

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Some of the statements contained in this Form 10-Q and any documents incorporated herein by reference constitute forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and the Private Securities Litigation Reform Act of 1995. All statements, other than statements of historical facts, included or incorporated in this Form 10-Q are forward-looking statements, particularly statements which relate to expectations, beliefs, projections, future plans and strategies, anticipated events or trends and similar expressions concerning matters that are not historical facts, such as statements regarding our future financial condition or results of operations, our prospects and strategies for future growth, the development and introduction of new products, and the implementation of our marketing and branding strategies. In many cases, you can identify forward-looking statements by terms such as "may," "will," "should," "expects," "plans," "anticipates," "believes," "estimates," "intends," "predicts," "potential" or the negative of these terms or other comparable terminology.

The forward-looking statements contained in this Form 10-Q and any documents incorporated herein by reference reflect our current views about future events and are subject to risks, uncertainties, assumptions and changes in circumstances that may cause events or our actual activities or results to differ significantly from those expressed in any forward-looking statement. Although we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future events, results, actions, levels of activity, performance or achievements. Readers are cautioned not to place undue reliance on these forward-looking statements. A number of important factors could cause actual results to differ materially from those indicated by the forward-looking statements, including, but not limited to, those factors described in "Risk Factors" and elsewhere in this report.

The forward-looking statements contained in this Form 10-Q reflect our views and assumptions only as of the date of this Form 10-Q and are expressly qualified in their entirety by the cautionary statements included in this Form 10-Q. Except as required by applicable securities law, we undertake no obligation to update any forward-looking statement to reflect events or circumstances after the date on which the statement is made or to reflect the occurrence of unanticipated events.

This information should be read in conjunction with the unaudited interim consolidated financial statements and the notes included in Item 1 of Part I of this Quarterly Report on Form 10-Q and the audited consolidated financial statements and notes, and Management's Discussion and Analysis of Financial Condition and Results of Operations, contained in our fiscal 2016 Annual Report on Form 10-K filed with the SEC on March 29, 2017.

We disclose material non-public information through one or more of the following channels: our investor relations website (<http://investor.lululemon.com/>), the social media channels identified on our investor relations website, press releases, SEC filings, public conference calls, and webcasts.

Overview

lululemon is a designer, distributor, and retailer of healthy lifestyle inspired athletic apparel. Since our inception, we have developed a distinctive corporate culture, and we have a mission to produce products which create transformational experiences for people to live happy, healthy, fun lives. We promote a set of core values in our business which include taking personal responsibility, nurturing entrepreneurial spirit, acting with honesty and courage, valuing connection, and choosing to have fun. These core values attract passionate and motivated employees who are driven to succeed and share our purpose of "elevating the world from mediocrity to greatness."

We offer a comprehensive line of apparel and accessories for women and men. We also offer activewear for girls under our ivivva brand name. Our apparel assortment includes items such as pants, shorts, tops, and jackets designed for healthy lifestyle and athletic activities such as yoga, running, training, and most other sweaty pursuits. We also offer fitness-related accessories, including an array of items such as bags, socks, underwear, yoga mats, and water bottles.

On June 1, 2017, we announced a plan to restructure our ivivva operations to a primarily e-commerce focused business, with a select number of stores remaining in key communities across North America. The restructuring was substantially completed during the third quarter of fiscal 2017. On August 20, 2017, as a part of the restructuring plan, we closed 48 of our 55 ivivva branded company-operated stores. The seven remaining ivivva branded stores remain in operation and are not expected to close. All of our ivivva branded showrooms and other temporary locations have been closed. We continue to offer ivivva branded products on our e-commerce websites.

Financial Highlights

The summary below provides both GAAP and adjusted non-GAAP financial measures. In connection with the restructuring of our ivivva operations, we recognized pre-tax costs totaling \$22.2 million in the third quarter of fiscal 2017. The

adjusted financial measures exclude these charges and their related tax effects, and also exclude certain discrete items related to our transfer pricing arrangements and taxes on repatriation of foreign earnings which were recognized during the third quarter of fiscal 2016.

For the third quarter of fiscal 2017, compared to the third quarter of fiscal 2016:

- Net revenue increased 14% to \$619.0 million. On a constant dollar basis, net revenue increased 12%.
- Total comparable sales, which includes comparable store sales and direct to consumer, increased 8%. On a constant dollar basis, total comparable sales increased 7%.
 - Comparable store sales increased 2%, or increased 1% on a constant dollar basis.
 - Direct to consumer net revenue increased 26%, or increased 25% on a constant dollar basis.
- Gross profit increased 16% to \$322.0 million. Adjusted gross profit increased 16% to \$323.1 million.
- Gross margin increased 90 basis points to 52.0%. Adjusted gross margin increased 110 basis points to 52.2%.
- Income from operations decreased 8% to \$85.6 million. Adjusted income from operations increased 16% to \$107.8 million.
- Operating margin decreased 330 basis points to 13.8%. Adjusted operating margin increased 30 basis points to 17.4%.
- Income tax expense increased 9% to \$27.7 million. Our effective tax rate for the third quarter of fiscal 2017 was 32.0% compared to 27.0% for the third quarter of fiscal 2016. The adjusted effective tax rate was 30.8% in the third quarter of fiscal 2017 compared to 31.3% in the third quarter of fiscal 2016.
- Diluted earnings per share were \$0.43 compared to \$0.50 in the third quarter of fiscal 2016. Adjusted diluted earnings per share were \$0.56 for the third quarter of fiscal 2017 compared to \$0.47 for the third quarter of fiscal 2016.

Refer to the non-GAAP reconciliation tables contained in the "Results of Operations" section of this "Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations" for reconciliations between constant dollar changes in net revenue, total comparable sales, comparable store sales, and direct to consumer net revenue, and adjusted gross profit, gross margin, income from operations, operating margin, effective tax rates, and diluted earnings per share, and the most directly comparable measures calculated in accordance with GAAP.

Results of Operations

Third Quarter Results

The following table summarizes key components of our results of operations for the quarters ended October 29, 2017 and October 30, 2016. The percentages are presented as a percentage of net revenue.

	Quarter Ended			
	October 29, 2017	October 30, 2016	October 29, 2017	October 30, 2016
	<i>(In thousands)</i>		<i>(Percentages)</i>	
Net revenue	\$ 619,018	\$ 544,416	100.0%	100.0%
Cost of goods sold	297,056	265,990	48.0	48.9
Gross profit	321,962	278,426	52.0	51.1
Selling, general and administrative expenses	215,367	185,451	34.8	34.1
Asset impairment and restructuring costs	21,007	—	3.4	—
Income from operations	85,588	92,975	13.8	17.1
Other income (expense), net	1,052	628	0.2	0.1
Income before income tax expense	86,640	93,603	14.0	17.2
Income tax expense	27,696	25,318	4.5	4.7
Net income	<u>\$ 58,944</u>	<u>\$ 68,285</u>	<u>9.5%</u>	<u>12.5%</u>

Net Revenue

Net revenue increased \$74.6 million, or 14%, to \$619.0 million for the third quarter of fiscal 2017 from \$544.4 million for the third quarter of fiscal 2016. On a constant dollar basis, assuming the average exchange rates for the third quarter of fiscal 2017 remained constant with the average exchange rates for the third quarter of fiscal 2016, net revenue increased \$67.8 million, or 12%.

The increase in net revenue was primarily due to net revenue generated by new company-operated stores as well as increased direct to consumer net revenue. Total comparable sales, which includes comparable store sales and direct to consumer, increased 8% in the third quarter of fiscal 2017 compared to the third quarter of fiscal 2016. Total comparable sales increased 7% on a constant dollar basis.

Net revenue on a segment basis for the quarters ended October 29, 2017 and October 30, 2016 is summarized below. The percentages are presented as a percentage of total net revenue.

	Quarter Ended			
	October 29, 2017	October 30, 2016	October 29, 2017	October 30, 2016
	<i>(In thousands)</i>		<i>(Percentages)</i>	
Company-operated stores	\$ 425,084	\$ 393,506	68.7%	72.3%
Direct to consumer	131,181	104,013	21.2	19.1
Other	62,753	46,897	10.1	8.6
Net revenue	<u>\$ 619,018</u>	<u>\$ 544,416</u>	<u>100.0%</u>	<u>100.0%</u>

Company-Operated Stores. Net revenue from our company-operated stores segment increased \$31.6 million, or 8%, to \$425.1 million in the third quarter of fiscal 2017 from \$393.5 million in the third quarter of fiscal 2016. The following contributed to the increase in net revenue from our company-operated stores segment:

- Net revenue from company-operated stores we opened or significantly expanded subsequent to October 30, 2016, and therefore not included in comparable store sales, contributed \$33.7 million to the increase. We opened 46 net new lululemon branded company-operated stores since the third quarter of fiscal 2016, including 30 stores in North America, 13 stores in Asia Pacific, and three stores in Europe.
- A comparable store sales increase of 2% in the third quarter of fiscal 2017 compared to the third quarter of fiscal 2016 resulted in a \$6.6 million increase to net revenue. Comparable store sales increased 1%, or \$3.0 million on a constant dollar basis. The increase in comparable store sales was primarily a result of improved conversion rates and increased dollar value per transaction. This was partially offset by a decrease in store traffic, due in part to shifting retail traffic trends from in-store to online.

The closure of 48 of our ivivva branded company-operated stores as part of the restructuring of our ivivva operations in the third quarter of fiscal 2017 reduced our net revenue from company-operated stores by \$8.8 million compared to the third quarter of fiscal 2016.

Direct to Consumer. Net revenue from our direct to consumer segment increased \$27.2 million, or 26%, to \$131.2 million in the third quarter of fiscal 2017 from \$104.0 million in the third quarter of fiscal 2016. Direct to consumer net revenue increased 25% on a constant dollar basis. This was primarily a result of increased website traffic, increased dollar value per transaction, and improved conversion rates.

Other. Net revenue from our other segment increased \$15.9 million, or 34%, to \$62.7 million in the third quarter of fiscal 2017 from \$46.9 million in the third quarter of fiscal 2016. This increase was primarily the result of an increased number of outlets and increased net revenue at existing outlets during the third quarter of fiscal 2017 compared to the third quarter of fiscal 2016. There was also an increase in net revenue from warehouse sales and temporary locations. The increase in net revenue from our other segment was partially offset by lower net revenue from showrooms, primarily due to a decreased number of showrooms open during the third quarter of fiscal 2017 compared to the third quarter of fiscal 2016.

Gross Profit

Gross profit increased \$43.5 million, or 16%, to \$322.0 million for the third quarter of fiscal 2017 from \$278.4 million for the third quarter of fiscal 2016.

Gross profit as a percentage of net revenue, or gross margin, increased 90 basis points to 52.0% in the third quarter of fiscal 2017 from 51.1% in the third quarter of fiscal 2016. The increase in gross margin was primarily the result of:

- an increase in product margin of 70 basis points which was primarily due to a favorable mix of higher margin product and lower product costs, partially offset by higher markdowns;
- a decrease in fixed costs, including occupancy and depreciation costs and costs related to our product and supply chain departments, of 20 basis points; and
- a favorable impact of foreign exchange rates of 20 basis points.

This was partially offset by accelerated depreciation charges related to the restructuring of our ivivva operations of 20 basis points.

During the third quarter of fiscal 2017, as a result of the restructuring of our ivivva operations, we recognized costs totaling \$1.2 million within costs of goods sold, as outlined in Note 6 to the unaudited interim consolidated financial statements included in Item 1 of Part I of this report. These costs primarily related to accelerated depreciation on leasehold improvements and furniture and fittings for stores which were closed during the third quarter of fiscal 2017. Excluding these charges, adjusted gross profit increased 16% to \$323.1 million, and adjusted gross margin increased 110 basis points to 52.2% compared to the third quarter of fiscal 2016.

Selling, General and Administrative Expenses

Selling, general and administrative expenses increased \$29.9 million, or 16%, to \$215.4 million in the third quarter of fiscal 2017 from \$185.5 million in the third quarter of fiscal 2016. The increase in selling, general and administrative expenses was primarily due to:

- an increase in costs related to our operating channels of \$25.3 million, comprised of:
 - an increase in employee costs of \$7.7 million primarily from a growth in labor hours and benefits, mainly associated with new company-operated stores and other new operating locations;
 - an increase in variable costs of \$3.7 million primarily due to an increase in credit card fees and packaging costs as a result of increased net revenue; and
 - an increase in other costs of \$13.9 million primarily due to an increase in digital marketing expenses, website related costs including photography costs, brand and community costs, and other costs associated with our operating locations;
- an increase in head office costs of \$3.1 million, comprised of:
 - an increase in employee costs of \$2.1 million primarily due to additional employees to support the growth in our business; and
 - an increase in other costs of \$1.0 million primarily due to increases in information technology related costs, an increase in brand and community costs, partially offset by a decrease in professional fees; and
- a decrease in net foreign exchange and derivative revaluation gains of \$1.6 million. There were net foreign exchange and derivative revaluation gains of \$2.7 million in the third quarter of fiscal 2017 compared to net foreign exchange revaluation gains of \$4.3 million in the third quarter of fiscal 2016. The net foreign exchange gains and losses primarily relate to the revaluation of U.S. dollar denominated monetary assets and liabilities held by Canadian subsidiaries, and the derivatives are designed to economically hedge these gains and losses.

As a percentage of net revenue, selling, general and administrative expenses increased 70 basis points, to 34.8% in the third quarter of fiscal 2017 from 34.1% in the third quarter of fiscal 2016.

Asset Impairment and Restructuring Costs

As a result of the restructuring of our ivivva operations, we recognized restructuring costs of \$21.0 million in the third quarter of fiscal 2017. This included lease termination costs of \$19.4 million, employee related costs of \$0.8 million, and other restructuring costs of \$0.8 million. We did not have any asset impairment and restructuring costs in the third quarter of fiscal 2016. Please refer to Note 6 to the unaudited interim consolidated financial statements included in Item 1 of Part I of this report.

Income from Operations

Income from operations decreased \$7.4 million, or 8%, to \$85.6 million in the third quarter of fiscal 2017 from \$93.0 million in the third quarter of fiscal 2016. Operating margin decreased 330 basis points to 13.8% compared to 17.1% in the third quarter of fiscal 2016.

In connection with the restructuring of our ivivva operations, we recognized pre-tax costs totaling \$22.2 million in the third quarter of fiscal 2017. This includes restructuring costs of \$21.0 million and costs recognized in cost of goods sold totaling \$1.2 million. Excluding these charges, adjusted income from operations increased 16% to \$107.8 million and adjusted operating margin increased 30 basis points to 17.4%.

On a segment basis, we determine income from operations without taking into account our general corporate expenses and the costs we incur in connection with the restructuring of our ivivva operations.

Segmented income from operations for the quarters ended October 29, 2017 and October 30, 2016 is summarized below. The percentages are presented as a percentage of net revenue of the respective operating segments.

	Quarter Ended			
	October 29, 2017	October 30, 2016	October 29, 2017	October 30, 2016
	<i>(In thousands)</i>		<i>(Percentages)</i>	
Company-operated stores	\$ 97,015	\$ 91,497	22.8%	23.3%
Direct to consumer	52,201	43,588	39.8	41.9
Other	9,319	5,709	14.9	12.2
Segmented income from operations	<u>158,535</u>	<u>140,794</u>		
General corporate expense	50,762	47,819		
Restructuring and related costs	22,185	—		
Income from operations	<u>\$ 85,588</u>	<u>\$ 92,975</u>		

Company-Operated Stores. Income from operations from our company-operated stores segment increased \$5.5 million, or 6%, to \$97.0 million for the third quarter of fiscal 2017 from \$91.5 million for the third quarter of fiscal 2016. The increase was primarily the result of increased gross profit of \$14.5 million which was primarily due to increased net revenue. This was partially offset by an increase in selling, general and administrative expenses, including increased store employee costs, increased brand and community costs, and increased store operating expenses. Income from operations as a percentage of company-operated stores net revenue decreased 50 basis points primarily due to deleverage of selling, general and administrative expenses.

Direct to Consumer. Income from operations from our direct to consumer segment increased \$8.6 million, or 20%, to \$52.2 million for the third quarter of fiscal 2017 from \$43.6 million for the third quarter of fiscal 2016. The increase was primarily the result of increased gross profit of \$21.3 million which was primarily due to increased net revenue and higher gross margin. This was partially offset by an increase in selling, general and administrative expenses including higher digital marketing expenses and website related costs, and higher variable costs such as packaging, distribution and credit card fees as a result of higher net revenue. Income from operations as a percentage of direct to consumer net revenue decreased 210 basis points primarily due to deleverage of selling, general and administrative expenses, partially offset by increased gross margin.

Other. Other income from operations increased \$3.6 million, or 63%, to \$9.3 million for the third quarter of fiscal 2017 from \$5.7 million for the third quarter of fiscal 2016. The increase was primarily the result of increased gross profit of \$8.8 million which was primarily due to increased net revenue and higher gross margin. The increase in gross profit was partially offset by an increase in selling, general and administrative expenses, including increased employee costs, increased brand and community costs, and increased other operating costs. Income from operations as a percentage of other net revenue increased 270 basis points primarily due to an increase in gross margin.

General Corporate Expense. General corporate expense increased \$2.9 million, or 6%, to \$50.8 million for the third quarter of fiscal 2017 from \$47.8 million for the third quarter of fiscal 2016. This increase was primarily due to increases in information technology costs, head office employee costs, and other brand and community costs, partially offset by decreased professional fees. There was also a decrease in net foreign exchange and derivative revaluation gains of \$1.6 million. There were net foreign exchange and derivative revaluation gains of \$2.7 million in the third quarter of fiscal 2017 compared to net foreign exchange revaluation gains of \$4.3 million in the third quarter of fiscal 2016. The net foreign exchange gains and losses primarily relate to the revaluation of U.S. dollar denominated monetary assets and liabilities held by Canadian subsidiaries, and the derivatives are designed to economically hedge these gains and losses.

Other Income (Expense), Net

Other income, net increased \$0.4 million, or 68%, to \$1.1 million for the third quarter of fiscal 2017 from income of \$0.6 million for the third quarter of fiscal 2016. The third quarter of fiscal 2016 included a net interest expense of \$0.2 million in

relation to certain tax adjustments that are outlined in Note 7 to the unaudited interim consolidated financial statements included in Item 1 of Part I of this report.

Income Tax Expense

Income tax expense increased \$2.4 million, or 9%, to \$27.7 million for the third quarter of fiscal 2017 from \$25.3 million for the third quarter of fiscal 2016.

The third quarters of fiscal 2017 and fiscal 2016 included certain adjustments which resulted in net income tax recoveries of \$5.8 million and \$4.0 million, respectively. As outlined in Notes 6 and 7 to the unaudited interim consolidated financial statements included in Item 1 of Part I of this report, the tax recovery recognized in the third quarter of fiscal 2017 relates to the tax effect of the costs recognized in connection with the ivivva restructuring, and the tax recovery recognized in the third quarter of fiscal 2016 relates to our transfer pricing arrangements and taxes on repatriation of foreign earnings.

The effective tax rate for the third quarter of fiscal 2017 was 32.0% compared to 27.0% for the third quarter of fiscal 2016. The adjusted effective tax rate was 30.8% for the third quarter of fiscal 2017 compared to 31.3% for the third quarter of fiscal 2016. The decrease in the adjusted effective tax rate compared to the third quarter of fiscal 2016 is primarily due to certain adjustments which were recorded during the third quarter of fiscal 2017 following the finalization of our U.S. tax return.

Net Income

Net income decreased \$9.3 million, or 14%, to \$58.9 million for the third quarter of fiscal 2017 from \$68.3 million for the third quarter of fiscal 2016. This was primarily due to an increase in selling, general and administrative expenses of \$29.9 million, asset impairment and restructuring costs of \$21.0 million, an increase in income tax expense of \$2.4 million, partially offset by an increase in gross profit of \$43.5 million and an increase in other income (expense), net of \$0.4 million.

First Three Quarters Results

The following table summarizes key components of our results of operations for the first three quarters ended October 29, 2017 and October 30, 2016. The percentages are presented as a percentage of net revenue.

	Three Quarters Ended			
	October 29, 2017	October 30, 2016	October 29, 2017	October 30, 2016
	<i>(In thousands)</i>		<i>(Percentages)</i>	
Net revenue	\$ 1,720,379	\$ 1,554,452	100.0%	100.0%
Cost of goods sold	844,100	782,734	49.1	50.4
Gross profit	876,279	771,718	50.9	49.6
Selling, general and administrative expenses	640,032	547,195	37.2	35.2
Asset impairment and restructuring costs	36,524	—	2.1	—
Income from operations	199,723	224,523	11.6	14.4
Other income (expense), net	2,771	720	0.2	0.1
Income before income tax expense	202,494	225,243	11.8	14.5
Income tax expense	63,593	57,997	3.7	3.7
Net income	<u>\$ 138,901</u>	<u>\$ 167,246</u>	<u>8.1%</u>	<u>10.8%</u>

Net Revenue

Net revenue increased \$165.9 million, or 11%, to \$1.720 billion for the first three quarters of fiscal 2017 from \$1.554 billion for the first three quarters of fiscal 2016. On a constant dollar basis, assuming the average exchange rates for the first three quarters of fiscal 2017 remained constant with the average exchange rates for the first three quarters of fiscal 2016, net revenue increased \$162.9 million, or 10%.

The increase in net revenue was primarily due to net revenue generated by new company-operated stores as well as increased direct to consumer net revenue. Total comparable sales, which includes comparable store sales and direct to consumer, increased 5% in the first three quarters of fiscal 2017 compared to the first three quarters of fiscal 2016. Total comparable sales increased 4% on a constant dollar basis.

Net revenue on a segment basis for the first three quarters ended October 29, 2017 and October 30, 2016 is summarized below. The percentages are presented as a percentage of total net revenue.

	Three Quarters Ended			
	October 29, 2017	October 30, 2016	October 29, 2017	October 30, 2016
	<i>(In thousands)</i>		<i>(Percentages)</i>	
Company-operated stores	\$ 1,218,127	\$ 1,133,599	70.8%	72.9%
Direct to consumer	341,453	288,978	19.8	18.6
Other	160,799	131,875	9.4	8.5
Net revenue	<u>\$ 1,720,379</u>	<u>\$ 1,554,452</u>	<u>100.0%</u>	<u>100.0%</u>

Company-Operated Stores. Net revenue from our company-operated stores segment increased \$84.5 million, or 7%, to \$1.218 billion in the first three quarters of fiscal 2017 from \$1.134 billion in the first three quarters of fiscal 2016. The following contributed to the increase in net revenue from our company-operated stores segment:

- Net revenue from company-operated stores we opened or significantly expanded subsequent to October 30, 2016, and therefore not included in comparable store sales, contributed \$89.0 million to the increase. We opened 46 net new lululemon branded company-operated stores since the third quarter of fiscal 2016, including 30 stores in North America, 13 stores in Asia Pacific, and three stores in Europe.
- A comparable store sales increase of 1% in the first three quarters of fiscal 2017 compared to the first three quarters of fiscal 2016 which resulted in a \$4.3 million increase to net revenue. Comparable store sales increased 1%, or \$2.3 million on a constant dollar basis. The increase in comparable store sales was primarily a result of increased dollar value per transaction and improved conversion rates. This was partially offset by a decrease in store traffic, due in part to shifting retail traffic trends from in-store to online.

The closure of 48 of our ivivva branded company-operated stores as part of the restructuring of our ivivva operations in the third quarter of fiscal 2017 reduced our net revenue from company-operated stores by \$8.8 million compared to the first three quarters of fiscal 2016.

Direct to Consumer. Net revenue from our direct to consumer segment increased \$52.5 million, or 18%, to \$341.5 million in the first three quarters of fiscal 2017 from \$289.0 million in the first three quarters of fiscal 2016. Direct to consumer net revenue increased 18% on a constant dollar basis. This was primarily a result of increased website traffic and increased dollar value per transaction, partially offset by lower conversion rates. During the second quarter of fiscal 2017, we held online warehouse sales in the United States and Canada which generated net revenue of \$12.3 million. We did not hold any online warehouse sales during the first three quarters of fiscal 2016. Excluding the impact of the online warehouse sales, direct to consumer net revenue increased 14%.

Other. Net revenue from our other segment increased \$28.9 million, or 22%, to \$160.8 million in the first three quarters of fiscal 2017 from \$131.9 million in the first three quarters of fiscal 2016. This increase was primarily the result of increased net revenue at existing outlets, and an increased number of outlets and temporary locations open during the first three quarters of fiscal 2017 compared to the first three quarters of fiscal 2016. The increase in net revenue from our other segment was partially offset by lower net revenue from showrooms, primarily due a decreased number of showrooms open during the first three quarters of fiscal 2017 compared to the first three quarters of fiscal 2016.

Gross Profit

Gross profit increased \$104.6 million, or 14%, to \$876.3 million for the first three quarters of fiscal 2017 from \$771.7 million for the first three quarters of fiscal 2016.

Gross profit as a percentage of net revenue, or gross margin, increased 130 basis points, to 50.9% in the first three quarters of fiscal 2017 from 49.6% in the first three quarters of fiscal 2016. The increase in gross margin was primarily the result of:

- an increase in product margin of 230 basis points which was primarily due to a favorable mix of higher margin product and lower product costs, partially offset by higher markdowns; and
- a favorable impact of foreign exchange rates of 10 basis points.

This was partially offset by an increase in fixed costs, including occupancy and depreciation costs, and costs related to our product and supply chain departments, of 60 basis points and costs incurred in connection with the restructuring of our ivivva operations of 50 basis points.

During the first three quarters of fiscal 2017, as a result of the restructuring of our ivivva operations, we recognized costs totaling \$8.8 million within costs of goods sold, as outlined in Note 6 to the unaudited interim consolidated financial statements included in Item 1 of Part I of this report. Excluding these charges, adjusted gross profit increased 15% to \$885.1 million and adjusted gross margin increased 180 basis points to 51.4% compared to the first three quarters of fiscal 2016.

Selling, General and Administrative Expenses

Selling, general and administrative expenses increased \$92.8 million, or 17%, to \$640.0 million in the first three quarters of fiscal 2017 from \$547.2 million in the first three quarters of fiscal 2016. The increase in selling, general and administrative expenses was primarily due to:

- an increase in costs related to our operating channels of \$63.3 million, comprised of:
 - an increase in employee costs of \$26.8 million, primarily from a growth in labor hours and benefits, mainly associated with new company-operated stores and other new operating locations;
 - an increase in variable costs of \$6.8 million, primarily due to an increase in credit card fees and distribution costs as a result of increased net revenue; and
 - an increase in other costs of \$29.7 million, primarily due to an increase in digital marketing expenses, website related costs, brand and community costs, and other costs associated with our operating locations; and
- an increase in head office costs of \$40.6 million, comprised of:
 - an increase in employee costs of \$13.4 million primarily due to additional employees to support the growth in our business; and

- an increase in other costs of \$27.2 million primarily due to a global brand campaign, increases in other brand and community costs, professional fees, depreciation, and information technology related costs.

The increase in selling, general and administrative expenses was partially offset by an increase in net foreign exchange and derivative revaluation gains of \$11.0 million. There were net foreign exchange and derivative revaluation gains of \$6.9 million in the first three quarters of fiscal 2017 compared to net foreign exchange revaluation losses of \$4.1 million in the first three quarters of fiscal 2016. The net foreign exchange gains and losses primarily relate to the revaluation of U.S. dollar denominated monetary assets and liabilities held by Canadian subsidiaries, and the derivatives are designed to economically hedge these gains and losses.

As a percentage of net revenue, selling, general and administrative expenses increased 200 basis points, to 37.2% in the first three quarters of fiscal 2017 from 35.2% in the first three quarters of fiscal 2016.

Asset Impairment and Restructuring Costs

As a result of the restructuring of our ivivva operations, we recognized asset impairment and restructuring costs of \$36.5 million in the first three quarters of fiscal 2017. This includes lease termination costs of \$19.9 million, long-lived asset impairment charges of \$11.6 million, employee related costs of \$4.0 million, and other restructuring costs of \$1.0 million. We did not have any asset impairment and restructuring costs in the first three quarters of fiscal 2016. Please refer to Note 6 to the unaudited interim consolidated financial statements included in Item 1 of Part I of this report.

Income from Operations

Income from operations decreased \$24.8 million, or 11%, to \$199.7 million in the first three quarters of fiscal 2017 from \$224.5 million in the first three quarters of fiscal 2016. Operating margin decreased 280 basis points to 11.6% compared to 14.4% in the first three quarters of fiscal 2016.

In connection with the restructuring of our ivivva operations, we recognized pre-tax costs totaling \$45.4 million in the first three quarters of fiscal 2017. This includes asset impairment and restructuring costs of \$36.5 million and costs recognized in cost of goods sold totaling \$8.8 million. Excluding these charges, adjusted income from operations increased 9% to \$245.1 million and adjusted operating margin decreased 20 basis points to 14.2%.

On a segment basis, we determine income from operations without taking into account our general corporate expenses and the costs we incur in connection with the restructuring of our ivivva operations.

Segmented income from operations for the first three quarters ended October 29, 2017 and October 30, 2016 is summarized below. The percentages are presented as a percentage of net revenue of the respective operating segments.

	Three Quarters Ended			
	October 29, 2017	October 30, 2016	October 29, 2017	October 30, 2016
	<i>(In thousands)</i>		<i>(Percentages)</i>	
Company-operated stores	\$ 267,178	\$ 245,056	21.9%	21.6%
Direct to consumer	127,746	114,744	37.4	39.7
Other	19,076	12,430	11.9	9.4
Segmented income from operations	<u>414,000</u>	<u>372,230</u>		
General corporate expense	168,912	147,707		
Restructuring and related costs	45,365	—		
Income from operations	<u>\$ 199,723</u>	<u>\$ 224,523</u>		

Company-Operated Stores. Income from operations from our company-operated stores segment increased \$22.1 million, or 9%, to \$267.2 million for the first three quarters of fiscal 2017 from \$245.1 million for the first three quarters of fiscal 2016. The increase was primarily the result of increased gross profit of \$55.4 million which was primarily due to increased net revenue and higher gross margin. The increase in gross profit was partially offset by an increase in selling, general and administrative expenses, including increased store employee costs, increased brand and community costs, and increased operating expenses associated with higher net revenues and new stores. Income from operations as a percentage of company-operated stores net revenue increased by 30 basis points, primarily due to an increase in gross margin, partially offset by deleverage of selling, general and administrative expenses.

Direct to Consumer. Income from operations from our direct to consumer segment increased \$13.0 million, or 11%, to \$127.7 million for the first three quarters of fiscal 2017 from \$114.7 million for the first three quarters of fiscal 2016. The increase was primarily the result of increased gross profit of \$40.6 million which was primarily due to increased net revenue and higher gross margin. The increase in gross profit was partially offset by an increase in selling, general and administrative expenses including higher digital marketing expenses, website related costs, and higher variable costs such as packaging and distribution and credit card fees as a result of higher net revenue. Income from operations as a percentage of direct to consumer net revenue decreased 230 basis points primarily due to deleverage of selling, general and administrative expenses, partially offset by increased gross margin.

Other. Other income from operations increased \$6.6 million, or 53%, to \$19.1 million for the first three quarters of fiscal 2017 from \$12.4 million for the first three quarters of fiscal 2016. The increase was primarily the result of increased gross profit of \$17.4 million which was primarily due to increased net revenue and higher gross margin. The increase in gross profit was partially offset by an increase in selling, general and administrative expenses, including increased employee costs, increased brand and community costs, and increased operating expenses associated with new locations and higher net revenues. Income from operations as a percentage of other net revenue increased 250 basis points primarily due to an increase in gross margin partially offset by deleverage of selling, general and administrative expenses as a percentage of other net revenue.

General Corporate Expense. General corporate expense increased \$21.2 million, or 14%, to \$168.9 million for the first three quarters of fiscal 2017 from \$147.7 million for the first three quarters of fiscal 2016. This increase was primarily due to increased head office employee costs, a global brand campaign, increases in other brand and community costs, professional fees, depreciation, and information technology related costs. These increases were partially offset by an increase in net foreign exchange and derivative revaluation gains of \$11.0 million. There were net foreign exchange and derivative revaluation gains of \$6.9 million in the first three quarters of fiscal 2017 compared to net foreign exchange losses of \$4.1 million in the first three quarters of fiscal 2016. The net foreign exchange gains and losses primarily relate to the revaluation of U.S. dollar denominated monetary assets and liabilities held by Canadian subsidiaries, and the derivatives are designed to economically hedge these gains and losses.

Other Income (Expense), Net

Other income, net increased \$2.1 million, or 285%, to \$2.8 million for the first three quarters of fiscal 2017 from income of \$0.7 million for the first three quarters of fiscal 2016. The increase was primarily due to net interest expense of \$1.7 million which was recorded in the first three quarters of fiscal 2016 in relation to certain tax adjustments that are outlined in Note 7 to the unaudited interim consolidated financial statements included in Item 1 of Part I of this report.

Income Tax Expense

Income tax expense increased \$5.6 million, or 10%, to \$63.6 million for the first three quarters of fiscal 2017 from \$58.0 million for the first three quarters of fiscal 2016.

The first three quarters of fiscal 2017 and fiscal 2016 included certain tax adjustments which resulted in net income tax recoveries of \$11.9 million and \$11.6 million, respectively. As outlined in Notes 6 and 7 to the unaudited interim consolidated financial statements included in Item 1 of Part I of this report, the tax recovery recognized in the first three quarters of fiscal 2017 relates to the tax effect of the costs recognized in connection with the ivivva restructuring, and the tax recovery recognized in the first three quarters of fiscal 2016 relates to our transfer pricing arrangements and taxes on repatriation of foreign earnings.

The effective tax rate for the first three quarters of fiscal 2017 was 31.4% compared to 25.7% for the first three quarters of fiscal 2016. The adjusted effective tax rate was 30.5% for the first three quarters of fiscal 2017 compared to 30.7% for the first three quarters of fiscal 2016. The decrease in the adjusted effective tax rate compared to first three quarters of fiscal 2016 is primarily due to certain adjustments which were recorded during the first three quarters of fiscal 2017 following the finalization of our U.S. and Canadian tax returns.

Net Income

Net income decreased \$28.3 million, or 17%, to \$138.9 million for the first three quarters of fiscal 2017 from \$167.2 million for the first three quarters of fiscal 2016. This was primarily due to an increase in selling, general and administrative expenses of \$92.8 million, long-lived asset impairment and restructuring costs of \$36.5 million, and an increase in income tax expense of \$5.6 million, partially offset by an increase in gross profit of \$104.6 million, and an increase in other income (expense), net of \$2.1 million.

Comparable Store Sales and Total Comparable Sales

We separately track comparable store sales, which reflect net revenue from company-operated stores that have been open for at least 12 months, or open for at least 12 months after being significantly expanded. Net revenue from a store is included in comparable store sales beginning with the first month for which the store has a full month of sales in the prior year. Comparable store sales exclude sales from new stores that have not been open for at least 12 months, from stores which have not been in their significantly expanded space for at least 12 months, and from stores which have been temporarily relocated for renovations. Comparable store sales also exclude sales from direct to consumer, outlets, showrooms, temporary locations, wholesale accounts, license and supply arrangements, warehouse sales, and sales from company-operated stores that we have closed.

Total comparable sales combines comparable store sales and direct to consumer sales.

The comparable sales measures we report may not be equivalent to similarly titled measures reported by other companies.

Non-GAAP Financial Measures

Constant dollar changes in net revenue, total comparable sales, comparable store sales, and direct to consumer net revenue, and the adjusted financial results are non-GAAP financial measures.

A constant dollar basis assumes the average foreign exchange rates for the period remained constant with the average foreign exchange rates for the same period of the prior year. We provide constant dollar changes in net revenue, total comparable sales, comparable store sales, and direct to consumer net revenue because we use these measures to understand the underlying growth rate of net revenue excluding the impact of changes in foreign exchange rates. We believe that disclosing these measures on a constant dollar basis is useful to investors because it enables them to better understand the level of growth of our business.

Adjusted gross profit, gross margin, income from operations, operating margin, effective tax rates, and diluted earnings per share exclude the costs recognized in connection with the restructuring of our ivivva operations, its related tax effects, and certain discrete items related to our transfer pricing arrangements and taxes on repatriation of foreign earnings. We believe these adjusted financial measures are useful to investors as the adjustments do not directly relate to our ongoing business operations and therefore do not contribute to a meaningful evaluation of the trend in our operating performance. Furthermore, we do not believe the adjustments are reflective of our expectations of our future operating performance and believe these non-GAAP measures are useful to investors because of their comparability to our historical information.

The presentation of this financial information is not intended to be considered in isolation or as a substitute for, or with greater prominence to, the financial information prepared and presented in accordance with GAAP. A reconciliation of the non-GAAP financial measures follows, which includes more detail on the GAAP financial measure that is most directly comparable to each non-GAAP financial measure, and the related reconciliations between these financial measures.

The below changes in net revenue, total comparable sales, comparable store sales, and direct to consumer net revenue show the change compared to the corresponding period in the prior year.

Constant dollar changes in net revenue, total comparable sales, comparable store sales, and direct to consumer net revenue

	Quarter Ended October 29, 2017		Three Quarters Ended October 29, 2017	
	<i>(In thousands)</i>	<i>(Percentages)</i>	<i>(In thousands)</i>	<i>(Percentages)</i>
Change in net revenue	\$ 74,602	14%	\$ 165,927	11%
Adjustments due to foreign exchange rate changes	(6,842)	(2)	(3,011)	(1)
Change in net revenue in constant dollars	<u>\$ 67,760</u>	<u>12%</u>	<u>\$ 162,916</u>	<u>10%</u>

	Quarter Ended October 29, 2017	Three Quarters Ended October 29, 2017
Change in total comparable sales ^{1,2}	8%	5%
Adjustments due to foreign exchange rate changes	(1)	(1)
Change in total comparable sales in constant dollars ^{1,2}	<u>7%</u>	<u>4%</u>

	Quarter Ended October 29, 2017		Three Quarters Ended October 29, 2017	
	<i>(In thousands)</i>	<i>(Percentages)</i>	<i>(In thousands)</i>	<i>(Percentages)</i>
Change in comparable store sales ²	\$ 6,611	2%	\$ 4,255	1%
Adjustments due to foreign exchange rate changes	(3,631)	(1)	(1,931)	—
Change in comparable store sales in constant dollars ²	<u>\$ 2,980</u>	<u>1%</u>	<u>\$ 2,324</u>	<u>1%</u>

	Quarter Ended October 29, 2017	Three Quarters Ended October 29, 2017
	<i>(Percentages)</i>	
Change in direct to consumer net revenue	26%	18%
Adjustments due to foreign exchange rate changes	(1)	—
Change in direct to consumer net revenue in constant dollars	<u>25%</u>	<u>18%</u>

¹Total comparable sales includes comparable store sales and direct to consumer sales.

²Comparable store sales reflects net revenue from company-operated stores that have been open for at least 12 months, or open for at least 12 months after being significantly expanded.

Adjusted financial measures

The following tables reconcile adjusted financial measures with the most directly comparable measures calculated in accordance with GAAP. The amounts are in thousands, except for the per share amounts.

	Quarter Ended October 29, 2017			Quarter Ended October 30, 2016		
	GAAP Results	Adjustments	Adjusted Results (Non-GAAP)	GAAP Results	Adjustments	Adjusted Results (Non-GAAP)
Gross profit ¹	\$ 321,962	\$ 1,178	\$ 323,140	\$ 278,426	\$ —	\$ 278,426
Gross margin ¹	52.0%	0.2 %	52.2%	51.1%	—%	51.1%
Income from operations ^{1,2}	85,588	22,186	107,774	92,975	—	92,975
Operating margin ^{1,2}	13.8%	3.6 %	17.4%	17.1%	—%	17.1%
Income before income tax expense ^{1,2,3}	86,640	22,185	108,825	93,603	186	93,789
Income tax expense ^{3,4}	27,696	5,813	33,509	25,318	4,005	29,323
Effective tax rate ^{3,4}	32.0%	(1.2)%	30.8%	27.0%	4.3%	31.3%
Diluted earnings per share ^{1,2,3,4}	\$ 0.43	\$ 0.13	\$ 0.56	\$ 0.50	\$ (0.03)	\$ 0.47

	Three Quarters Ended October 29, 2017			Three Quarters Ended October 30, 2016		
	GAAP Results	Adjustments	Adjusted Results (Non-GAAP)	GAAP Results	Adjustments	Adjusted Results (Non-GAAP)
Gross profit ¹	\$ 876,279	\$ 8,841	\$ 885,120	\$ 771,718	\$ —	\$ 771,718
Gross margin ¹	50.9%	0.5 %	51.4%	49.6%	—%	49.6%
Income from operations ^{1,2}	199,723	45,365	245,088	224,523	—	224,523
Operating margin ^{1,2}	11.6%	2.6 %	14.2%	14.4%	—%	14.4%
Income before income tax expense ^{1,2,3}	202,494	45,365	247,859	225,243	1,696	226,939
Income tax expense ^{3,4}	63,593	11,886	75,479	57,997	11,576	69,573
Effective tax rate ^{3,4}	31.4%	(0.9)%	30.5%	25.7%	5.0%	30.7%
Diluted earnings per share ^{1,2,3,4}	\$ 1.02	\$ 0.24	\$ 1.26	\$ 1.22	\$ (0.07)	\$ 1.15

¹ During the quarter and three quarters ended October 29, 2017, we recognized costs totaling \$1.2 million and \$8.8 million, respectively, within cost of goods sold related to the restructuring of our ivivva operations.

² During the quarter and three quarters ended October 29, 2017, we recognized asset impairment and restructuring costs related to the restructuring of our ivivva operations totaling \$21.0 million and \$36.5 million, respectively.

³ The adjustments in the quarter and three quarters ended October 30, 2016 relate to our transfer pricing arrangements and the associated repatriation of foreign earnings and were recorded in other income (expense), net and income tax expense.

⁴ The adjustment to income tax expense for the quarter and three quarters ended October 29, 2017 represents the tax effect of the ivivva related restructuring adjustments, calculated based on the expected annual tax rate of the applicable tax jurisdictions.

Please refer to Notes 6 and 7 to the unaudited interim consolidated financial statements included in Item 1 of Part I of this report for further information on these adjustments.

Seasonality

Our business is affected by the general seasonal trends common to the retail apparel industry. Our annual net revenue is weighted more heavily toward our fourth fiscal quarter, reflecting our historical strength in sales during the holiday season, while our operating expenses are more equally distributed throughout the year. As a result, a substantial portion of our operating profits are generated in the fourth quarter of our fiscal year. For example, we generated approximately 47%, 45%, and 42% of our full year operating profit during the fourth quarters of fiscal 2016, fiscal 2015, and fiscal 2014, respectively.

Liquidity and Capital Resources

Our primary sources of liquidity are our current balances of cash and cash equivalents, cash flows from operations, and capacity under our revolving credit facility. Our primary cash needs are capital expenditures for opening new stores and remodeling or relocating existing stores, making information technology system enhancements, funding working capital requirements, and making other strategic capital investments both in North America and internationally. We may also use cash to repurchase shares of our common stock. Cash and cash equivalents in excess of our needs are held in interest bearing accounts with financial institutions.

As of October 29, 2017, our working capital (excluding cash and cash equivalents) was \$297.7 million, our cash and cash equivalents were \$650.1 million and our capacity under our revolving facility was \$148.9 million.

The following table summarizes our net cash flows provided by and used in operating, investing and financing activities for the periods indicated:

	Three Quarters Ended	
	October 29, 2017	October 30, 2016
	<i>(In thousands)</i>	
Total cash provided by (used in):		
Operating activities	\$ 131,309	\$ 98,659
Investing activities	(120,051)	(106,168)
Financing activities	(100,707)	(25,288)
Effect of exchange rate changes on cash.	4,657	11,701
(Decrease) increase in cash and cash equivalents.	<u>\$ (84,792)</u>	<u>\$ (21,096)</u>

Operating Activities

Cash flows provided by operating activities consist primarily of net income adjusted for certain items including depreciation and amortization, stock-based compensation expense, and the effect of changes in operating assets and liabilities.

Cash provided by operating activities increased \$32.7 million, to \$131.3 million for the first three quarters of fiscal 2017 compared to \$98.7 million for the first three quarters of fiscal 2016. This increase was primarily the result of a decrease in net cash outflows from changes in operating assets and liabilities of \$47.0 million, an increase in depreciation and amortization of \$16.5 million, and asset impairment related to our ivivva restructuring of \$11.6 million. This was partially offset by a decrease in net income of \$28.3 million and a change in deferred income taxes of \$18.4 million.

Investing Activities

Cash flows used in investing activities relate to capital expenditures, the settlement of net investment hedges, and other investing activities. The capital expenditures were primarily for opening new company-operated stores, remodeling or relocating certain stores, and ongoing store refurbishment. We also had capital expenditures related to information technology and business systems, related to corporate buildings, and for opening retail locations other than company-operated stores.

Cash used in investing activities increased \$13.9 million to \$120.1 million for the first three quarters of fiscal 2017 from \$106.2 million for the first three quarters of fiscal 2016. This increase was primarily the result of an increase in capital expenditures for our direct to consumer and company-operated stores segments, primarily related to our new website and an increased number of stores opened during the first three quarters of fiscal 2017 compared to the first three quarters of fiscal 2016. The increase in cash used in investing activities was partially offset by a decrease in capital expenditures at our corporate level. In the second quarter of fiscal 2016, we purchased a land parcel in Vancouver, BC for \$19.7 million for general corporate purposes.

Financing Activities

Cash flows used in or provided by financing activities consist primarily of cash used to repurchase shares of our common stock and certain cash flows related to stock-based compensation.

Cash used in financing activities increased \$75.4 million, to \$100.7 million for the first three quarters of fiscal 2017 compared to \$25.3 million for the first three quarters of fiscal 2016.

On June 11, 2014, our board of directors approved a program to repurchase shares of our common stock up to an aggregate value of \$450.0 million. This stock repurchase program was completed during the second quarter of fiscal 2016. On December 1, 2016, our board of directors approved a program to repurchase shares of our common stock up to an aggregate value of \$100.0 million. This stock repurchase program was completed during the third quarter of fiscal 2017.

Our cash used in financing activities for the first three quarters of fiscal 2017 included \$99.3 million to repurchase 1.8 million shares of our common stock compared to \$28.6 million to repurchase 0.4 million shares for the first three quarters of fiscal 2016. The common stock was repurchased in the open market at prevailing market prices, including under plans complying with the provisions of Rule 10b5-1 and Rule 10b-18 of the Securities Exchange Act of 1934, with the timing and actual number of shares repurchased depending upon market conditions, eligibility to trade, and other factors.

We believe that our cash and cash equivalent balances, cash generated from operations, and borrowings available to us under our revolving credit facility will be adequate to meet our liquidity needs and capital expenditure requirements for at least the next 12 months. Our cash from operations may be negatively impacted by a decrease in demand for our products as well as the other factors described in Item 1 of Part II of this Quarterly Report on Form 10-Q. In addition, we may make discretionary capital improvements with respect to our stores, distribution facilities, headquarters, or systems, or we may repurchase shares under an approved stock repurchase program, which we would expect to fund through the use of cash, issuance of debt or equity securities or other external financing sources to the extent we were unable to fund such capital expenditures out of our cash and cash equivalents and cash generated from operations.

Revolving Credit Facility

On December 15, 2016, we entered into a credit agreement for \$150.0 million under an unsecured five-year revolving credit facility. Bank of America, N.A., is administrative agent and HSBC Bank Canada is the syndication agent and letter of credit issuer, and the lenders party thereto. Borrowings under the revolving credit facility may be made, in U.S. Dollars, Euros, Canadian Dollars, and in other currencies, subject to the approval of the administrative agent and the lenders. Up to \$35.0 million of the revolving credit facility is available for the issuance of letters of credit and up to \$25.0 million is available for the issuance of swing line loans. Commitments under the revolving credit facility may be increased by up to \$200.0 million, subject to certain conditions, including the approval of the lenders. Borrowings under the agreement may be prepaid and commitments may be reduced or terminated without premium or penalty (other than customary breakage costs). The principal amount outstanding under the credit agreement will be due and payable in full on December 15, 2021, subject to provisions that permit us to request a limited number of one year extensions annually.

Borrowings made under the revolving credit facility bear interest at a rate per annum equal to, at our option, either (a) a rate based on the rates applicable for deposits on the interbank market for U.S. Dollars or the applicable currency in which the borrowings are made ("LIBOR") or (b) an alternate base rate, plus, in each case, an applicable margin. The applicable margin is determined by reference to a pricing grid, based on the ratio of indebtedness to earnings before interest, tax depreciation, amortization and rent ("EBITDAR") and ranges between 1.00%-1.75% for LIBOR loans and 0.00%-0.75% for alternate base rate loans. Additionally, a commitment fee of between 0.125%-0.200%, also determined by reference to the pricing grid, is payable on the average daily unused amounts under the revolving credit facility.

The credit agreement contains negative covenants that, among other things and subject to certain exceptions, limit the ability of our subsidiaries to incur indebtedness, incur liens, undergo fundamental changes, make dispositions of all or substantially all of their assets, alter their businesses and enter into agreements limiting subsidiary dividends and distributions.

We are also required to maintain a consolidated rent-adjusted leverage ratio of not greater than 3.50:1.00 and we are not permitted to allow the ratio of consolidated EBITDAR to consolidated interest charges (plus rent) to be less than 2.00:1.00. The credit agreement also contains certain customary representations, warranties, affirmative covenants, and events of default (including, among others, an event of default upon the occurrence of a change of control). If an event of default occurs, the credit agreement may be terminated and the maturity of any outstanding amounts may be accelerated.

As of October 29, 2017, aside from letters of credit of \$1.1 million, we had no other borrowings outstanding under this credit facility.

Off-Balance Sheet Arrangements

We enter into standby letters of credit to secure certain of our obligations, including leases, taxes and duties. As of October 29, 2017, letters of credit and letters of guarantee totaling \$1.1 million had been issued.

We have not entered into any transactions, agreements or other contractual arrangements to which an entity unconsolidated with us is a party and under which we have (i) any obligation under a guarantee, (ii) any retained or contingent

interest in assets transferred to an unconsolidated entity that serves as credit, liquidity or market risk support to such entity, (iii) any obligation under derivative instruments that are indexed to our shares and classified as equity in our consolidated balance sheets, or (iv) any obligation arising out of a variable interest in any unconsolidated entity that provides financing, liquidity, market risk or credit support to us or engages in leasing, hedging or research and development services with us.

Critical Accounting Policies and Estimates

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions. Predicting future events is inherently an imprecise activity and, as such, requires the use of judgment. Actual results may vary from our estimates in amounts that may be material to the financial statements. An accounting policy is deemed to be critical if it requires an accounting estimate to be made based on assumptions about matters that are highly uncertain at the time the estimate is made, and if different estimates that reasonably could have been used or changes in the accounting estimates that are reasonably likely to occur periodically, could materially impact our consolidated financial statements. Our critical accounting policies and estimates are discussed in our fiscal 2016 Annual Report on Form 10-K filed with the SEC on March 29, 2017, and in Notes 2, 4, and 5 included in Item 1 of Part I of this Quarterly Report on Form 10-Q.

Operating Locations

Our company-operated stores by brand and by country as of October 29, 2017 and January 29, 2017, are summarized in the table below.

	<u>October 29, 2017</u>	<u>January 29, 2017</u>
lululemon		
United States	263	245
Canada	54	51
Australia	27	27
United Kingdom	9	9
China	6	3
New Zealand	6	5
Hong Kong	3	3
Singapore	3	3
South Korea	3	2
Germany	2	1
Ireland	1	—
Japan	1	—
Puerto Rico	1	1
Switzerland	1	1
Taiwan	1	—
	<u>381</u>	<u>351</u>
ivivva		
United States	4	42
Canada	3	13
	<u>7</u>	<u>55</u>
Total	<u><u>388</u></u>	<u><u>406</u></u>

Retail locations operated by third parties under license and supply arrangements are not included in the above table. As of October 29, 2017, there were five licensed stores, including three in the United Arab Emirates, one in Mexico, and one in Qatar.

On August 20, 2017, as part of the restructuring of our ivivva operations, we closed 48 of our 55 ivivva branded company-operated stores. The seven remaining ivivva branded stores remain in operation and are not expected to close.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Foreign Currency Exchange Risk. The functional currency of our foreign subsidiaries is generally the applicable local currency. Our consolidated financial statements are presented in U.S. dollars. Therefore, the net revenue, expenses, assets, and liabilities of our foreign subsidiaries are translated from their functional currencies into U.S. dollars. Fluctuations in the value of the U.S. dollar affect the reported amounts of net revenue, expenses, assets, and liabilities. Foreign exchange differences which arise on translation of our foreign subsidiaries' balance sheets into U.S. dollars are recorded as a foreign currency translation adjustment in accumulated other comprehensive income or loss within stockholders' equity.

We also have exposure to changes in foreign exchange rates associated with transactions which are undertaken by our subsidiaries in currencies other than their functional currency. Such transactions include intercompany transactions and inventory purchases denominated in currencies other than the functional currency of the purchasing entity. As a result, we have been impacted by changes in exchange rates and may be impacted for the foreseeable future. The potential impact of currency fluctuation increases as our international expansion increases.

As of October 29, 2017 we had certain forward currency contracts outstanding in order to hedge a portion of the foreign currency exposure that arises on translation of a Canadian subsidiary into U.S. dollars. We also had certain forward currency contracts outstanding in an effort to reduce our exposure to the foreign exchange revaluation gains and losses that are recognized by our Canadian subsidiaries on U.S. dollar denominated monetary assets and liabilities. Please refer to Note 5 to the unaudited interim consolidated financial statements included in Item 1 of Part I of this report for further information, including details of the notional amounts outstanding.

In the future, in an effort to reduce foreign exchange risks, we may enter into further derivative financial instruments including hedging additional currency pairs. We do not, and do not intend to, engage in the practice of trading derivative securities for profit.

We currently generate a significant portion of our net revenue and incur a significant portion of our expenses in Canada. We also hold a significant portion of our net assets in Canada. The reporting currency for our consolidated financial statements is the U.S. dollar. A weakening of the U.S. dollar against the Canadian dollar results in:

- the following impacts to the consolidated statements of operations:
 - an increase in our net revenue upon translation of the sales made by our Canadian operations into U.S. dollars for the purposes of consolidation;
 - an increase in our selling, general and administrative expenses incurred by our Canadian operations upon translation into U.S. dollars for the purposes of consolidation;
 - foreign exchange revaluation losses by our Canadian subsidiaries on U.S. dollar denominated monetary assets and liabilities; and
 - derivative valuation gains on forward currency contracts not designated in a hedging relationship;
- the following impacts to the consolidated balance sheets:
 - an increase in the foreign currency translation adjustment which arises on the translation of our Canadian subsidiaries' balance sheets into U.S. dollars; and
 - a decrease in the foreign currency translation adjustment from derivative valuation losses on forward currency contracts, entered into as net investment hedges of a Canadian subsidiary.

During the first three quarters of fiscal 2017, the change in the relative value of the U.S. dollar against the Canadian dollar resulted in a \$30.4 million increase in accumulated other comprehensive loss within stockholders' equity. During the first three quarters of fiscal 2016, the change in the relative value of the U.S. dollar against the Canadian dollar resulted in a \$25.3 million reduction in accumulated other comprehensive loss within stockholders' equity.

A 10% depreciation in the relative value of the U.S. dollar against the Canadian dollar compared to the exchange rates in effect for the first three quarters of fiscal 2017 would have resulted in lower income from operations of approximately \$4.4 million in the first three quarters of fiscal 2017. This assumes a consistent 10% appreciation in the U.S. dollar against the Canadian dollar throughout the first three quarters of fiscal 2017. The timing of changes in the relative value of the U.S. dollar combined with the seasonal nature of our business, can affect the magnitude of the impact that fluctuations in foreign exchange rates have on our income from operations.

Interest Rate Risk. Our revolving credit facility provides us with available borrowings in an amount up to \$150.0 million in the aggregate. Because our revolving credit facility bears interest at a variable rate, we will be exposed to market risks

relating to changes in interest rates, if we have a meaningful outstanding balance. As of October 29, 2017, aside from letters of credit of \$1.1 million, we had no other borrowings outstanding under this credit facility. We currently do not engage in any interest rate hedging activity and currently have no intention to do so. However, in the future, if we have a meaningful outstanding balance under our revolving facility, in an effort to mitigate losses associated with these risks, we may at times enter into derivative financial instruments, although we have not historically done so. These may take the form of forward contracts, option contracts, or interest rate swaps. We do not, and do not intend to, engage in the practice of trading derivative securities for profit.

Credit Risk. We are primarily exposed to credit-related losses in the event of nonperformance by the counterparties to the forward currency contracts. The credit risk amount is our unrealized gains on our derivative instruments, based on foreign currency rates at the time of nonperformance. Our forward currency contracts are entered into with large, reputable financial institutions that are monitored for counterparty risk.

Inflation

Inflationary factors such as increases in the cost of our product and overhead costs may adversely affect our operating results. Although we do not believe that inflation has had a material impact on our financial position or results of operations to date, a high rate of inflation in the future may have an adverse effect on our ability to maintain current levels of gross margin and selling, general and administrative expenses as a percentage of net revenue if the selling prices of our products do not increase with these increased costs.

ITEM 4. CONTROLS AND PROCEDURES

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed by us in the reports we file or submit under the Securities Exchange Act of 1934, or the Exchange Act, is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer (principal executive officer) and Chief Financial Officer (principal financial officer and principal accounting officer), to allow timely decisions to be made regarding required disclosure. We have established a Disclosure Committee, consisting of certain members of management, to assist in this evaluation. The Disclosure Committee meets on a quarterly basis, and as needed.

Our management, including 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) promulgated under the Exchange Act) at October 29, 2017. Based on that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that, at October 29, 2017, our disclosure controls and procedures were effective.

There were no changes in our internal control over financial reporting during the quarter ended October 29, 2017 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.