new to the market and not yet established and the characteristics specific to the transaction. Financial instruments with readily available active quoted prices for which fair value can be measured generally will have a higher degree of pricing observability and a lesser degree of judgment used in measuring fair value. Conversely, financial instruments rarely traded or not quoted will generally have less, or no, pricing observability and a higher degree of judgment used in measuring fair value.

The Company’s financial assets and liabilities measured and reported at fair value are classified and disclosed in one of the following categories:

- Level 1—Quoted prices are available in active markets for identical investments as of the reporting date.
- Level 2—Pricing inputs are other than quoted prices in active markets, which are either directly or indirectly observable as of the reporting date, and fair value is determined through the use of models or other valuation methodologies.
- Level 3—Pricing inputs are unobservable for the investment and include situations where there is little, if any, market activity for the investment. The inputs used in the determination of fair value require significant management judgment or estimation.

A financial instrument’s categorization within the fair value hierarchy is based upon the lowest level of input that is significant to the fair value measurement.

Fair Value Measurements

All of the Company’s investments are classified as available-for-sale and are carried at fair value. The Company did not hold any short-term or long-term investments as of October 28, 2017. Assets measured at fair value were as follows as of January 28, 2017 (in thousands):

	Level 1	Level 2	Total
Cash equivalents			
Money market funds	$2,510	$—	$2,510
Commercial paper	—	5,493	5,493
Total cash equivalents	2,510	5,493	8,003
Short-term investments			
Commercial paper	—	34,534	34,534
Government agency obligations	2,553	105,590	108,143
Total short-term investments	2,553	140,124	142,677
Long-term investments			
Government agency obligations	—	33,212	33,212
Total long-term investments	—	33,212	33,212
Total	$5,063	$178,829	$183,892

The following table summarizes the amortized cost and estimated fair value of the available-for-sale securities within the Company’s investment portfolio as of January 28, 2017 based on stated maturities, which are recorded within cash and cash equivalents, short-term investments and long-term investments on the condensed consolidated balance sheets (in thousands):

	Cost	Fair Value
Range of maturity		
Due within 1 year	$148,155	$148,170
Due in 1 to 2 years	$33,238	$33,212

The Company invests excess cash primarily in investment-grade interest-bearing securities such as money market funds, certificates of deposit, commercial paper, government agency obligations and guaranteed obligations of the U.S. government, all of which are subject to minimal credit and market risks. The Company estimates the fair value of its commercial paper and U.S. government agency bonds by taking into consideration valuations obtained from third party pricing services. The pricing services utilize industry standard valuation models, including both income and market based approaches, for which all significant inputs are observable, either directly or indirectly, to estimate fair value. These inputs include reported trade dates of and broker/dealer quotes on the same or similar securities; issuer credit spreads; benchmark securities, prepayment/default projections based on historical data; and other observable inputs.

There were no purchases, sales, issuances, or settlements related to recurring level 3 measurements during the three and nine months ended October 28, 2017 or October 29, 2016. There were no transfers into or out of level 1 and level 2 during the three and nine months ended October 28, 2017 or October 29, 2016.

Fair Value of Financial Instruments

Amounts reported as cash and equivalents, receivables, and accounts payable and accrued expenses approximate fair value, due to the short-term nature of activity within these accounts. The estimated fair value and carrying value of the 2019 Notes and 2020 Notes (carrying value excludes the equity component of the 2019 Notes and 2020 Notes classified in stockholders' equity) were as follows (in thousands):

	October 28, 2017		January 28, 2017	
	Fair Value	Carrying Value	Fair Value	Carrying Value
Convertible senior notes due 2019	$312,281	$325,334	$295,381	$314,543
Convertible senior notes due 2020	$247,300	$251,771	$232,463	$239,876

The fair value of each of the 2019 Notes and 2020 Notes was determined based on inputs that are observable in the market or that could be derived from, or corroborated with, observable market data, including the trading price of the Company's convertible notes, when available, the Company’s stock price and interest rates based on similar debt issued by parties with credit ratings similar to the Company (level 2).

The estimated fair value of the asset based credit facility was $341.0 million, which approximates cost, as of October 28, 2017. Fair value approximates cost as the interest rate associated with the facility is variable and resets frequently.

The estimated fair value of the LILO term loan is $80.0 million, which approximates cost, as of October 28, 2017. Fair value approximates cost as the interest rate associated with the facility is variable and resets frequently.

NOTE 12—INCOME TAXES

The Company recorded income tax expense of $6.2 million and $1.8 million in the three months ended October 28, 2017 and October 29, 2016, respectively. The Company recorded income tax expense of $9.9 million and an income tax benefit of $2.6 million in the nine months ended October 28, 2017 and October 29, 2016, respectively. The effective tax rate was 32.1% and 41.4% for the three months ended October 28, 2017 and October 29, 2016, respectively. The effective tax rate was 83.7% and 38.9% for the nine months ended October 28, 2017 and October 29, 2016, respectively. The effective tax rates for the three and nine months ended October 28, 2017 were impacted by net excess tax benefits from stock-based compensation of $1.9 million and $4.3 million, respectively, resulting from the Company’s adoption of ASU 2016-09 in the first quarter of fiscal 2017. The effective tax rate for the nine months ended October 28, 2017 was also significantly impacted by non-deductible stock-based compensation.

As of October 28, 2017 and January 28, 2017, $6.8 million and $1.4 million, respectively, of the exposures related to unrecognized tax benefits would affect the effective tax rate if realized, of which, as of both October 28, 2017 and January 28, 2017, $1.4 million is included in other non-current obligations on the condensed consolidated balance sheets. In October 2017, the Company filed an amended federal tax return claiming a $5.4 million refund, however, no income tax benefit was recorded during the three months ended October 28, 2017 given the technical nature and amount of the refund claim. An income tax benefit related to this refund claim could be recorded in a future period upon settlement with the respective taxing authority. As of October 28, 2017, the Company does not have any exposures related to unrecognized tax benefits that are expected to decrease in the next 12 months.

NOTE 13—NET INCOME (LOSS) PER SHARE

The weighted-average shares used for net income (loss) per share is presented in the table below. As the Company was in a net loss position for the nine months ended October 29, 2016, the weighted-average shares outstanding for basic and diluted are the same.

	Three Months Ended		Nine Months Ended	
	October 28, 2017	October 29, 2016	October 28, 2017	October 29, 2016
Weighted-average shares—basic	21,221,848	40,730,059	29,076,556	40,653,091
Effect of dilutive stock-based awards	2,313,769	196,391	1,516,826	—

Weighted-average shares—diluted	23,535,617	40,926,450	30,593,382	40,653,091

The following number of options and restricted stock units were excluded from the calculation of diluted net income (loss) per share because their inclusion would have been anti-dilutive:

	Three Months Ended		Nine Months Ended	
	October 28, 2017	October 29, 2016	October 28, 2017	October 29, 2016
Options	2,222,103	7,995,703	3,701,484	8,594,487
Restricted stock units	128,723	892,279	305,744	1,151,993
Total anti-dilutive stock-based awards	2,350,826	8,887,982	4,007,228	9,746,480

NOTE 14—SHARE REPURCHASES

$700 Million Share Repurchase Program

On May 2, 2017, the Company's Board of Directors authorized a stock repurchase program of up to $700 million (the "$700 Million Repurchase Program"). Under the $700 Million Repurchase Program, the Company repurchased approximately 12.4 million shares of its common stock at an average price of $56.60 per share, for an aggregate repurchase amount of approximately $700 million, during the three months ended July 29, 2017. As the $700 Million Repurchase Program was completed during the three months ended July 29, 2017, no additional shares were repurchased during the three months ended October 28, 2017 and there will be no repurchases in future periods under this repurchase authorization.

$300 Million Share Repurchase Program

On February 21, 2017, the Company's Board of Directors authorized a stock repurchase program of up to $300 million (the "$300 Million Repurchase Program"). Under the $300 Million Repurchase Program, the Company repurchased approximately 7.8 million shares of its common stock at an average price of $38.24 per share, for an aggregate repurchase amount of approximately $300 million, during the three months ended April 29, 2017. As the $300 Million Repurchase Program was completed during the three months ended April 29, 2017, no additional shares were repurchased during the three months ended October 28, 2017 and there will be no repurchases in future periods under this repurchase authorization.

Share Repurchases Under Equity Plans

Certain options and awards granted under the Company's equity plans contain a repurchase right, which may be exercised at the Company's discretion in the event of the termination of an employee's employment with the Company. No shares were repurchased under equity plans during either the three and nine months ended October 28, 2017 or October 29, 2016. As of both October 28, 2017 and January 28, 2017, the aggregate unpaid principal amount of the notes payable for share repurchases was $19.4 million, which is included in other non-current obligations on the condensed consolidated balance sheets. During both the three months ended October 28, 2017 and October 29, 2016, the Company recorded interest expense on the outstanding notes of $0.2 million. During both the nine months ended October 28, 2017 and October 29, 2016, the Company recorded interest expense on the outstanding notes of $0.7 million.

Of the $19.4 million notes payable for share repurchases outstanding as of both October 28, 2017 and January 28, 2017, $15.5 million was due to a current board member of the Company.

NOTE 15—STOCK-BASED COMPENSATION

The Company estimates the value of equity grants based upon an option-pricing model and recognizes this estimated value as compensation expense over the vesting periods. The Company recognizes expense associated with performance-based awards when it becomes probable that the performance condition will be met. Once it becomes probable that an award will vest, the Company recognizes compensation expense equal to the number of shares which are probable to vest multiplied by the fair value of the related shares measured at the grant date.

Stock-based compensation expense is included in selling, general and administrative expenses on the condensed consolidated statements of operations. The Company recorded stock-based compensation expense of $6.7 million and

$7.4 million during the three months ended October 28, 2017 and October 29, 2016, respectively. The Company recorded stock-based compensation expense of $42.9 million and $21.7 million during the nine months ended October 28, 2017 and October 29, 2016, respectively. No stock-based compensation cost has been capitalized in the accompanying condensed consolidated financial statements.

2012 Stock Incentive Plan and 2012 Stock Option Plan

As of October 28, 2017, 8,837,586 options were outstanding with a weighted-average exercise price of $50.20 per share and 6,318,980 options were vested with a weighted-average exercise price of $51.96 per share. The aggregate intrinsic value of options outstanding, options vested or expected to vest, and options exercisable as of October 28, 2017 was $323.7 million, $283.8 million, and $220.6 million, respectively. Stock options exercisable as of October 28, 2017 had a weighted-average remaining contractual life of 6.37 years. As of October 28, 2017, the total unrecognized compensation expense related to unvested options was $26.8 million, which is expected to be recognized on a straight-line basis over a weighted-average period of 3.33 years.

As of October 28, 2017, the Company had 825,307 restricted stock units outstanding with a weighted-average grant date fair value of $52.20 per share. During the three months ended October 28, 2017, 18,590 restricted stock units vested with a weighted-average grant date and vest date fair value of $73.95 per share and $73.06 per share, respectively. During the nine months ended

October 28, 2017, 264,843 restricted stock units vested with a weighted-average grant date and vest date fair value of $59.11 per share and $54.71 per share, respectively. As of October 28, 2017, there was $22.5 million of total unrecognized compensation expense related to unvested restricted stock and restricted stock units which is expected to be recognized over a weighted-average period of 3.26 years.

Chairman and Chief Executive Officer Option Grant

On May 2, 2017, the Company's Board of Directors granted Mr. Friedman an option to purchase 1,000,000 shares of the Company's common stock with an exercise price equal to $50 per share.

The option contains dual-condition restrictions consisting of both time-based service restrictions over four years and performance-based restrictions linked to achieving the Company's common stock price objectives of $100, $125 and $150 per share. The option is fully vested on the date of grant but the shares underlying the option remain subject to transfer restrictions to the extent the performance-based and time-based requirements have not been met. The option resulted in a one-time non-cash stock compensation charge of $23.9 million in the nine months ended October 28, 2017. The Company did not record any expense related to this grant in the three months ended October 28, 2017.

Time-Based Restrictions

The time-based restrictions are measured over an initial four year service period from the date of the award and these restrictions will lapse at the end of each of these first four years at a rate of 250,000 shares per year if (i) Mr. Friedman remains employed at the end of such year, and (ii) the stock price goals have been achieved in such year as described further below.

Performance-Based Restrictions

The stock price objectives are measured each year and are set at prices for the Company's common stock of $100, $125 and $150 per share. If all three stock price objectives are met in the first performance year, restrictions will lapse as to 250,000 shares in aggregate at the end of such year, with 83,333 shares tied to a $100 price per share, 83,333 shares tied to a $125 price per share and 83,334 shares tied to a $150 price per share.

The same price performance tests are applied in the second year of performance such that restrictions will lapse for an additional 250,000 shares at the end of the second year and then again as to an additional 250,000 shares at the end of each of the third and fourth years so long as Mr. Friedman remains employed at the end of each year.

To the extent that any of the price performance objectives is not reached within one of these first four performance years, the stock price objective can be achieved in any subsequent year until the 8th anniversary of the date of grant.

2012 Stock Incentive Plan Grant to Waterworks Associates

On May 27, 2016, on the date of our acquisition of Waterworks, the Company granted stock options to certain Waterworks associates under the 2012 Stock Incentive Plan to purchase 322,784 shares of its common stock, with an exercise price of $33.54 per share, which is equal to the closing price of the Company's common stock on the date of grant. These options are fully vested as of the date of grant but any shares issued upon exercise of such options will be subject to selling restrictions which are scheduled to lapse in five equal installments on the first, second, third, fourth and fifth anniversaries of the grant date. The fully vested options resulted in a one-time non-cash stock-based compensation charge of $3.7 million in the second quarter of fiscal 2016.

Rollover Units

In connection with the acquisition of Waterworks, $1.5 million rollover units in the Waterworks subsidiary (the "Rollover Units") were recorded as part of the transaction. The Rollover Units are subject to the terms of the Waterworks LLC agreement, including redemption rights at an amount equal to the greater of (i) the $1.5 million remitted as consideration in the business combination or (ii) an amount based on the percentage interest represented in the overall valuation of the Waterworks subsidiary (the "Appreciation Rights"). The Appreciation Rights are measured at fair value and are subject to fair value measurements during the expected life of the Rollover Units, with changes to fair value recorded in the condensed consolidated statements of operations. The fair value of the Appreciation Rights is determined based on an option pricing method ("OPM"). The Company did not record any expense related to the Appreciation Rights during the three or nine months ended October 28, 2017 or October 29, 2016. As of both October 28, 2017 and January 28, 2017, the liability associated with the Rollover Units and related Appreciation Rights was $1.5 million, which is included in other non-current obligations on the condensed consolidated balance sheets.

Profit Interests

In connection with the acquisition of Waterworks, profit interests units in the Waterworks subsidiary (the “Profit Interests”) were issued to certain Waterworks associates. The Profit Interests are measured at their grant date fair value and expensed on a straight-line basis over their expected life, or five years. The Profit Interests are subject to fair value measurements during their expected life, with changes to fair value recorded in the condensed consolidated statements of operations. The fair value of the Profit Interests is determined based on an OPM. For the three and nine months ended October 28, 2017, the Company recorded $0.1 million and $0.3 million, respectively, related to the Profit Interests, which is included in selling, general and administrative expenses on the condensed consolidated statements of operations. For the three and nine months ended October 29, 2016 the Company recorded $0.1 million and $0.2 million, respectively, related to the Profit Interests. As of October 28, 2017 and January 28, 2017, the liability associated with the Profit Interests was $0.6 million and $0.3 million, respectively, which is included in other non-current obligations on the condensed consolidated balance sheets.

NOTE 16—RELATED PARTY TRANSACTIONS

Aircraft Time Sharing Agreement

On March 29, 2016, Restoration Hardware, Inc., a wholly-owned subsidiary of the Company entered into an Amended and Restated Aircraft Time Sharing Agreement (the “Time Sharing Agreement”) with Gary Friedman, its Chairman and Chief Executive Officer. The Time Sharing Agreement governs use of any of the Company’s aircraft (“Corporate Aircraft”) by Mr. Friedman for personal trips and provides that Mr. Friedman will lease such Corporate Aircraft and pay Restoration Hardware, Inc. an amount equal to the aggregate actual expenses of each personal use flight based on the variable costs of the flight, with the amount of such lease payments not to exceed the maximum payment level established under the Federal Aviation Administration rules. Mr. Friedman maintains a deposit with the Company, to be used towards payment of amounts due under the Time Sharing Agreement. The amount of the deposit is immaterial to the condensed consolidated financial statements.

NOTE 17—COMMITMENTS AND CONTINGENCIES

Commitments

The Company had no material off balance sheet commitments as of October 28, 2017.

Contingencies

The Company is involved in lawsuits, claims and proceedings incident to the ordinary course of its business. These disputes are increasing in number as the business expands and the Company grows larger. Litigation is inherently unpredictable. As a result, the outcome of matters in which the Company is involved could result in unexpected expenses and liability that could adversely affect the Company’s operations. In addition, any claims against the Company, whether meritorious or not, could be time consuming, result in costly litigation, require significant amounts of management time and result in the diversion of significant operational resources.

The Company reviews the need for any loss contingency reserves and establishes reserves when, in the opinion of management, it is probable that a matter would result in liability, and the amount of loss, if any, can be reasonably estimated. Generally, in view of the inherent difficulty of predicting the outcome of those matters, particularly in cases in which claimants seek substantial or indeterminate damages, it is not possible to determine whether a liability has been incurred or to reasonably estimate the ultimate or minimum amount of that liability until the case is close to resolution, in which case no reserve is established until that time. When and to the extent that the Company does establish a reserve, there can be no assurance that any such recorded liability for estimated losses will be for the appropriate amount, and actual losses could be higher or lower than what the Company accrues from time to time. The Company believes that the ultimate resolution of its current matters will not have a material adverse effect on its condensed consolidated financial statements.

RH Modern Securities Class Action

On February 2, 2017, City of Miami General Employees' & Sanitation Employees' Retirement Trust filed a class action complaint in the United States District Court, Northern District of California, against the Company, Gary Friedman, and Karen Boone. On March 16, 2017, Peter J. Errichiello, Jr. filed a similar class action complaint in the same forum and against the same parties. On April 26, 2017, the court consolidated the two actions. The consolidated action is captioned In re RH, Inc. Securities Litigation. The complaints allege, among other things, fraud in connection with alleged misstatements under sections 10(b) and 20(a) of the Securities Exchange Act of 1934, as amended. Both complaints purport to make claims on behalf of a class of purchasers of Company common stock from March 26, 2015 to June 8, 2016. The alleged misstatements relate to forward looking statements regarding the roll out of the RH Modern product line. The claims are currently at an early stage and it is not possible to estimate the amount or range of any potential loss at this time. An amended consolidated complaint was filed in June 2017 and the Company and its officers have moved to dismiss the complaint. While the outcome of litigation is inherently uncertain, the Company and its officers intend to vigorously defend the claims and believe the complaints lack merit.

NOTE 18—SEGMENT REPORTING

The Company defines reportable and operating segments on the same basis that it uses to evaluate performance internally by the Chief Operating Decision Maker (the “CODM”). The Company has determined that the Chief Executive Officer is its CODM. As of October 28, 2017, the Company had two operating segments: RH Segment and Waterworks. The two operating segments include all sales channels accessed by the Company’s customers, including sales through catalogs, sales through the Company’s websites, sales through stores, and sales through the commercial channel.

The Company’s two operating segments are strategic business units that offer products for the home furnishings customer. While RH Segment and Waterworks have a shared management team and customer base, the Company has determined that their results cannot be aggregated as they do not share similar economic characteristics, as well as due to other quantitative factors.

The Company uses operating income to evaluate segment profitability. Operating income is defined as net income (loss) before interest expense—net and income taxes.

Prior to the Waterworks acquisition, the Company had one reportable segment. As the Company’s acquisition of Waterworks was completed on May 27, 2016, reportable segment financial information for Waterworks below represents twenty-two weeks of results for the nine months ended October 29, 2016, whereas the RH Segment results represent thirty-nine weeks for the nine months ended October 29, 2016. The results for both the three months ended October 28, 2017 and October 29, 2016 include thirteen weeks for both the RH Segment and Waterworks.

Segment Information

The following table presents the statements of operations metrics reviewed by the CODM to evaluate performance internally (in thousands):

	Three Months Ended October 28, 2017			Three Months Ended October 29, 2016		
	RH Segment	Waterworks	Total	RH Segment	Waterworks	Total
Net revenues	$563,174	$ 29,299	$592,473	$521,027	$ 28,301	$549,328
Gross profit	$203,221	$ 11,104	$214,325	$166,124	$ 9,695	$175,819
Depreciation and amortization	$17,474	$ 1,072	$18,546	$13,966	$ 1,070	$15,036

Nine Months Ended October 28, 2017			Nine Months Ended October 29, 2016		
	Waterworks	Total		Waterworks	Total

	RH Segment			RH Segment		
Net revenues	$1,680,495	$ 89,384	$1,769,879	$1,499,101	$ 49,064	$1,548,165
Gross profit	$555,844	$ 34,550	$590,394	$467,402	$ 15,731	$483,133
Depreciation and amortization	$47,761	$ 3,331	$51,092	$39,484	$ 1,764	$41,248

The following table presents the balance sheet metrics reviewed by the CODM to evaluate performance internally (in thousands):

	October 28, 2017 RH Segment	Waterworks	Total	January 28, 2017 RH Segment	Waterworks	Total
Goodwill [(1)]	$124,409	$ 51,144	$175,553	$124,374	$ 49,229	$173,603
Trademarks and domain names	$48,563	$ 52,100	$100,663	$48,524	$ 52,100	$100,624
Total assets	$1,649,057	$ 152,509	$1,801,566	$2,040,346	$ 152,174	$2,192,520

(1) Waterworks goodwill increased $1.9 million during the nine months ended October 28, 2017 due to purchase price accounting adjustments. Refer to Note 3—Business Combination.

The Company uses segment operating income to evaluate segment performance and allocate resources. Segment operating income excludes (i) non-cash compensation charges related to a fully vested option grant made to Mr. Friedman and the fully vested option grants made in connection with the acquisition of Waterworks, (ii) reduction of net revenues, incremental costs and inventory charges associated with product recalls, (iii) non-cash amortization of the inventory fair value adjustment recorded in connection with the acquisition of Waterworks, (iv) costs associated with anticipated distribution center closures, (v) gain on sale of building and land, (vi) charges incurred for the estimated cumulative impact of coupons redeemed in connection with a legal claim, (vii) costs associated with a reorganization, which include severance costs and related taxes, partially offset by a reversal of stock-based compensation expense related to unvested equity awards, and (viii) costs incurred in connection with the acquisition of Waterworks including professional fees. These items are excluded from segment operating income in order to provide better transparency of segment operating results. Accordingly, these items are not presented by segment because they are excluded from the segment profitability measure that management reviews.

The following table shows segment operating income (loss) and income (loss) before tax (in thousands):

	Three Months Ended October 28, 2017	October 29, 2016	Nine Months Ended October 28, 2017	October 29, 2016
Operating income (loss):				
RH Segment	$48,724	$18,660	$98,332	$51,687
Waterworks	(719)	(514)	(2,143)	344
Non-cash compensation	—	—	(23,872)	(3,672)
Recall accrual	(3,552)	—	(8,285)	—
Impact of inventory step-up	(248)	(1,786)	(2,108)	(5,187)
Distribution center closures	(1,862)	—	(1,862)	—
Gain on sale of building and land	819	—	2,119	—
Legal claim	—	—	—	(8,701)
Reorganization related costs	—	(974)	—	(5,698)
Acquisition related costs	—	—	—	(2,847)

Operating income	43,162	15,386	62,181	25,926
Interest expense—net	18,915	11,091	45,496	32,528
Loss on extinguishment of debt	4,880	—	4,880	—
Income (loss) before tax	$19,367	$4,295	$11,805	$(6,602)

The Company classifies its sales into furniture and non-furniture product lines. Furniture includes both indoor and outdoor furniture. Non-furniture includes lighting, textiles, fittings, fixtures, surfaces, accessories and home décor. Net revenues in each category were as follows (in thousands):

	Three Months Ended		Nine Months Ended	
	October 28, 2017	October 29, 2016	October 28, 2017	October 29, 2016
Furniture	$383,281	$343,946	$1,125,220	$985,639
Non-furniture	209,192	205,382	644,659	562,526
Total net revenues	$592,473	$549,328	$1,769,879	$1,548,165

The Company is domiciled in the United States and primarily operates its retail and outlet stores in the United States. As of October 28, 2017, the Company operates 4 retail and 2 outlet stores in Canada and 1 retail store in the U.K. Revenues from Canadian and U.K. operations, and the long-lived assets in Canada and the U.K., are not material to the Company. Geographic revenues are determined based upon where service is rendered.

No single customer accounted for more than 10% of the Company's revenues in the three or nine months ended October 28, 2017 or October 29, 2016.

NOTE 19—SUBSEQUENT EVENT

Distribution Center Closures

During the third quarter of fiscal 2017, the Company committed to a plan to close its Mira Loma, CA and Dallas, TX furniture distribution centers by the end of fiscal 2017, prior to the end of the respective lease terms. The Mira Loma, CA distribution center closed in November 2017 and the Dallas, TX distribution center is expected to close by the end of fiscal 2017. During the three months ended October 28, 2017, the Company incurred costs in its RH Segment of $1.9 million associated with the distribution center closures, including $1.4 million of severance which is included in selling, general and administrative expenses on the condensed consolidated statements of operations and $0.5 million of inventory transfers costs which is included in cost of goods sold on the condensed consolidated statements of operations. As of October 28, 2017, the remaining accrual associated with these closures was $1.7 million which is included in accounts payable and accrued expenses on the condensed consolidated balance sheets. The Company expects to record additional expenses related to the distribution center closures during the fourth quarter of fiscal 2017, primarily related to liabilities for lease losses and losses on disposal of capitalized property and equipment. The Company estimates that the remaining charge will be approximately $0.5 million to $1.0 million for the Mira Loma, CA distribution center closure. The Company is not currently able to estimate the remaining charge expected to be incurred upon the Dallas, TX distribution center closure due to the uncertainty in the timing and the market rental rates the Company will be able to obtain for a sublease agreement for the space.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion and analysis of the financial condition and results of our operations should be read together with our condensed consolidated financial statements and the related notes included in Item 1 of Part I of this Quarterly Report on Form 10-Q and with our audited consolidated financial statements and the related notes included in our 2016 Form 10-K.

FORWARD-LOOKING STATEMENTS AND MARKET DATA

This quarterly report contains forward-looking statements that are subject to risks and uncertainties. Forward-looking statements give our current expectations and projections relating to our financial condition, results of operations, plans, objectives, future performance and business. You can identify forward-looking statements by the fact that they do not relate strictly to historical or current facts. These statements may include words such as "anticipate," "estimate," "expect," "project," "plan," "intend," "believe," "may," "will," "short-term," "non-recurring," "one-time," "unusual," "should," words and terms of similar meaning in connection with any discussion of the timing or nature of future operating or financial performance or other events.

Forward-looking statements are subject to risk and uncertainties that may cause actual results to differ materially from those that we expected. We derive many of our forward-looking statements from our operating budgets and forecasts, which are based upon many detailed assumptions. While we believe that our assumptions are reasonable, we caution that it is very difficult to predict the impact of known factors and it is impossible for us to anticipate all factors that could affect our actual results and matters that we identify as "short term," "non-recurring," "unusual," "one-time," or other words and terms of similar meaning may in fact recur in one or more future financial reporting periods. Important factors that could cause actual results to differ materially from our expectations, or cautionary statements, include those factors disclosed under the sections entitled Risk Factors in Part II of this quarterly report, in our Annual Report on Form 10-K for the fiscal year ended January 28, 2017 ("2016 Form 10-K"), and Management's Discussion and Analysis of Financial Condition and Results of Operations in Part I of this quarterly report and in our 2016 Form 10-K. All forward-looking statements attributable to us, or persons acting on our behalf, are expressly qualified in their entirety by these cautionary statements, as well as other cautionary statements. You should evaluate all forward-looking statements made in this quarterly report in the context of these risks and uncertainties.

We cannot assure you that we will realize the results or developments we expect or anticipate or, even if substantially realized, that they will result in the consequences or affect us or our operations in the way we expect. The forward-looking statements included in this quarterly report are made only as of the date hereof. We undertake no obligation to publicly update or revise any forward-looking statement as a result of new information, future events or otherwise, except as otherwise required by law.

Overview

We are a leading luxury retailer in the home furnishings marketplace. Our curated and fully-integrated assortments are presented consistently across our sales channels in sophisticated and unique lifestyle settings that we believe are on par with world-class interior designers. We offer dominant merchandise assortments across a growing number of categories, including furniture, lighting, textiles, bathware, décor, outdoor and garden, tableware, and child and teen furnishings. We position our Galleries as showrooms for our brand, while our Source Books and websites act as virtual extensions of our stores.

Our business is fully integrated across our multiple channels of distribution, consisting of our stores, Source Books and websites. As of October 28, 2017, we operated a total of 84 retail Galleries, consisting of 48 legacy Galleries, 6 larger format Design Galleries, 9 next generation Design Galleries, 1 RH Modern Gallery and 5 RH Baby & Child Galleries throughout the United States and Canada, and 15 Waterworks showrooms in the United States and in the U.K. In addition, as of October 28, 2017, we operated 31 outlet stores throughout the United States and Canada.

In fiscal 2016, we experienced a slowdown in sales and substantially lower level of profits than in prior periods. We have undertaken initiatives to specifically address the temporal factors affecting our results in fiscal 2016, in addition to the other numerous initiatives we are undertaking to improve our business and financial performance in fiscal 2017 and beyond. If these initiatives are successful, we may return to rates of growth in revenues and improvements in margins and profitability that are more in line with our historical growth patterns prior to the downturn that we experienced in fiscal 2016. However, there can be no assurance that these efforts will be successful or that we will not encounter other operational difficulties during fiscal 2017 and future time periods that may have a negative impact on growth and profitability. For further information on the temporal factors affecting our results and our initiatives, see Item 2—Management's Discussion and Analysis of Financial Condition and Results of Operations—Overview—Key Value Driving Strategies in this Quarterly Report on Form 10-Q and Item 7—Management's Discussion and Analysis of Financial Condition and Results of Operations—Factors Affecting our Results of Operations in our 2016 Form 10-K.

Over the past 18 months, we transformed our business from a promotional to a membership model that is enhancing our brand, streamlining our operations, and improving the customer experience. We believe that the transition to a membership model has had a favorable impact on our business and financial performance including through a reduction in our return rate, exchange rate and cancel rate resulting in higher conversion of demand into revenues. As of October 28, 2017, we had approximately 380,000 members which drove approximately 95% of sales of our core RH business during the three months ended October 28, 2017.

Simultaneously we began the redesign of our supply chain network, rationalizing our product offerings, and transitioning inventory into fewer facilities, creating a more capital efficient model. As a result, we were able to forego building a fifth furniture distribution center planned to open in 2017 and we expect to consolidate our current furniture distribution center network from four to two locations by the fourth quarter of 2017. We anticipate that managing our business in fewer facilities will reduce inventory risk, increase turns, improve merchandise margins and eliminate the occupancy and overhead of approximately 1.75 million square feet of distribution space.

We continue to pursue and test numerous initiatives to improve many aspects of our business including through efforts to optimize inventory, elevate the home delivery experience and simplify our distribution network, as well as to expand our product offering and transform our real estate. There can be no assurance as to the timing and extent of the operational benefits and financial contributions of these strategic efforts. In addition, our pursuit of multiple initiatives with respect to our business in any given period may result in period-to-period changes in, and increased fluctuation in, our results of operations. For example, our efforts to optimize our distribution network could cause us to incur costs and expenses in the short term with respect to changes in the way in which we operate our business such as charges related to closure of distribution centers. The above factors and other current and future operational initiatives of the Company may create additional uncertainty with respect to our consolidated net revenues and profit in the near term.

Acquisition of Waterworks

On May 27, 2016, we acquired a controlling interest in Design Investors WW Acquisition Company, LLC, which owns the business operating under the name "Waterworks," for consideration consisting of approximately $119.9 million, consisting of $118.4 million funded with available cash and $1.5 million representing the fair value of rollover units, which amount is subject to adjustment for changes in working capital and other items. After the transaction, and giving effect to equity interests acquired by management in the business, we own in excess of 90% of the total equity interests in Waterworks.

Waterworks has long been the definition of the well-appointed bath, and is the only complete bath and kitchen business offering fittings, fixtures, furniture, furnishings, accessories, lighting, hardware and surfaces under one brand in the market. Waterworks is composed of the Waterworks, Waterworks Kitchen and Waterworks Studio brands, all built on a foundation of impeccable style, design integrity, quality and craftsmanship. Waterworks prides itself on its deep relationships in the design community and the technical expertise and tenure of its people.

Waterworks products are sold through its 15 showrooms in the United States and in the U.K., as well as through its boutique retail partners, hospitality division and online.

Key Value Driving Strategies

In order to drive growth across our business, we are focused on the following long-term key strategies:

- Transform Our Real Estate Platform. We believe we have an opportunity to significantly increase our sales by transforming our real estate platform from our existing legacy retail footprint to a portfolio of next generation Design Galleries that are sized to the potential of each market and the size of our assortment. New next generation Design Gallery sites are identified based on a variety of factors, including timing of legacy Gallery lease expiration, availability of suitable new site locations, the negotiation of favorable economic terms to the Company for the new location, as well as satisfactory and timely completion of real estate development including procurement of permits and completion of construction. The number of next generation Design Galleries we open in any fiscal year is highly dependent upon these variables and individual new Design Galleries may be subject to delay or postponement depending on the circumstances of specific projects. We opened RH Toronto in October 2017 and RH West Palm in November 2017, both with integrated food and beverage offerings, and expect to open at least three Design Galleries in fiscal 2018.

- Expand Our Offering and Increase Our Market Share. We believe we have a significant opportunity to increase our market share by:
  - growing our merchandise assortment;
  - introducing new products and categories, including our introduction of RH Modern, RH TEEN and the addition of the Waterworks business;

- expanding our service offerings, including the introduction of the RH Interior Design program and cafes, wine vaults and coffee bars at our next generation Design Galleries;
- exploring and testing new business opportunities complementary to our core business; and
- increasing our brand awareness and customer loyalty through our Source Book circulation strategy, our digital marketing initiatives and our advertising and public relations activities and events.
- Elevate the Customer Experience. We are focused on improving the end-to-end customer experience. As we have elevated our brand, especially at retail, we are also working to enhance the brand experience in other aspects of our business. We are making changes in many aspects of our business processes that affect our customers, including improvements in product quality and enhancements in sourcing, product availability, in-home delivery and all aspects of customer care and service. We have invested significant time in fiscal 2017 architecting a new fully integrated back-end operating platform, inclusive of the supply chain network, the home delivery experience as well as a new metric driven quality system and company-wide decision data. We also believe that the introduction of experiential brand-enhancing products and services, such as expanded design ateliers, the RH Interior Design program and the planned launch of an integrated food and beverage experience in a number of our new Galleries, will further enhance our customers' in-store experience, in addition to allowing us to further disrupt the highly fragmented home furnishings landscape and achieve market share gains.
- Increase Operating Margins. We have the opportunity to continue to improve our operating margins by leveraging our fixed occupancy, advertising and corporate general and administrative costs, as well as leveraging our scalable infrastructure. Key areas in which we believe we will increase operating margins include:
- Occupancy leverage;
- Advertising cost leverage;
- Improved product margin and shipping efficiencies; and
- Other selling, general and administrative expenses.
- Optimize the Allocation of Capital in the Business. We believe that our operations and current initiatives present a significant opportunity to optimize the allocation of capital in our business, including generating free cash flow and optimizing cash on our balance sheet as well as deploying capital to repurchase shares of our common stock which we believe creates a long term benefit to our shareholders. We have also incurred additional debt to fund a portion of our share repurchase programs and we believe that was a good capital allocation given favorable interest rates on debt and the ability of our business to generate cash in light of current business initiatives in order to paydown and service such debt. During fiscal 2017, one of our initiatives has been to generate additional cash flow through the optimization of inventory and other efforts to make our business more efficient in its use of capital to support operations. Our current efforts to generate more cash flow in our business include rationalizing our SKU count and reducing overall levels of inventory, which involves selling slower moving, discontinued and other inventory through markdowns and through our outlet channel. We have also undertaken initiatives to optimize our distribution network and make significant improvements in the way that we handle merchandise in the distribution and delivery part of our business. We expect that these improvements will result in operational efficiencies in the handling and transportation of merchandise and will enable us to achieve greater efficiency and lower requirements for carrying inventory to meet customer demand. We plan to lower our new Gallery opening cadence to three to five Galleries per year, which we believe will result in improved deal economics, lower build out costs and higher returns and will lower our capital requirements and execution risk over the course of our real estate transformation. We also believe the slower opening cadence will put less pressure on our infrastructure, enabling greater capital discipline throughout the organization. In addition, we have a number of assets that can be sold to third parties in order to generate cash. We expect to transition from a lease to a development model and may enter into sale leaseback transactions with respect to certain real estate that we own, for example, and may enter into capital or operating leases in lieu of purchasing or holding certain assets that are used in our business. We intend to continue to seek out and evaluate opportunities for effectively managing and deploying capital in ways that support and enhance our business initiatives and strategies.
- Pursue International Expansion. We plan to strategically expand our business into select countries outside of the United States, Canada and the U.K. in the future. We believe that our luxury brand positioning and unique aesthetic will have strong international appeal.

In fiscal 2016, we made several strategic investments and changes to our business model in order to strengthen our brand and position the business for growth in the future. Our fiscal 2016 results also reflected the effect of temporal issues that we faced, including the costs related to the launch of RH Modern; the timing of recognizing Membership revenues related to the transition from a promotional to a membership model; efforts to reduce inventories and rationalize our SKU count; and the decision to move our 2016 Source Book mailing from the spring to the fall.

In fiscal 2017, we have continued our efforts to optimize inventory and rationalize our SKU count. In the nine months ended October 28 2017, net revenues increased 14%, of which 3 points of growth was related to higher outlet and warehouse sales stemming from our accelerated inventory optimization efforts. While our higher outlet revenues and inventory optimization efforts had a positive impact on revenues and working capital in the first nine months of the year, they had a negative impact on margins and earnings.

Additionally, in fiscal 2017, we expect incremental revenues from the four new Design Galleries opened in 2016, our new Design Gallery in Toronto which opened in October 2017, and the Design Gallery in West Palm Beach which opened in November 2017. The majority of our new Design Galleries under development include a dedicated floor for RH Modern as well as an RH Hospitality offering including restaurants, wine vaults, and pantries, similar to our successful hospitality offering at RH Chicago, The Gallery at the Three Arts Club.

Basis of Presentation and Results of Operations

The following table sets forth our condensed consolidated statements of operations and other financial and operating data.

	Three Months Ended		Nine Months Ended	
	October 28, 2017	October 29, 2016	October 28, 2017	October 29, 2016
	(dollars in thousands)			
Condensed Consolidated Statements of Operations:				
Net revenues	$592,473	$549,328	$1,769,879	$1,548,165
Cost of goods sold	378,148	373,509	1,179,485	1,065,032
Gross profit	214,325	175,819	590,394	483,133
Selling, general and administrative expenses	171,163	160,433	528,213	457,207
Income from operations	43,162	15,386		