

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

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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.

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## INDEX TO FORM 10-Q

|  | Page |
|--|------|
| <b><u>PART I. FINANCIAL INFORMATION</u></b>  |      |
| Item 1. <u>Financial Statements</u>  | 3    |
| <u>Condensed Consolidated Balance Sheets (Unaudited) as of October 28, 2017, and January 28, 2017</u>  | 3    |
| <u>Condensed Consolidated Statements of Operations (Unaudited) for the three and nine months ended October 28, 2017, and October 29, 2016</u>                  | 4    |
| <u>Condensed Consolidated Statements of Comprehensive Income (Loss) (Unaudited) for the three and nine months ended October 28, 2017, and October 29, 2016</u> | 5    |
| <u>Condensed Consolidated Statements of Cash Flows (Unaudited) for the nine months ended October 28, 2017 and October 29, 2016</u>                             | 6    |
| <u>Notes to Condensed Consolidated Financial Statements (Unaudited)</u>  | 7    |
| Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>   | 27   |
| Item 3. <u>Quantitative and Qualitative Disclosures about Market Risk</u>  | 49   |
| Item 4. <u>Controls and Procedures</u>   | 50   |
| <b><u>PART II. OTHER INFORMATION</u></b>   |      |
| Item 1. <u>Legal Proceedings</u>   | 51   |
| Item 1A. <u>Risk Factors</u>   | 51   |
| Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>   | 51   |
| Item 3. <u>Defaults Upon Senior Securities</u>   | 51   |
| Item 4. <u>Mine Safety Disclosures</u>   | 52   |
| Item 5. <u>Other Information</u>   | 52   |
| Item 6. <u>Exhibits</u>  | 53   |
| <u>Signatures</u>  | 54   |

## PART I

## Item 1. Financial Statements

RH

## CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except share amounts)

(Unaudited)

|  | October 28,<br>2017 | January 28,<br>2017 |
|--|---------------------|---------------------|
| <b>ASSETS</b>  |                     |                     |
| 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         |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY (DEFICIT)</b>                                  |                     |                     |
| 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 | —                   | —                   |

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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.

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## CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except share and per share amounts)

(Unaudited)

|  | Three Months Ended  |                     | Nine Months Ended   |                     |
|--|---------------------|---------------------|---------------------|---------------------|
|  | October 28,<br>2017 | October 29,<br>2016 | October 28,<br>2017 | October 29,<br>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<br>Ended  |                        | Nine Months<br>Ended   |                        |
|--|------------------------|------------------------|------------------------|------------------------|
|  | October<br>28,<br>2017 | October<br>29,<br>2016 | October<br>28,<br>2017 | October<br>29,<br>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<br>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,<br>2017 | October<br>29,<br>2016<br>As<br>Revised |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES</b>  |                     |   |
| 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 )                               |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES</b>  |                     |   |
| 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)                               |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES</b>  |                     |   |
| Borrowing under asset based credit facility  | 446,000             | —                                       |
| Repayments under asset based credit facility   | (105,000 )          | —                                       |
| Borrowings under term loans  | 180,000             | —                                       |



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|   |             |           |
|---|-------------|-----------|
| 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.

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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,<br>2016 |              |               |
|   | As<br>Reported      | Adjustment   | As<br>Revised |
| <b>Cash flows from operating activities:</b>    |                     |              |               |
| 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 )   |
| <b>Cash and cash equivalents:</b>               |                     |              |               |
| 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<br>28,<br>2017 | Purchase<br>Price<br>Allocation<br>Adjustments | October<br>28,<br>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<br>28,<br>2017 | January<br>28,<br>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<br>28,<br>2017 | January<br>28,<br>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<br>Carrying<br>Amount | Accumulated<br>Amortization | Foreign<br>Currency<br>Translation | Net Book<br>Value |
|--|-----------------------------|-----------------------------|------------------------------------|-------------------|
| <b>Intangible assets subject to amortization</b>     |                             |                             |                                    |                   |
| Fair value of leases <sup>(1)</sup>                  |                             |                             |                                    |                   |
| Fair market write-up                                 | \$1,925                     | \$ (1,862 )                 | \$ —                               | \$63              |
| Fair market write-down <sup>(2)</sup>                | (1,467 )                    | 1,393                       | —                                  | (74 )             |
| Total intangible assets subject to amortization      | \$458                       | \$ (469 )                   | \$ —                               | \$(11 )           |
| <b>Intangible assets not subject to amortization</b> |                             |                             |                                    |                   |
| Goodwill <sup>(3)(4)</sup>                           | \$175,605                   | \$ —                        | \$ (52 )                           | \$175,553         |
| Trademarks and domain names <sup>(4)</sup>           | \$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.

11

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

|  | Gross         |                  | Foreign     |              |
|--|---------------|------------------|-------------|--------------|
|  | Carrying      | Accumulated      | Currency    | Net Book     |
|  | Amount        | Amortization     | Translation | Value        |
| <b>Intangible assets subject to amortization</b>       |               |                  |             |              |
| Fair value of leases <sup>(1)</sup>                    |               |                  |             |              |
| Fair market write-up                                   | \$ 1,925      | \$ (1,792 )      | \$ —        | \$ 133       |
| Fair market write-down <sup>(2)</sup>                  | (1,467 )      | 1,350            | —           | (117 )       |
| <b>Total intangible assets subject to amortization</b> | <b>\$ 458</b> | <b>\$ (442 )</b> | <b>\$ —</b> | <b>\$ 16</b> |
| <b>Intangible assets not subject to amortization</b>   |               |                  |             |              |
| Goodwill <sup>(3)(4)</sup>                             | \$ 173,690    | \$ —             | \$ (87 )    | \$ 173,603   |
| Trademarks and domain names <sup>(3)(4)</sup>          | \$ 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           | January           |
|--|-------------------|-------------------|
|  | 28,               | 28,               |
|  | 2017              | 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             |
| <b>Total accounts payable and accrued expenses</b> | <b>\$ 252,569</b> | <b>\$ 226,980</b> |

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

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

- (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<br>28,<br>2017 | January<br>28,<br>2017 |
|---------------------------------|------------------------|------------------------|
| <b>Liability component</b>      |                        |                        |
| Principal                       | \$ 300,000             | \$ 300,000             |
| Less: Debt discount             | (48,229 )              | (60,124 )              |
| Net carrying amount             | \$ 251,771             | \$ 239,876             |
| Equity component <sup>(1)</sup> | \$ 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<br>28,<br>2017 | January<br>28,<br>2017 |
|---------------------------------|------------------------|------------------------|
| Liability component             |                        |                        |
| Principal                       | \$350,000              | \$350,000              |
| Less: Debt discount             | (24,666 )              | (35,457 )              |
| Net carrying amount             | \$325,334              | \$314,543              |
| Equity component <sup>(1)</sup> | \$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 | Unamortized Debt Issuance | Net Carrying |
|-----------------------------|-------------|---------------------------|--------------|
|                             | Amount      | Costs                     | Amount       |
| Asset based credit facility | \$ 341,000  | \$ —                      | \$ 341,000   |
| LIFO term loan              | 80,000      | (529 )                    | 79,471       |
| Total credit facilities     | \$ 421,000  | \$ (529 )                 | \$ 420,471   |

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   |           | Total     |
|-------------------------------|---------|-----------|-----------|
|                               | 1       | Level 2   |           |
| <b>Cash equivalents</b>       |         |           |           |
| Money market funds            | \$2,510 | \$—       | \$2,510   |
| Commercial paper              | —       | 5,493     | 5,493     |
| Total cash equivalents        | 2,510   | 5,493     | 8,003     |
| <b>Short-term investments</b> |         |           |           |
| 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   |
| <b>Long-term investments</b>  |         |           |           |
| 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 |
|--------------------------|-----------|------------|
| <b>Range of maturity</b> |           |            |
| 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,<br>2017 |           | January 28,<br>2017 |           |
|-----------------------------------|---------------------|-----------|---------------------|-----------|
|                                   | Fair                | Carrying  | Fair                | Carrying  |
|                                   | Value               | Value     | Value               | 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,<br>2017 | October 29,<br>2016 | October 28,<br>2017 | October 29,<br>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           | —                   |

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|                                 |            |            |            |            |
|---------------------------------|------------|------------|------------|------------|
| 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<br>28,<br>2017 | October<br>29,<br>2016 | October<br>28,<br>2017 | October<br>29,<br>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<br>October 28,<br>2017 |            |           | Three Months Ended<br>October 29,<br>2016 |            |           |
|-------------------------------|---|------------|-----------|---|------------|-----------|
|                               | RH  |            |           | RH  |            |           |
|                               | Segment                                   | Waterworks | Total     | 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<br>October 28,<br>2017  |            |           | Nine Months Ended<br>October 29,<br>2016  |            |           |
|                               | Waterworks Total                          |            |           | Waterworks Total                          |            |           |

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|                               | 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    |

24

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

|                             | October 28,<br>2017<br>RH |            |             | January 28,<br>2017<br>RH |            |             |
|-----------------------------|---------------------------|------------|-------------|---------------------------|------------|-------------|
|                             | Segment                   | Waterworks | Total       | Segment                   | Waterworks | Total       |
| Goodwill <sup>(1)</sup>     | \$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<br>Ended  |                        | Nine Months<br>Ended   |                        |
|-----------------------------------|------------------------|------------------------|------------------------|------------------------|
|                                   | October<br>28,<br>2017 | October<br>29,<br>2016 | October<br>28,<br>2017 | October<br>29,<br>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 )               |

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|                                |          |         |          |           |
|--------------------------------|----------|---------|----------|-----------|
| 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<br>28,<br>2017 | October<br>29,<br>2016 | October<br>28,<br>2017 | October<br>29,<br>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;

28

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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                | October   | October           | October     |
|   | 28,                    | 29,       | 28,               | 29,         |
|   | 2017                   | 2016      | 2017              | 2016        |
|   | (dollars in thousands) |           |                   |             |
| <b>Condensed Consolidated Statements of Operations:</b> |                        |           |                   |             |
| 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      |
| <b>Other expenses</b>                                   |                        |           |                   |             |
| 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 )  |
| <b>Other Financial and Operating Data:</b>              |                        |           |                   |             |
| <b>Net revenues:</b>                                    |                        |           |                   |             |
| Stores <sup>(1)</sup>                                   | \$343,222              | \$306,800 | \$1,010,120       | \$872,662   |
| Direct  | \$249,251              | \$242,528 | \$759,759         | \$675,503   |
| Direct as a percentage of net revenues <sup>(2)</sup>   | 42                     | % 44      | % 43              | % 44        |
| <b>Growth in net revenues:</b>                          |                        |           |                   |             |
| Stores <sup>(1)</sup>                                   | 12                     | % 9       | % 16              | % 14        |

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|  |          |          |          |           |   |
|--|----------|----------|----------|-----------|---|
| Direct   | 3        | % -3     | % 12     | % -3      | % |
| Total  | 8        | % 3      | % 14     | % 6       | % |
| Comparable brand revenue growth <sup>(3)</sup> | 6        | % -6     | % 7      | % -2      | % |
| Adjusted net income <sup>(4)</sup>             | \$24,424 | \$8,019  | \$45,919 | \$23,861  |   |
| Capital:                                       |          |          |          |           |   |
| Capital expenditures                           | \$37,427 | \$58,876 | \$76,789 | \$104,152 |   |
| Construction related deposits <sup>(5)</sup>   | 7,487    | 168      | 12,772   | 3,829     |   |
| Total capital                                  | \$44,914 | \$59,044 | \$89,561 | \$107,981 |   |

(1) Stores data represents retail stores, including Waterworks showrooms, plus outlet stores. Net revenues for outlet stores, which include warehouse sales, were \$41.2 million and \$36.0 million for the three months ended October 28, 2017 and October 29, 2016, respectively, and were \$148.4 million and \$99.1 million for the nine months ended October 28, 2017 and October 29, 2016, respectively.

(2) Direct revenues include sales through our Source Books, websites, and phone orders, including our Contract business and a portion of our Trade business.

30

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- (3) Comparable brand revenue growth includes direct net revenues and retail comparable store sales, including RH Baby & Child and RH Modern Galleries. Comparable brand revenue growth excludes retail non-comparable store sales, closed store sales and outlet net revenues. Comparable store sales have been calculated based upon retail stores, excluding outlet stores, that were open at least fourteen full months as of the end of the reporting period and did not change square footage by more than 20% between periods. If a store is closed for seven days during a month, that month will be excluded from comparable store sales. Membership revenue was included in comparable brand revenue growth beginning April 2017, which is the first full month following the one-year anniversary of the program launch. Waterworks revenue was included in comparable brand revenue growth beginning June 2017, which is the first full month following the one-year anniversary of the acquisition.
- (4) Adjusted net income is a supplemental measure of financial performance that is not required by, or presented in accordance with, GAAP. We define adjusted net income as net income (loss), adjusted for the impact of certain non-recurring and other items that we do not consider representative of our underlying operating performance. Adjusted net income is included in this filing because management believes that adjusted net income provides meaningful supplemental information for investors regarding the performance of our business and facilitates a meaningful evaluation of actual results on a comparable basis with historical results. Our management uses this non-GAAP financial measure in order to have comparable financial results to analyze changes in our underlying business from quarter to quarter. The following table presents a reconciliation of net income (loss), the most directly comparable GAAP financial measure, to adjusted net income for the periods indicated below.

|  | Three Months                    |                        | Nine Months Ended      |                        |
|--|---------------------------------|------------------------|------------------------|------------------------|
|  | Ended<br>October<br>28,<br>2017 | October<br>29,<br>2016 | October<br>28,<br>2017 | October<br>29,<br>2016 |
|  | (in thousands)                  |                        |                        |                        |
| Net income (loss)                                | \$13,151                        | \$2,517                | \$1,919                | \$(4,035 )             |
| Adjustments pre-tax:                             |                                 |                        |                        |                        |
| Executive non-cash compensation <sup>(a)</sup>   | —                               | —                      | 23,872                 | —                      |
| Amortization of debt discount <sup>(b)</sup>     | 6,879                           | 6,629                  | 20,384                 | 19,550                 |
| Recall accrual <sup>(c)</sup>                    | 3,552                           | —                      | 8,285                  | —                      |
| Loss on extinguishment of debt <sup>(d)</sup>    | 4,880                           | —                      | 4,880                  | —                      |
| Distribution center closure <sup>(e)</sup>       | 1,862                           | —                      | 1,862                  | —                      |
| Gain on sale of building and land <sup>(f)</sup> | (819 )                          | —                      | (2,119 )               | —                      |
| Legal claim <sup>(g)</sup>                       | —                               | —                      | —                      | 8,701                  |
| Reorganization related costs <sup>(h)</sup>      | —                               | 974                    | —                      | 5,698                  |
| Waterworks acquisition related:                  |                                 |                        |                        |                        |
| Non-cash compensation <sup>(i)</sup>             | —                               | —                      | —                      | 3,672                  |
| Impact of inventory step-up <sup>(i)</sup>       | 248                             | 1,786                  | 2,108                  | 5,187                  |
| Acquisition related costs <sup>(k)</sup>         | —                               | —                      | —                      | 2,847                  |
| Subtotal adjusted items                          | 16,602                          | 9,389                  | 59,272                 | 45,655                 |
| Impact of income tax items <sup>(l)</sup>        | (5,329 )                        | (3,887)                | (15,272)               | (17,759)               |
| Adjusted net income                              | \$24,424                        | \$8,019                | \$45,919               | \$23,861               |

- (a) Represents a non-cash compensation charge related to a fully vested option grant made to Mr. Friedman in May 2017.
- (b) 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 GAAP purposes for the \$350 million aggregate principal amount of convertible senior notes that were issued in June 2014 (the "2019 Notes") and for the

\$300 million aggregate principal amount of convertible senior notes that were issued in June and July 2015 (the “2020 Notes”), we separated the 2019 Notes and 2020 Notes into liability (debt) and equity (conversion option) components and we are amortizing as debt discount an amount equal to the fair value of the equity components as interest expense on the 2019 Notes and 2020 Notes over their expected lives. The equity components represent the difference between the proceeds from the issuance of the 2019 Notes and 2020 Notes and the fair value of the liability components of the 2019 Notes and 2020 Notes, respectively. Amounts are presented net of interest capitalized for capital projects of \$0.8 million and \$0.6 million during the three months ended October 28, 2017 and October 29, 2016, respectively. Amounts are presented net of interest capitalized for capital projects of \$2.3 million and \$1.9 million during the nine months ended October 28, 2017 and October 29, 2016, respectively.

(c) Represents costs and inventory charges associated with a product recall initiated in the second quarter of fiscal 2017, as well as an adjustment in the nine months ended October 28, 2017 of the accrual related to certain product recalls initiated in the fourth quarter of fiscal 2016. The recall adjustments, which affected our results for the three and nine months ended October 28, 2017, had the following effect on our income before taxes:

|  | Three<br>Months<br>Ended<br>October<br>28,<br>2017<br>(in thousands) | Nine<br>Months<br>Ended<br>October<br>28,<br>2017 |
|--|--|---|
| Reduction of net revenues                                | \$—  | \$ 3,813  |
| Incremental cost of goods sold and inventory charges     | 3,552  | 4,315   |
| Impact on gross profit                                   | 3,552  | 8,128   |
| Incremental selling, general and administrative expenses | —  | 157   |
| Impact on income (loss) before income taxes              | \$3,552  | \$ 8,285  |

- (d) Represents the loss on extinguishment of debt related to the second lien term loan which was repaid in full in October 2017.
- (e) Represents severance expense and certain inventory transfer costs associated with two distribution center closures, one of which was completed in November 2017 and one which is expected to occur in January 2018.
- (f) Represents the gain on the sale of building and land. As we entered into a short-term lease agreement to lease the property subsequent to the sale, the total gain associated with the sale of this property was amortized over a five month period.
- (g) Represents the estimated cumulative impact of coupons redeemed in connection with a legal claim alleging that the Company violated California's Song-Beverly Credit Card Act of 1971 by requesting and recording ZIP codes from customers paying with credit cards.
- (h) Represents 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.
- (i) Represents a non-cash compensation charge related to the fully vested option grants made in connection with our acquisition of Waterworks.
- (j) Represents the non-cash amortization of the inventory fair value adjustment recorded in connection with our acquisition of Waterworks.
- (k) Represents costs incurred in connection with our acquisition of Waterworks including professional fees.
- (l) The adjustment for the three months ended October 28, 2017 represents the tax effect of the adjusted items based on our effective tax rate of 32.1%. The nine months ended October 28, 2017 includes an adjustment to calculate income tax expense at an adjusted tax rate of 35.4%, which is calculated based on the weighted-average fiscal 2017 quarterly adjusted effective tax rates. The adjustments for the three and nine months ended October 29, 2016 represent the tax effect of the adjusted items based on our effective tax rates of 41.4% and 38.9%, respectively.
- (5) Construction related deposits relate to payments to escrow accounts for future construction of Design Galleries.

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The following tables present retail Gallery metrics, which have been calculated based upon retail stores, which includes our RH Baby & Child, RH Modern Galleries and Waterworks Showrooms, and excludes outlet stores.

|  | Nine Months Ended   |                        |                     |                        |
|--|---------------------|------------------------|---------------------|------------------------|
|  | October 28,<br>2017 |                        | October 29,<br>2016 |                        |
|  | Total               |                        | Total               |                        |
|  | Leased              |                        | Leased              |                        |
|  | Selling             |                        | Selling             |                        |
|  | Store Square        |                        | Store Square        |                        |
|  | Count               | Footage <sup>(1)</sup> | Count               | Footage <sup>(1)</sup> |
|  | (in thousands)      |                        | (in thousands)      |                        |
| Beginning of period                      | 85                  | 912                    | 69                  | 725                    |
| Waterworks Showrooms acquired            | —                   | —                      | 15                  | 51.0                   |
| Retail Galleries opened:                 |                     |                        |                     |                        |
| Waterworks Boston Showroom               | 1                   | 5.0                    | —                   | —                      |
| Yorkdale next generation Design Gallery  | 1                   | 43.3                   | —                   | —                      |
| Leawood next generation Design Gallery   | —                   | —                      | 1                   | 33.5                   |
| Waterworks San Francisco Showroom        | —                   | —                      | 1                   | 5.8                    |
| Austin next generation Design Gallery    | —                   | —                      | 1                   | 39.6                   |
| Las Vegas next generation Design Gallery | —                   | —                      | 1                   | 47.6                   |
| Retail Galleries closed:                 |                     |                        |                     |                        |
| Waterworks Boston Showroom               | (1)                 | (2.1)                  | —                   | —                      |
| Toronto (Bayview) Legacy Gallery         | (1)                 | (6.0)                  | —                   | —                      |
| Toronto (Yonge Street) Legacy Gallery    | (1)                 | (8.6)                  | —                   | —                      |
| Kansas City Legacy Gallery               | —                   | —                      | (1)                 | (9.9)                  |
| Waterworks - Kansas Street, SF           | —                   | —                      | (1)                 | (2.0)                  |
| Austin Legacy Gallery                    | —                   | —                      | (1)                 | (6.2)                  |
| End of period                            | 84                  | 944                    | 85                  | 884                    |

(1) Leased selling square footage is retail space at our stores used to sell our products. Leased selling square footage excludes backrooms at retail stores used for storage, office space or similar purpose, as well as exterior sales space located outside a store, such as courtyards, gardens and rooftops. Leased selling square footage for the three and nine months ended October 28, 2017 includes approximately 4,800 square feet related to one owned store location. Leased selling square footage for the three and nine months ended October 29, 2016 includes approximately 13,000 square feet related to two owned store locations.

|   | Three Months Ended |                  | Nine Months Ended |                  |
|---|--------------------|------------------|-------------------|------------------|
|   | October 28, 2017   | October 29, 2016 | October 28, 2017  | October 29, 2016 |
|   | (in thousands)     |                  |                   |                  |
| Total leased square footage at end of period <sup>(1)</sup>   | 1,276              | 1,208            | 1,276             | 1,208            |
| Weighted-average leased square footage <sup>(2)</sup>         | 1,250              | 1,146            | 1,245             | 1,066            |
| Weighted-average leased selling square footage <sup>(2)</sup> | 918                | 816              | 914               | 767              |

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Retail sales per leased selling square foot (in dollars)<sup>(3)</sup>    \$ 329    \$ 330    \$ 941    \$ 1,004

- (1) Total leased square footage as of October 28, 2017 includes approximately 5,400 square feet related to one owned store location. Total leased square footage as of October 29, 2016 includes approximately 24,000 square feet related to two owned store locations.
- (2) Weighted-average leased square footage and leased selling square footage is calculated based on the number of days a Gallery location was opened during the period divided by the total number of days in the period.
- (3) Retail sales per leased selling square foot is calculated by dividing total net revenues for all retail stores, comparable and non-comparable, by the weighted-average leased selling square footage for the period.

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The following table sets forth our condensed consolidated statements of operations as a percentage of total net revenues.

|  | Three Months Ended |                  | Nine Months Ended |                  |
|--|--------------------|------------------|-------------------|------------------|
|  | October 28, 2017   | October 29, 2016 | October 28, 2017  | October 29, 2016 |
| Condensed Consolidated Statements of Operations: |                    |                  |                   |                  |
| Net revenues                                     | 100.0%             | 100.0 %          | 100.0%            | 100.0 %          |
| Cost of goods sold                               | 63.8               | 68.0             | 66.6              | 68.8             |
| Gross profit                                     | 36.2               | 32.0             | 33.4              | 31.2             |
| Selling, general and administrative expenses     | 28.9               | 29.2             | 29.9              | 29.5             |
| Income from operations                           | 7.3                | 2.8              | 3.5               | 1.7              |
| Other expenses                                   |                    |                  |                   |                  |
| Interest expense—net                             | 3.2                | 2.0              | 2.5               | 2.1              |
| Loss on extinguishment of debt                   | 0.8                | —                | 0.3               | —                |
| Total other expenses                             | 4.0                | 2.0              | 2.8               | 2.1              |
| Income (loss) before income taxes                | 3.3                | 0.8              | 0.7               | (0.4 )           |
| Income tax expense (benefit)                     | 1.1                | 0.3              | 0.6               | (0.1 )           |
| Net income (loss)                                | 2.2 %              | 0.5 %            | 0.1 %             | (0.3 %)          |

Three Months Ended October 28, 2017 Compared to Three Months Ended October 29, 2016

|  | Three Months Ended October 28, 2017 |                |           | October 29, 2016 |                |           |
|--|-------------------------------------|----------------|-----------|------------------|----------------|-----------|
|  | RH Segment                          | Waterworks (1) | Total     | RH Segment       | Waterworks (1) | Total     |
| (in thousands)                               |                                     |                |           |                  |                |           |
| Net revenues                                 | \$563,174                           | \$ 29,299      | \$592,473 | \$521,027        | \$ 28,301      | \$549,328 |
| Cost of goods sold                           | 359,953                             | 18,195         | 378,148   | 354,903          | 18,606         | 373,509   |
| Gross profit                                 | 203,221                             | 11,104         | 214,325   | 166,124          | 9,695          | 175,819   |
| Selling, general and administrative expenses | 159,092                             | 12,071         | 171,163   | 148,438          | 11,995         | 160,433   |
| Income (loss) from operations                | \$44,129                            | \$ (967 )      | \$43,162  | \$17,686         | \$ (2,300 )    | \$15,386  |

(1) Waterworks results include non-cash amortization of \$0.2 million and \$1.8 million related to the inventory fair value adjustment recorded in connection with our acquisition of Waterworks during the three months ended October 28, 2017 and October 29, 2016, respectively.

Net revenues

Consolidated net revenues increased \$43.1 million, or 7.9%, to \$592.5 million in the three months ended October 28, 2017 compared to \$549.3 million in the three months ended October 29, 2016. Stores net revenues increased \$36.4 million, or 11.9%, to \$343.2 million in the three months ended October 28, 2017 compared to \$306.8 million in the three months ended October 29, 2016. Direct net revenues increased \$6.7 million, or 2.8%, to \$249.3 million in the three months ended October 28, 2017 compared to \$242.5 million in the three months ended October 29, 2016. Comparable brand revenue was 6% for the three months ended October 28, 2017.

#### RH Segment net revenues

RH Segment net revenues increased \$42.1 million, or 8.1%, to \$563.2 million in the three months ended October 28, 2017 compared to \$521.0 million in the three months ended October 29, 2016.

A number of factors contributed to the increase in RH Segment net revenues during the three months ended October 28, 2017, including, in order of magnitude, the introduction of new product categories and the expansion of existing product categories, the performance of our new Design Galleries and an increase in retail weighted-average leased selling square footage, as well as an increase in revenues from our Contract business which represents sales to commercial customers.

Outlet sales, which include sales via warehouse locations, increased \$5.1 million in the three months ended October 28, 2017 compared to the three months ended October 29, 2016. We also had an increase in Membership revenue recognized of \$4.6 million.

The above increases were partially offset by an approximate 1% negative impact of Hurricanes Harvey and Irma primarily due to store closures and lost sales.

#### Waterworks net revenues

Waterworks net revenues increased \$1.0 million, or 3.5%, to \$29.3 million in the three months ended October 28, 2017 compared to \$28.3 million in the three months ended October 29, 2016. Waterworks net revenues represented 4.9% and 5.2% of our net revenues for the three months ended October 28, 2017 and October 29, 2016, respectively.

#### Gross profit

Consolidated gross profit increased \$38.5 million, or 21.9%, to \$214.3 million in the three months ended October 28, 2017 from \$175.8 million in the three months ended October 29, 2016. As a percentage of net revenues, consolidated gross margin increased 4.2% to 36.2% of net revenues in the three months ended October 28, 2017 from 32.0% of net revenues in the three months ended October 29, 2016.

RH Segment gross profit for the three months ended October 28, 2017 was negatively impacted by \$3.6 million related to inventory charges associated with product recalls and \$0.5 million related to costs associated with anticipated distribution center closures. Waterworks gross profit for the three months ended October 28, 2017 and October 29, 2016 was negatively impacted by \$0.2 million and \$1.8 million, respectively, of amortization related to the inventory fair value adjustment recorded in connection with the acquisition.

Excluding the product recall costs, costs associated with anticipated distribution center closures and the impact of the amortization related to the inventory fair value adjustment mentioned above, consolidated gross margin would have increased 4.6% to 36.9% of net revenues in the three months ended October 28, 2017 from 32.3% of net revenues in the three months ended October 29, 2016.

#### RH Segment gross profit

RH Segment gross profit increased \$37.1 million, or 22.3%, to \$203.2 million in the three months ended October 28, 2017 from \$166.1 million in the three months ended October 29, 2016. As a percentage of net revenues, RH Segment gross margin increased 4.2% to 36.1% of net revenues in the three months ended October 28, 2017 from 31.9% of net revenues in the three months ended October 29, 2016.

Excluding the product recalls and costs associated with anticipated distribution center closures mentioned above, RH Segment gross margin would have increased 4.9% to 36.8% of net revenues in the three months ended October 28, 2017 from 31.9% of net revenues in the three months ended October 29, 2016. The increase, in order of magnitude, was due to improvements in our core merchandise margins as our SKU rationalization efforts had a reduced impact on our margins this year compared to last year, partially offset by higher outlet and warehouse sales driven by increased promotions and higher discounts. Additionally, gross margin increased due to improvement in shipping costs as a percentage of net revenues.

#### Waterworks gross profit

Waterworks gross profit increased \$1.4 million, or 14.5%, to \$11.1 million in the three months ended October 28, 2017 from \$9.7 million in the three months ended October 29, 2016. As a percentage of net revenues, Waterworks gross margin increased 3.6% to 37.9% of net revenues in the three months ended October 28, 2017 from 34.3% of net revenues in the three months ended October 29, 2016.

Excluding the impact of the amortization related to the inventory fair value adjustment mentioned above, Waterworks gross margin would have decreased 1.9% to 38.7% of net revenues in the three months ended October 28, 2017 from



40.6% of net revenues in the three months ended October 29, 2016. The decrease in gross margin is primarily due to changes in product mix and deleverage in occupancy costs.

Selling, general and administrative expenses

Consolidated selling, general and administrative expenses increased \$10.7 million, or 6.7%, to \$171.2 million in the three months ended October 28, 2017 compared to \$160.4 million in the three months ended October 29, 2016.

## RH Segment selling, general and administrative expenses

RH Segment selling, general and administrative expenses increased \$10.7 million, or 7.2%, to \$159.1 million in the three months ended October 28, 2017 compared \$148.4 million in the three months ended October 29, 2016.

RH Segment selling, general and administrative expenses for the three months ended October 28, 2017 included \$1.4 million related to costs associated with anticipated distribution center closures and a gain of \$0.8 million related to the sale of building and land. RH Segment selling, general and administrative expenses for the three months ended October 29, 2016 included \$1.0 million associated with a reorganization, including severance and related taxes.

Advertising and marketing costs increased \$9.8 million during the three months ended October 28, 2017 as compared to October 29, 2016, primarily due to the timing of our Source Book mailings. In the third quarter of fiscal 2017 we amortized costs related to our 2016 Interiors Source Book which was circulated in the fall of 2016. The 2016 Interiors Source Book mailing was complete in mid-December and therefore resulted in amortized costs in the third quarter of fiscal 2017, whereas the third quarter of fiscal 2016 did not incur similarly timed expenses.

RH Segment selling, general and administrative expenses were 28.2% and 28.3% of net revenues for the three months ended October 28, 2017 and October 29, 2016, respectively, excluding the costs associated with anticipated distribution center closures, the gain related to the sale of building and land and the reorganization costs mentioned above. The decrease in selling, general and administrative expenses as a percentage of net revenues was primarily driven by leverage in employment and employment related costs and, to a lesser extent, leverage in our corporate occupancy costs, partially offset by an increase in advertising and marketing costs.

## Waterworks selling, general and administrative expenses

Waterworks selling, general and administrative expenses increased \$0.1 million, or 0.6%, to \$12.1 million in the three months ended October 28, 2017 compared to \$12.0 million in the three months ended October 29, 2016.

## Interest expense—net

Interest expense increased \$7.8 million to \$18.9 million for the three months ended October 28, 2017 compared to \$11.1 million for the three months ended October 29, 2016. Interest expense consisted of the following:

|   | Three Months<br>Ended  |                        |
|---|------------------------|------------------------|
|   | October<br>28,<br>2017 | October<br>29,<br>2016 |
|   | (in thousands)         |                        |
| Amortization of convertible senior notes debt discount          | \$7,667                | \$7,254                |
| Build-to-suit lease transactions                                | 4,133                  | 3,083                  |
| Term loans  | 2,721                  | —                      |
| Asset based credit facility                                     | 2,622                  | 584                    |
| Amortization of debt issuance costs and deferred financing fees | 1,996                  | 634                    |
| Other interest expense  | 772                    | 833                    |
| Capitalized interest for capital projects                       | (966 )                 | (625 )                 |
| Interest income   | (30 )                  | (672 )                 |
| Total interest expense—net                                      | \$18,915               | \$11,091               |

Loss on extinguishment of debt

We incurred a \$4.9 million loss on extinguishment of debt in the three months ended October 28, 2017 due to the repayment in full of the second lien term loan on October 10, 2017, which includes a prepayment penalty of \$3.0 million and acceleration of amortization of debt issuance costs of \$1.9 million.

Income tax expense

Income tax expense was \$6.2 million and \$1.8 million in the three months ended October 28, 2017 and October 29, 2016, respectively. Our 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 in the three months ended October 28, 2017 was impacted by net excess tax benefits from stock-based compensation of \$1.9 million resulting from the Company's adoption of ASU 2016-09 in the first quarter of fiscal 2017.

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Nine Months Ended October 28, 2017 Compared to Nine Months Ended October 29, 2016

Prior to the Waterworks acquisition on May 27, 2016, we had one reportable segment. As we acquired the Waterworks business on May 27, 2016, reportable segment information presented below for Waterworks includes results for twenty-two weeks during the nine months ended October 29, 2016 and includes results for thirty-nine weeks during the nine months ended October 28, 2017. The RH Segment includes results for thirty-nine weeks during both the nine months ended October 28, 2017 and October 29, 2016.

|   | Nine Months Ended<br>October 28,<br>2017 |                   |             | October 29,<br>2016 |                   |             |
|---|--|-------------------|-------------|---------------------|-------------------|-------------|
|   | RH<br>Segment<br>(in thousands)          | Waterworks<br>(1) | Total       | RH<br>Segment       | Waterworks<br>(1) | Total       |
| Net revenues                                    | \$1,680,495                              | \$ 89,384         | \$1,769,879 | \$1,499,101         | \$ 49,064         | \$1,548,165 |
| Cost of goods sold                              | 1,124,651                                | 54,834            | 1,179,485   | 1,031,699           | 33,333            | 1,065,032   |
| Gross profit                                    | 555,844                                  | 34,550            | 590,394     | 467,402             | 15,731            | 483,133     |
| Selling, general and administrative<br>expenses | 489,412                                  | 38,801            | 528,213     | 432,961             | 24,246            | 457,207     |
| Income (loss) from operations                   | \$66,432                                 | \$ (4,251 )       | \$62,181    | \$34,441            | \$ (8,515 )       | \$25,926    |

(1) Waterworks results include non-cash amortization of \$2.1 million and \$5.2 million related to the inventory fair value adjustment recorded in connection with our acquisition of Waterworks during the nine months ended October 28, 2017 and October 29, 2016, respectively.

Net revenues

Consolidated net revenues increased \$221.7 million, or 14.3%, to \$1,769.9 million in the nine months ended October 28, 2017 compared to \$1,548.2 million in the nine months ended October 29, 2016. Stores net revenues increased \$137.5 million, or 15.8%, to \$1,010.1 million in the nine months ended October 28, 2017 compared to \$872.7 million in the nine months ended October 29, 2016. Direct net revenues increased \$84.3 million, or 12.5%, to \$759.8 million in the nine months ended October 28, 2017 compared to \$675.5 million in the nine months ended October 29, 2016. Comparable brand revenue was 7% for the nine months ended October 28, 2017.

RH Segment net revenues

RH Segment net revenues increased \$181.4 million, or 12.1%, to \$1,680.5 million in the nine months ended October 28, 2017 compared to \$1,499.1 million in the nine months ended October 29, 2016.

A number of factors contributed to the increase in RH Segment net revenues during the nine months ended October 28, 2017, the most significant of which was our decision to move the mailing of our 2016 Interiors Source Book to the fall of 2016. The 2016 Interiors Source Book mailing was complete in mid-December and therefore was a contributor to net revenues in the first three quarters of fiscal 2017, whereas the first three quarters of fiscal 2016 did not benefit from a similarly timed mailing.

In addition, the following factors resulted in increased RH Segment net revenues, which are listed in order of magnitude. Outlet sales, which include sales via warehouse locations, increased \$49.2 million in the nine months ended October 28, 2017 compared to the nine months ended October 29, 2016, representing 3.3% of growth in RH

Segment net revenues. Increased outlet sales occurred primarily as a result of our inventory optimization efforts as we increased our outlet promotional activity, including through warehouse sales, and we increased outlet selling square footage by approximately 32% compared to the prior period. Additionally, the performance of our new Design Galleries and an increase in retail weighted-average leased selling square footage contributed to the increase in RH Segment net revenues. Net revenues also increased related to deeper markdowns on discontinued merchandise based on our continued efforts to rationalize our SKU count. We also had an increase in Membership revenue recognized of \$18.2 million.

RH Segment net revenues for the nine months ended October 28, 2017 were negatively impacted by \$3.8 million related to the reduction of revenue associated with product recalls. During the nine months ended October 29, 2016, RH Segment net revenues were reduced by an estimated \$16 million due to customer accommodation and related expenses as a result of our initiative to elevate the customer experience, including in response to production delays related to RH Modern. We did not experience similar production delays during the nine months ended October 28, 2017.

#### Waterworks net revenues

On May 27, 2016, we acquired a controlling interest in Waterworks. As a result of this acquisition, we acquired 15 Waterworks showrooms and included such additional retail stores in our weighted-average leased selling square footage for both the nine months

ended October 28, 2017 and October 29, 2016. Waterworks net revenues increased \$40.3 million, or 82.2%, to \$89.4 million in the nine months ended October 28, 2017 compared to \$49.1 million in the nine months ended October 29, 2016. Waterworks net revenues represented 5.1% and 3.2% of our net revenues for the nine months ended October 28, 2017 and October 29, 2016, respectively. The increase in Waterworks net revenues is primarily due to the nine months ended October 28, 2017 representing thirty-nine weeks of results, whereas the nine months ended October 29, 2016 only includes twenty-two weeks of results as Waterworks was acquired on May 27, 2016.

#### Gross profit

Consolidated gross profit increased \$107.3 million, or 22.2%, to \$590.4 million in the nine months ended October 28, 2017 from \$483.1 million in the nine months ended October 29, 2016. As a percentage of net revenues, consolidated gross margin increased 2.2% to 33.4% of net revenues in the nine months ended October 28, 2017 from 31.2% of net revenues in the nine months ended October 29, 2016.

RH Segment gross profit for the nine months ended October 28, 2017 was negatively impacted by \$8.2 million related to the reduction of revenue, incremental costs and inventory charges associated with product recalls and \$0.5 million related to costs associated with anticipated distribution center closures. RH Segment gross profit for the nine months ended October 29, 2016 was negatively impacted by \$7.7 million related to the estimated cumulative impact of coupons redeemed in connection with a legal claim alleging that the Company violated California's Song-Beverly Credit Card Act of 1971 by requesting and recording ZIP codes from customers paying with credit cards. The coupons expired in March 2016.

Waterworks gross profit for the nine months ended October 28, 2017 and October 29, 2016 was negatively impacted by \$2.1 million and \$5.2 million, respectively, of amortization related to the inventory fair value adjustment recorded in connection with the acquisition.

Excluding the product recall costs, costs associated with the distribution center closure, impact of the coupons redeemed in connection with the legal claim and amortization related to the inventory fair value adjustment mentioned above, consolidated gross margin would have increased 1.9% to 33.9% of net revenues in the nine months ended October 28, 2017 from 32.0% of net revenues in the nine months ended October 29, 2016.

#### RH Segment gross profit

RH Segment gross profit increased \$88.4 million, or 18.9%, to \$555.8 million in the nine months ended October 28, 2017 from \$467.4 million in the nine months ended October 29, 2016. As a percentage of net revenues, RH Segment gross margin increased 1.9% to 33.1% of net revenues in the nine months ended October 28, 2017 from 31.2% of net revenues in the nine months ended October 29, 2016. Excluding the product recall costs, costs associated with anticipated distribution center closures and impact of the coupons redeemed in connection with the legal claim mentioned above, RH Segment gross margin would have increased 1.8% to 33.5% of net revenues in the nine months ended October 28, 2017 from 31.7% of net revenues in the nine months ended October 29, 2016.

The increase in gross margin was primarily due to incremental shipping charges incurred during the nine months ended October 29, 2016 related to RH Modern production delays and our investment to elevate the customer experience. In addition, our merchandise margins were impacted by our SKU rationalization efforts that had a reduced impact on our margins this year compared to last year, partially offset by higher outlet and warehouse sales driven by increased promotions and higher discounts. During the nine months ended October 28, 2017, we experienced occupancy leverage in our fixed distribution and retail occupancy costs, partially offset by increased outlet occupancy costs.

#### Waterworks gross profit

Waterworks gross profit increased \$18.8 million, or 119.6%, to \$34.6 million in the nine months ended October 28, 2017 from \$15.7 million in the nine months ended October 29, 2016. The increase in Waterworks gross profit is primarily due to the nine months ended October 28, 2017 representing thirty-nine weeks of results, whereas the nine months ended October 29, 2016 only includes twenty-two weeks of results as Waterworks was acquired on May 27, 2016. As a percentage of net revenues, Waterworks gross margin increased 6.6% to 38.7% of net revenues in the nine months ended October 28, 2017 from 32.1% of net revenues in the nine months ended October 29, 2016. Excluding the impact of the amortization related to the inventory fair value adjustment mentioned above, Waterworks gross margin would have decreased 1.6% to 41.0% of net revenues in the nine months ended October 28, 2017 from 42.6% of net revenues in the nine months ended October 29, 2016. The decrease in gross margin is primarily due to changes in product mix and deleverage in occupancy costs.

Selling, general and administrative expenses

Consolidated selling, general and administrative expenses increased \$71.0 million, or 15.5%, to \$528.2 million in the nine months ended October 28, 2017 compared to \$457.2 million in the nine months ended October 29, 2016.

RH Segment selling, general and administrative expenses

RH Segment selling, general and administrative expenses increased \$56.5 million, or 13.0%, to \$489.4 million in the nine months ended October 28, 2017 compared \$433.0 million in the nine months ended October 29, 2016.

RH Segment selling, general and administrative expenses for the nine months ended October 28, 2017 included \$23.9 million related to a fully vested option grant made to Mr. Friedman in May 2017, \$0.1 million incremental costs associated with product recalls, \$1.4 million costs associated with anticipated distribution center closures and a gain of \$2.1 million related to the sale of building and land.

RH Segment selling, general and administrative expenses for the nine months ended October 29, 2016 included \$5.7 million associated with a reorganization, including severance and related taxes, \$2.8 million related to charges and expenses incurred as a result of the Waterworks transaction, and \$1.0 million related to the estimated cumulative impact of coupons redeemed in connection with a legal claim alleging that the Company violated California's Song-Beverly Credit Card Act of 1971 by requesting and recording ZIP codes from customers paying with credit cards.

Advertising and marketing costs increased \$26.9 million during the nine months ended October 28, 2017 as compared to October 29, 2016, primarily due to the timing of our Source Book mailings. In the nine months ended October 28, 2017 we amortized costs related to our 2016 Interiors Source Book which was circulated in the fall of 2016. The 2016 Interiors Source Book mailing was complete in mid-December and therefore resulted in amortized costs in the nine months ended October 28, 2017, whereas the nine months ended October 29, 2016 did not incur similarly timed expenses. In addition, we had an increase in employment and employment related costs.

RH Segment selling, general and administrative expenses were 27.7% and 28.2% of net revenues for the nine months ended October 28, 2017 and October 29, 2016, respectively, excluding the fully vested option grant made to Mr. Friedman in May 2017, the product recall costs, costs associated with anticipated distribution center closures, the gain related to the sale of building and land, the reorganization costs, the charges and expenses incurred as a result of the Waterworks transaction, and the impact of coupons redeemed in connection with the legal claim mentioned above. The decrease in selling, general and administrative expenses as a percentage of net revenues was primarily driven by leverage in our employment and employment related costs and, to a lesser extent, leverage in our corporate occupancy costs, partially offset by an increase in advertising and marketing costs.

Waterworks selling, general and administrative expenses

Waterworks selling, general and administrative expenses increased \$14.6 million, or 60.0%, to \$38.8 million in the nine months ended October 28, 2017 compared \$24.2 million in the nine months ended October 29, 2016.

The increase in Waterworks selling, general and administrative expenses is primarily due to the nine months ended October 28, 2017 representing thirty-nine weeks of results, whereas the nine months ended October 29, 2016 only includes twenty-two weeks of results as Waterworks was acquired on May 27, 2016. This increase is partially offset by stock-based compensation of \$3.7 million related to the fully vested option grants made in connection with our acquisition of Waterworks during the nine months ended October 29, 2016.

Excluding the fully vested option grants made in connection with our acquisition of Waterworks, Waterworks selling, general and administrative expenses would have been 43.4% and 41.9% of net revenues in the nine months ended



October 28, 2017 and October 29, 2016, respectively. The increase in selling, general and administrative expenses as a percentage of net revenues was primarily driven by increased employment and employment related costs.

## Interest expense—net

Interest expense increased \$13.0 million to \$45.5 million for the nine months ended October 28, 2017 compared to \$32.5 million for the nine months ended October 29, 2016. Interest expense consisted of the following:

|   | Nine Months<br>Ended   |                        |
|---|------------------------|------------------------|
|   | October<br>28,<br>2017 | October<br>29,<br>2016 |
|   | (in thousands)         |                        |
| Amortization of convertible senior notes debt discount          | \$22,685               | \$21,467               |
| Build-to-suit lease transactions                                | 12,360                 | 9,418                  |
| Asset based credit facility                                     | 4,049                  | 1,465                  |
| Amortization of debt issuance costs and deferred financing fees | 3,933                  | 1,884                  |
| Term loans  | 3,545                  | —                      |
| Other interest expense  | 1,910                  | 2,515                  |
| Capitalized interest for capital projects                       | (2,547)                | (1,917)                |
| Interest income   | (439)                  | (2,304)                |
| Total interest expense—net                                      | \$45,496               | \$32,528               |

## Loss on extinguishment of debt

We incurred a \$4.9 million loss on extinguishment of debt in the nine months ended October 28, 2017 due to the repayment in full of the second lien term loan on October 10, 2017, which includes a prepayment penalty of \$3.0 million and acceleration of amortization of debt issuance costs of \$1.9 million.

## Income tax expense (benefit)

Income tax expense was \$9.9 million in the nine months ended October 28, 2017 compared to an income tax benefit of \$2.6 million in the nine months ended October 29, 2016. Our 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 rate in the nine months ended October 28, 2017 was significantly impacted by non-deductible stock-based compensation related to the May 2017 grant to Mr. Friedman of an option to purchase 1,000,000 shares of the Company's common stock and net excess tax benefits from stock-based compensation of \$4.3 million resulting from the Company's adoption of ASU 2016-09 in the first quarter of fiscal 2017. Refer to Note 15—Stock-Based Compensation in our condensed consolidated financial statements for a description of the option grant to Mr. Friedman.

## Liquidity and Capital Resources

## General

The primary cash needs of our business have historically been for merchandise inventories, payroll, Source Books, store rent, capital expenditures associated with opening new stores and updating existing stores, as well as the development of our infrastructure and information technology. We seek out and evaluate opportunities for effectively managing and deploying capital in ways that improve working capital and support and enhance our business initiatives and strategies. We completed our first share repurchase program in an amount of \$300 million during the first quarter of fiscal 2017 and completed our second repurchase program in an amount of \$700 million during the

second quarter of fiscal 2017 (refer to “Share Repurchase Programs” below). We intend to evaluate our capital allocation from time to time and may engage in future share repurchases in circumstances where buying shares of our common stock represents a good value and provides a favorable return for our shareholders.

We have \$650 million in aggregate principal amount of convertible notes outstanding, of which \$350 million mature in June 2019 and \$300 million mature in June 2020, and we may need to pursue additional sources of liquidity to repay such convertible notes in cash at their respective maturity dates. There can be no assurance as to the availability of capital to fund such repayments, or that if capital is available through additional debt issuances or refinancing of the convertible notes, that such capital will be available on terms that are favorable to us.

We extended and amended our revolving line of credit in June 2017, which has a total availability of \$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 \$800.0 million if and to the extent the lenders revise their credit commitments to encompass a larger facility. In addition, we have an \$80.0 million last out, delayed draw term loan (“LILO term loan”) facility. The revolving line of credit and LILO term loan facility have a maturity date of June 28, 2022.

In July 2017, Restoration Hardware, Inc. entered into a credit agreement (the “second lien credit agreement”) 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”). Refer to Second Lien Credit Agreement below. The proceeds of the second lien term loan were used to support our share repurchase program. We repaid this debt in full in October 2017.

We believe that cash expected to be generated from operations, net cash proceeds from the issuance of the convertible senior notes, borrowing availability under the revolving line of credit, borrowings under our term loan and other financing arrangements will be sufficient to meet working capital requirements, anticipated capital expenditures and other capital needs for the next 12 months.

Our business has relied on cash flows from operations, net cash proceeds from the issuance of the convertible senior notes, as well as borrowings under our credit facilities as our primary sources of liquidity. We have pursued in the past, and may pursue in the future, additional strategies to generate liquidity for our operations, including through the strategic sale of assets, utilization of our credit facilities, and entry into new debt financing arrangements that present attractive terms.

During the first quarter of fiscal 2017, we received cash of \$4.9 million for the sale of an aircraft, net of \$0.3 million of costs to dispose of the aircraft, which was classified as asset held for sale, and during the second quarter of fiscal 2017 we received cash of \$10.2 million for the sale of a real estate parcel that we owned on which one of our retail Galleries was located, which was classified as asset held for sale. We may in the future pursue additional strategies, through the use of existing assets and debt facilities, or through the pursuit of new external sources of liquidity and debt financings, to fund our strategies to enhance stockholder value. There can be no assurance that additional capital, whether raised through the sale of assets, utilization of our existing debt financing sources, or pursuit of additional debt financing sources, will be available to us on a timely manner, on favorable terms or at all. To the extent we pursue additional debt as a source of liquidity, our capitalization profile may change and may include significant leverage, and as a result we may be required to use future liquidity to repay such indebtedness and may be subject to additional terms and restrictions which affect our operations and future uses of capital.

In addition, our capital needs may change in the future due to changes in our business or new opportunities that we choose to pursue. We have invested significant capital expenditures in remodeling and opening new Galleries, and these capital expenditures have increased in the past and may continue to increase in future periods as we open additional next generation Design Galleries, which may require us to undertake upgrades to historical buildings or construction of new buildings. During fiscal 2016, we spent \$157.6 million for capital expenditures. Additionally, we made payments of \$23.4 million in fiscal 2016 to escrow accounts for future construction of next generation Design Galleries.

We anticipate our gross capital expenditures to be approximately \$120 million to \$130 million for fiscal 2017. Our fiscal 2017 capital expenditures will be offset by cash flows from operating activities. Our efforts to optimize inventory and reduce capital spending generated substantial free cash flow in the nine months ended October 28, 2017, and we expect to generate additional free cash flow for the remainder of the year.

The majority of the current lease arrangements for our new Galleries require the landlord to fund a portion of the construction related costs directly to third parties, rather than through traditional construction allowances and accordingly, we do not expect to receive significant contributions directly from our landlords related to the building of our larger format and next generation Design Galleries in fiscal 2017. As we develop new Galleries, as well as potentially other strategic initiatives in the future like our integrated hospitality experience; we may explore other models for our real estate, which could include longer lease terms or further purchases of, or joint ventures or other forms of equity ownership in, real estate interests associated with new sites and buildings. These approaches might require greater capital investment on our part than a traditional store lease with a landlord. In the event that such capital and other expenditures require us to pursue additional funding sources, we can provide no assurances that we will be successful in securing additional funding on attractive terms or at all.

There can be no assurance that we will have sufficient financial resources, or will be able to arrange financing on favorable terms to the extent necessary to fund all of our initiatives, or that sufficient incremental debt will be available to us in order to fund our cash payments in respect of the repayment of our outstanding convertible senior notes in an aggregate principal amount of \$650 million at maturity of such senior convertible notes or our terms loan at the maturity dates of such term loan. In addition, agreements governing existing or new debt facilities may restrict our ability to operate our business in the manner we currently expect or to make required payments with respect to existing commitments including the repayment of the principal amount of our convertible senior notes in cash upon maturity of such senior notes. To the extent we need to seek waivers from any provider of debt financing, or we fail to observe the covenants or other requirements of existing or new debt facilities, any such event could have an impact on our other commitments and obligations including triggering cross defaults or other consequences with respect to other indebtedness. Our current level of indebtedness, and any additional indebtedness that we may incur, exposes us to certain risks with regards to interest rate increases and fluctuations. Our ability to make interest payments or to refinance any of our indebtedness to manage such interest rates may be limited or negatively affected by credit market conditions, macroeconomic trends and other risks.

Any weakening of, or other adverse developments in, the U.S. or global credit markets could affect our ability to manage our debt obligations and our ability to access future debt. We cannot assure you that we will be able to raise necessary funds on favorable terms, if at all, or that future financing requirements would not require us to raise money through an equity financing or by other means that could be dilutive to holders of our capital stock. If we fail to raise sufficient additional funds, we may be required to delay or abandon some of our planned future expenditures or aspects of our current operations.

### Cash Flow Analysis

A summary of operating, investing, and financing activities is set forth in the following table:

|  | Nine Months Ended      |                        |
|--|------------------------|------------------------|
|  | October<br>28,<br>2017 | October<br>29,<br>2016 |
|  | As<br>Revised          |                        |
|  | (in thousands)         |                        |
| Provided by (used in) operating activities | \$386,762              | \$(18,985 )            |
| Provided by (used in) investing activities | \$101,324              | \$(263,378)            |
| Used in financing activities               | \$(552,969)            | \$(2,311 )             |
| Decrease in cash and cash equivalents      | \$(64,861 )            | \$(284,332)            |
| Cash and cash equivalents at end of period | \$22,162               | \$47,135               |

### Net Cash Provided By (Used In) Operating Activities

Operating activities consist primarily of net income (loss) adjusted for non-cash items including depreciation and amortization, stock-based compensation, amortization of debt discount and the effect of changes in working capital and other activities.

For the nine months ended October 28, 2017, net cash provided by operating activities was \$386.8 million and consisted of net income of \$1.9 million, and an increase in cash provided by working capital and other activities of \$259.3 million and non-cash items of \$125.6 million. Working capital and other activities consisted primarily of decreases in inventory of \$190.6 million due to our SKU rationalization initiative, outlet inventory optimization efforts and revised DC network strategy. We also had decreases in prepaid expense and other current assets of \$38.4 million primarily due to amortization of our capitalized catalog costs, reduction of federal and state tax receivables, and a reduction in prepaid rent. In addition, we had increases in deferred revenue and customer deposits of \$20.6 million and increases in accounts payable and accrued liabilities of \$10.5 million due to the timing of payments.

For the nine months ended October 29, 2016, net cash used in operating activities was \$19.0 million and consisted of a net loss of \$4.0 million and an increase in uses of working capital and other activities of \$109.8 million, offset by non-cash items of \$94.8 million. Working capital and other activities consisted primarily of decreases in accounts payable and accrued liabilities of \$63.4 million primarily due to the timing of payments to our vendors, and prepaid expense and other current assets increased \$30.4 million due to an increase in capitalized catalog costs related to our decision to move the mailing of our annual Source Books from the Spring to the Fall. In addition, other current liabilities decreased \$25.4 million primarily due to federal and state tax payments, and inventory increased \$23.3 million related to the increase in both existing and new products. This was partially offset by increases in deferred revenue and customer deposits of \$22.7 million and an increase in other non-current obligations of \$8.5 million

primarily due to a deferred contract incentive.

#### Net Cash Provided By (Used In) Investing Activities

Investing activities consist primarily of investments in capital expenditures related to new Gallery openings, the acquisition of buildings and land, investments in supply chain and systems infrastructure, construction related deposits, acquisition of businesses, as well as activities associated with investing in available-for-sale securities.

For the nine months ended October 28, 2017, net cash provided by investing activities was \$101.3 million primarily as a result of sales and maturities of investments in available-for-sale securities of \$145.0 million and \$46.9 million, respectively, the proceeds of which were used to fund the share repurchases made under the \$300 Million Repurchase Program. In addition, we had net proceeds from the sale of building and land and the sale of an aircraft of \$10.2 million and \$4.9 million, respectively. These increases to cash were partially offset by investments in new Galleries, information technology and systems infrastructure, and supply chain investments of \$76.8 million, purchases of investments in available-for-sale securities of \$16.1 million and payments of \$12.8 million to escrow accounts for future construction of next generation Design Galleries.

For the nine months ended October 29, 2016, net cash used in investing activities was \$263.4 million primarily as a result of our acquisition of Waterworks, net of cash acquired, of \$116.1 million. In addition, we made \$104.2 million of investments in new

galleries, information technology and systems infrastructure, supply chain and other corporate assets, as well as payments of \$3.8 million to escrow accounts for future construction of next generation Design Galleries. In addition, we made investments in available-for-sale securities of \$187.0 million, partially offset by maturities and sales of such investments of \$115.9 million and \$31.9 million, respectively.

#### Net Cash Used In Financing Activities

Financing activities consist primarily of borrowings related to the convertible senior notes offerings, credit facilities, as well as share repurchases and other equity related transactions.

For the nine months ended October 28, 2017, net cash used in financing activities was \$553.0 million primarily due to \$1.0 billion of share repurchases made under the \$300 Million Repurchase Program and \$700 Million Repurchase Program. Cash funding for the share repurchase programs was provided by available cash balances, net borrowings under the asset based credit facility of \$341.0 million, as well as borrowings under the term loans of \$180.0 million, borrowings under loans secured by certain equipment of \$20.0 million and borrowings under a promissory note secured by our aircraft of \$14.0 million. Additionally, proceeds from exercise of employee stock options were \$15.4 million. The cash provided by these financing activities was partially offset by repayment of the second lien term loan of \$100.0 million, \$8.7 million of payments on build-to-suit transactions, debt issuance costs of \$8.3 million and \$4.9 million cash paid for employee taxes related to net settlement of equity awards.

For the nine months ended October 29, 2016, net cash used in financing activities was \$2.3 million primarily due to tax shortfalls from the exercise of stock options of \$2.3 million and cash paid for employee taxes related to net settlement of equity awards of \$1.4 million.

#### Non-Cash Transactions

Non-cash transactions consist of non-cash additions of property and equipment.

#### Build-to-Suit Lease Transactions

The non-cash additions of property and equipment due to build-to-suit lease transactions are the result of the accounting requirements of Accounting Standards Codification (“ASC”) 840—Leases (“ASC 840”) for those construction projects for which we are the “deemed owner” of the construction project given the extent to which we are involved in constructing the leased asset. If we are the “deemed owner” for accounting purposes, upon commencement of the construction project, we are required to capitalize contributions by the landlord toward construction as property and equipment on our condensed consolidated balance sheets. The contributions by the landlord toward construction, including the building, existing site improvements at construction commencement and any amounts paid by the landlord to those responsible for construction, are included as property and equipment additions due to build-to-suit lease transactions within the non-cash section of our condensed consolidated statements of cash flows.

Over the lease term, these non-cash additions to property and equipment due to build-to-suit lease transactions do not impact our cash outflows, nor do they impact net income within our condensed consolidated statements of operations.

#### Convertible Senior Notes

##### 0.00% Convertible Senior Notes due 2020

In June 2015, we issued in a private offering \$250 million principal amount of 0.00% convertible senior notes due 2020 and, in July 2015, we issued an additional \$50 million principal amount pursuant to the exercise of the overallotment option granted to the initial purchasers as part of our June 2015 offering (collectively, the “2020 Notes”). The 2020 Notes are governed by the terms of an indenture between us and U.S. Bank National Association, as the



Trustee. The 2020 Notes will mature on July 15, 2020, unless earlier purchased by us 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 our failure to perform certain of our 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 us or any of our 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 our 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, we 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 our 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 our 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 our election, in cash, shares of our common stock, or a combination of cash and shares of our common stock.

We 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 us 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, we 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, we 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.

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 over-allotment option in July 2015, we entered into convertible note hedge transactions whereby we have the option to purchase a total of approximately 2.5 million shares of our 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, we sold warrants whereby the holders of the warrants have the option to purchase a total of approximately 2.5 million shares of our 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). We 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 our 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.

We 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, we issued \$350 million aggregate 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 us and U.S. Bank National Association, as the Trustee. The 2019 Notes will mature on June 15, 2019, unless earlier purchased by us 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 our failure to perform certain of our 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 us or any of our 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,” we 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 our 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 our 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 our election, in cash, shares of our common stock, or a combination of cash and shares of our common stock.

We 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 us 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, we 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 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, we 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.

## 2019 Notes—Convertible Bond Hedge and Warrant Transactions

In connection with the offering of the 2019 Notes, we entered into convertible note hedge transactions whereby we have the option to purchase a total of approximately 3.0 million shares of our 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, we sold warrants whereby the holders of the warrants have the option to purchase a total of approximately 3.0 million shares of our 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). We 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 and are not accounted for as derivatives. 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.

We 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 asset are recorded in deferred tax assets on the condensed consolidated balance sheets.

## Asset Based Credit Facility

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 \$800.0 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 availability of credit at any given time under the credit agreement is limited by reference to a borrowing base formula based upon numerous factors, including the value of eligible inventory and eligible accounts receivable. As a result of the borrowing base formula, actual borrowing availability under the revolving line of credit could be less than the stated amount of the revolving line of credit (as reduced by the actual borrowings and outstanding letters of credit under the revolving line of credit). All obligations under the credit agreement are secured by substantially all of the assets, including accounts receivable, inventory, intangible assets, property, equipment, goods and fixtures of Restoration Hardware, Inc., Restoration Hardware Canada, Inc., RH US, LLC, Waterworks Operating Co., LLC and Waterworks IP Co., LLC.

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.

The credit agreement does not contain any significant financial or coverage ratio covenants unless the domestic availability under the revolving line of credit is less than the greater of (i) \$40.0 million and (ii) 10% of the sum of (a) the lesser of (x) the aggregate revolving commitments under the credit agreement and (y) the aggregate revolving borrowing base, plus (b) the lesser of (x) the then outstanding amount of the LILO term loan or (y) the LILO term loan borrowing base . If the availability under the credit agreement is less than the foregoing amount, then Restoration Hardware, Inc. is required to maintain a consolidated fixed-charge coverage ratio (“FCCR”) of at least one to one. The consolidated FCCR is based upon the ratio on the last day of each month on a trailing twelve-month basis of (a) (i) consolidated EBITDA (as defined in the agreement) minus (ii) capital expenditures, minus (iii) the income taxes paid in cash to (b) the sum of (i) debt service charges plus (ii) certain dividends and distributions paid. As of October 28, 2017, Restoration Hardware, Inc. was in compliance with all applicable covenants of the credit agreement.

The credit agreement requires a daily sweep of cash to prepay the loans under the agreement while (i) an event of default exists or (ii) the availability under the revolving line of credit for extensions of credit is less than the greater of (A) \$40.0 million and (B) 10% of the sum of (a) the lesser of (x) the aggregate revolving commitments under the credit agreement and (y) the aggregate revolving borrowing base, plus (b) the lesser of (x) the then outstanding amount of the LILO term loan or (y) the LILO term loan borrowing base.

As of October 28, 2017, Restoration Hardware, Inc. 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 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 would be approximately \$125.2 million.

### Second Lien Credit Agreement

On July 7, 2017, Restoration Hardware, Inc., a wholly-owned subsidiary of RH, entered into 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 the second lien 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 of \$100.0 million was repaid in full on October 10, 2017. As a result of the repayment, we 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.

### 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.

### Share Repurchase Programs

On February 21, 2017, our board of directors authorized a stock repurchase program of up to \$300 million (the “\$300 Million Repurchase Program”) through open market purchases, privately negotiated transactions or other means, including through Rule 10b18 open market repurchases, Rule 10b5-1 trading plans or through the use of other techniques such as accelerated share repurchases. During the three months ended April 29, 2017, we repurchased approximately 7.8 million shares of our common stock under the \$300 Million Repurchase Program at an average price of \$38.24 per share, for an aggregate repurchase amount of approximately \$300 million. No additional shares will be repurchased in future periods under the \$300 Million Repurchase Program.

Following completion of the \$300 Million Repurchase Program, our board of directors authorized on May 2, 2017 an additional stock repurchase program of up to \$700 million (the “\$700 Million Repurchase Program”) through open market purchases, privately negotiated transactions or other means, including through Rule 10b18 open market repurchases, Rule 10b5-1 trading plans or through the use of other techniques such as accelerated share repurchases including through privately-negotiated arrangements in which a portion of the share repurchase program is committed in advance through a financial intermediary and/or in transactions involving hedging or derivatives. During the three



months ended July 29, 2017, we repurchased approximately 12.4 million shares of our common stock under the \$700 Million Repurchase Program at an average price of \$56.60 per share, for an aggregate repurchase amount of approximately \$700 million. No additional shares will be repurchased in future periods under the \$700 Million Repurchase Program.

## Contractual Obligations

We enter into long-term contractual obligations and commitments, primarily debt obligations and non-cancelable operating leases, in the normal course of business. As of October 28, 2017, our contractual cash obligations were as follows (in thousands):

|  | Payments Due by Period |           |            |            |              |
|--|------------------------|-----------|------------|------------|--------------|
|  | Total                  | 2017      | 2018-2019  | 2020-2021  | Thereafter   |
|  | Remainder of           |           |            |            |              |
|  | of                     |           |            |            |              |
|  | (in thousands)         |           |            |            |              |
| Convertible senior notes due 2019            | \$ 350,000             | \$ —      | \$ 350,000 | \$ —       | \$ —         |
| Convertible senior notes due 2020            | 300,000                | —         | —          | 300,000    | —            |
| Asset based credit facility <sup>(1)</sup>   | 341,000                | —         | —          | —          | 341,000      |
| Term loan <sup>(2)</sup>                     | 80,000                 | —         | —          | —          | 80,000       |
| Operating leases <sup>(3)</sup>              | 683,685                | 23,058    | 163,223    | 122,998    | 374,406      |
| Other non-current obligations <sup>(4)</sup> | 792,723                | 9,335     | 78,971     | 86,513     | 617,904      |
| Capital lease obligations                    | 14,913                 | 357       | 2,832      | 2,569      | 9,155        |
| Equipment security notes                     | 19,626                 | 1,129     | 10,281     | 8,216      | —            |
| Notes payable for share repurchases          | 19,390                 | —         | 893        | —          | 18,497       |
| Promissory note                              | 13,533                 | 350       | 2,800      | 2,800      | 7,583        |
| Letters of credit                            | 27,718                 | 27,718    | —          | —          | —            |
| Total  | \$2,642,588            | \$ 61,947 | \$ 609,000 | \$ 523,096 | \$ 1,448,545 |

(1) Under the credit agreement, the asset based credit facility has a maturity date of June 28, 2022.

(2) Under the credit agreement, the \$80.0 million LILO term loan facility has a maturity date of June 28, 2022.

(3) We enter into operating leases in the normal course of business. Most lease arrangements provide us with the option to renew the leases at defined terms. The table above does not include future obligations for renewal options that have not yet been exercised. The future operating lease obligations would change if we were to exercise these options. Amounts above do not include estimated contingent rent due under operating leases. Our obligation for contingent rent as of October 28, 2017 was \$3.6 million.

(4) Other non-current obligations include estimated payments for rent associated with build-to-suit lease transactions.

These amounts may be reduced in the event we are able to effect a sale-leaseback on any of these locations.

## Off Balance Sheet Arrangements

We have no material off balance sheet arrangements as of October 28, 2017.

## Critical Accounting Policies and Estimates

The preparation of financial statements in accordance with GAAP requires management to make estimates and assumptions that affect amounts reported in our consolidated financial statements and related notes, as well as the related disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Management evaluates its accounting policies, estimates, and judgments on an on-going basis. Management bases its estimates and judgments on historical experience and various other factors that are believed to be reasonable under the circumstances. Actual results may differ from these estimates under different assumptions and conditions and such differences could be material to the consolidated financial statements.

Management evaluated the development and selection of its critical accounting policies and estimates and believes that the following involve a higher degree of judgment or complexity and are most significant to reporting our consolidated results of operations and financial position, and are therefore discussed as critical:

- Revenue Recognition
- Merchandise Inventories
- Advertising Expenses
- Impairment of Goodwill and Long-Lived Assets
- Lease Accounting
- Stock-Based Compensation
- Income Taxes

48

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For further discussion regarding these policies, refer to Management's Discussion and Analysis of Financial Condition and Results of Operations—Critical Accounting Policies and Estimates in the 2016 Form 10-K. There have been no material changes to the critical accounting policies and estimates listed in the 2016 Form 10-K.

#### Recent Accounting Pronouncements

Refer to Note 2—Recently Issued Accounting Standards in our condensed consolidated financial statements for a description of recently proposed accounting standards which may impact our consolidated financial statements in future reporting periods.

### Item 3. Quantitative and Qualitative Disclosure of Market Risks

#### Interest Rate Risk

We currently do not engage in any interest rate hedging activity and we have no intention to do so in the foreseeable future.

We are subject to interest rate risk in connection with borrowings under our revolving line of credit which bears interest at variable rates and we may incur additional indebtedness that bears interest at variable rates. At October 28, 2017, \$341.0 million was outstanding under the revolving line of credit. As of October 28, 2017, the undrawn borrowing availability under the revolving line of credit was \$189.0 million, net of \$27.7 million in outstanding letters of credit. As a result of the FCCR restriction that limits the last 10% of borrowing availability, actual incremental borrowing available under the revolving line of credit would be approximately \$125.2 million. Based on the average interest rate on the revolving line of credit during the three months ended October 28, 2017, and to the extent that borrowings were outstanding on such line of credit, we do not believe that a 10% change in the interest rate would have a material effect on our consolidated results of operations or financial condition. To the extent that we incur additional indebtedness, we may increase our exposure to risk from interest rate fluctuations.

We are subject to interest rate risk in connection with borrowings under our LILO term loan, which bears interest at variable rates. At October 28, 2017, \$80.0 million was outstanding under the LILO term loan. Based on the average interest rates on the LILO term loan during the three months ended October 28, 2017, we do not believe that a 10% change in the interest rate would have a material effect on our consolidated results of operations or financial condition.

As of October 28, 2017, we had \$350 million principal amount of 0.00% convertible senior notes due 2019 outstanding (the "2019 Notes"). As this instrument does not bear interest, we do not have interest rate risk exposure related to this debt.

As of October 28, 2017, we had \$300 million principal amount of 0.00% convertible senior notes due 2020 outstanding (the "2020 Notes"). As this instrument does not bear interest, we do not have interest rate risk exposure related to this debt.

#### Market Price Sensitive Instruments

##### 0.00% Convertible Senior Notes due 2019

In connection with the issuance of the 2019 Notes, we entered into privately-negotiated convertible note hedge transactions with certain counterparties. The convertible note hedge transactions relate to, collectively, 3.0 million

shares of our common stock, which represents the number of shares of our common stock underlying the 2019 Notes, subject to anti-dilution adjustments substantially similar to those applicable to the 2019 Notes. These convertible note hedge transactions are expected to reduce the potential earnings dilution with respect to our common stock upon conversion of the 2019 Notes and/or reduce our exposure to potential cash or stock payments that may be required upon conversion of the 2019 Notes.

We also entered into separate warrant transactions with the same group of counterparties initially relating to the number of shares of our common stock underlying the convertible note hedge transactions, subject to customary anti-dilution adjustments. The warrant transactions will have a dilutive effect with respect to our common stock to the extent that the price per share of our common stock exceeds the strike price of the warrants unless we elect, subject to certain conditions, to settle the warrants in cash. The strike price of the warrant transactions is initially \$171.98 per share. Refer to Note 9—Convertible Senior Notes in our condensed consolidated financial statements.

#### 0.00% Convertible Senior Notes due 2020

In connection with the issuance of the 2020 Notes, we entered into privately-negotiated convertible note hedge transactions with certain counterparties. The convertible note hedge transactions relate to, collectively, 2.5 million shares of our common stock, which represents the number of shares of our common stock underlying the 2020 Notes, subject to anti-dilution adjustments substantially similar to those applicable to the 2020 Notes. These convertible note hedge transactions are expected to reduce the potential earnings

dilution with respect to our common stock upon conversion of the 2020 Notes and/or reduce our exposure to potential cash or stock payments that may be required upon conversion of the 2020 Notes.

We also entered into separate warrant transactions with the same group of counterparties initially relating to the number of shares of our common stock underlying the convertible note hedge transactions, subject to customary anti-dilution adjustments. The warrant transactions will have a dilutive effect with respect to our common stock to the extent that the price per share of our common stock exceeds the strike price of the warrants unless we elect, subject to certain conditions, to settle the warrants in cash. The strike price of the warrant transactions is initially \$189.00 per share. Refer to Note 9—Convertible Senior Notes in our condensed consolidated financial statements.

#### Impact of Inflation

Our results of operations and financial condition are presented based on historical cost. While it is difficult to accurately measure the impact of inflation due to the imprecise nature of the estimates required, we believe the effects of inflation, if any, on our consolidated results of operations and financial condition have been immaterial.

#### Item 4. Controls and Procedures

##### Evaluation of Disclosure Controls and Procedures

Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended) as of the end of the period covered by this quarterly report. Based on that evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that as of the end of the period covered by this report our disclosure controls and procedures were effective to provide reasonable assurance that information required to be disclosed by us in reports that we file or submit under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and include controls and procedures designed to ensure that the information required to be disclosed by us in such reports is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosures.

##### Changes in Internal Control Over Financial Reporting

There were no changes in our internal control over financial reporting that occurred during our most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

## PART II

## Item 1. Legal Proceedings

From time to time we and/or our management are involved in litigation, claims and other proceedings relating to the conduct of our business, including purported class action litigation. Such legal proceedings may include claims related to our employment practices, wage and hour claims, claims of intellectual property infringement, including with respect to trademarks and trade dress, claims asserting unfair competition and unfair business practices, claims with respect to our collection and sale of reproduction products, and consumer class action claims relating to our consumer practices including the collection of zip code or other information from customers. In addition, from time to time, we are subject to product liability and personal injury claims for the products that we sell and the stores we operate. Subject to certain exceptions, our purchase orders generally require the vendor to indemnify us against any product liability claims; however, if the vendor does not have insurance or becomes insolvent, we may not be indemnified. In addition, we could face a wide variety of employee claims against us, including general discrimination, privacy, labor and employment, ERISA and disability claims. Any claims could result in litigation against us and could also result in regulatory proceedings being brought against us by various federal and state agencies that regulate our business, including the U.S. Equal Employment Opportunity Commission. Often these cases raise complex factual and legal issues, which are subject to risks and uncertainties and which could require significant management time. Litigation and other claims and regulatory proceedings against us could result in unexpected expenses and liability and could also materially adversely affect our operations and our reputation.

For additional information, refer to Note 17—Commitments and Contingencies in our condensed consolidated financial statements within Part I of this Quarterly Report on Form 10-Q.

## Item 1A. Risk Factors

We operate in a rapidly changing environment that involves a number of risks that could materially and adversely affect our business, financial condition, prospects, operating results or cash flows. For a detailed discussion of certain risks that affect our business, refer to the section entitled “Risk Factors” in our Annual Report on Form 10-K for the fiscal year ended January 28, 2017 (“2016 Form 10-K”). There have been no material changes to the risk factors disclosed in our 2016 Form 10-K.

The risks described in our 2016 Form 10-K are not the only risks we face. We describe in Management’s Discussion and Analysis of Financial Condition and Results of Operations in Part I of this quarterly report certain known trends and uncertainties that affect our business. Additional risks and uncertainties that we are unaware of, or that we currently believe are not material, may also become important factors that adversely affect our business, operating results and financial condition.

## Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

Repurchases of Common Stock during the Three Months Ended October 28, 2017

During the three months ended October 28, 2017, we repurchased the following shares of our common stock:

| Number<br>of<br>Shares<br>(1) | Average<br>Purchase<br>Price Per | Total<br>Number of<br>shares<br>Repurchased<br>as Part of | Approximate<br>Dollar Value<br>of Shares<br>That May<br>Yet Be |
|-------------------------------|----------------------------------|---|--|
|-------------------------------|----------------------------------|---|--|

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|                                       |        | Share    | Publicly<br>Announced<br>Plans or<br>Programs | Purchased<br>Under the<br>Plans or<br>Programs<br>(in millions) |
|---------------------------------------|--------|----------|---|---|
| July 30, 2017 to August 26, 2017      | —      | \$ —     | —   | \$ —  |
| August 27, 2017 to September 30, 2017 | 40,414 | \$ 72.18 | —   | \$ —  |
| October 1, 2017 to October 28, 2017   | 752    | \$ 77.20 | —   | \$ —  |
| Total                                 | 41,166 | \$ 72.28 | —   |   |

(1) Represents shares withheld from delivery to satisfy exercise price and tax withholding obligations of employee recipients that occur upon the exercise of stock options and vesting of restricted stock units granted under the Company's 2012 Stock Incentive Plan.

Item 3. Defaults Upon Senior Securities

Not applicable.



Item 4. Mine Safety Disclosures

Not applicable.

Item 5. Other Information

Not applicable.

52

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## Item 6. Exhibits

| Exhibit<br>Number | Exhibit Description   | Incorporated by<br>Reference |         |              |        |          |
|-------------------|---|------------------------------|---------|--------------|--------|----------|
|                   |   | File                         | Date of | Exhibit      | Filed  |          |
|                   |   | Form                         | Number  | First Filing | Number | Herewith |
| 31.1              | <u>Certification of Chief Executive Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended.</u>                            | —                            | —       | —            | —      | X        |
| 31.2              | <u>Certification of Chief Financial Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended.</u>                            | —                            | —       | —            | —      | X        |
| 32.1              | <u>Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.</u> | —                            | —       | —            | —      | X        |
| 32.2              | <u>Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.</u> | —                            | —       | —            | —      | X        |
| 101.INS           | XBRL Instance Document  | —                            | —       | —            | —      | X        |
| 101.SCH           | XBRL Taxonomy Extension Schema Document   | —                            | —       | —            | —      | X        |
| 101.CAL           | XBRL Taxonomy Extension Calculation Linkbase Document   | —                            | —       | —            | —      | X        |
| 101.DEF           | XBRL Taxonomy Extension Definition Linkbase Document  | —                            | —       | —            | —      | X        |
| 101.LAB           | XBRL Taxonomy Extension Label Linkbase Document   | —                            | —       | —            | —      | X        |
| 101.PRE           | XBRL Taxonomy Extension Presentation Linkbase Document  | —                            | —       | —            | —      | X        |

SIGNATURES

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

RH

Date: December 6, 2017

By: /s/ Gary Friedman  
Gary Friedman  
Chairman and Chief Executive Officer  
(Principal Executive Officer)

Date: December 6, 2017

By: /s/ Karen Boone  
Karen Boone  
President, Chief Financial and Administrative  
Officer  
(Principal Financial Officer and Principal  
Accounting Officer)