

## **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 the Private Securities Litigation Reform Act of 1995, Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. 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 2017 Annual Report on Form 10-K filed with the SEC on March 27, 2018.

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 athletica inc. is principally a designer, distributor, and retailer of healthy lifestyle inspired athletic apparel and accessories. We have a mission to create transformational products and experiences which enable people to live a life they love, and have developed a brand for those pursuing an active, mindful lifestyle. Since our inception, we have fostered a distinctive corporate culture; 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 achieve personal and professional goals, and share our purpose of "elevating the world through the power of practice."

Our healthy lifestyle inspired athletic apparel and accessories are marketed under the lululemon and ivivva brand names. We offer a comprehensive line of apparel and accessories for women, men, and female youth. Our apparel assortment includes items such as pants, shorts, tops, and jackets designed for a healthy lifestyle and athletic activities such as yoga, running, training, and most other sweaty pursuits. We also offer fitness-related accessories, including items such as bags, socks, underwear, yoga mats and equipment, and water bottles.

During fiscal 2017, we restructured our ivivva operations. On August 20, 2017, we closed 48 of our 55 ivivva branded company-operated stores and all other ivivva branded temporary locations. We now operate ivivva primarily as an e-commerce business.

### ***Financial Highlights***

The summary below provides both GAAP and adjusted non-GAAP financial measures. During the third quarter of fiscal 2018, we adjusted the provisional amount recorded for the transition tax under the U.S. Tax Cuts and Jobs Act, resulting in the

recognition of an additional tax expense of \$5.2 million. In the third quarter of fiscal 2017, in connection with the restructuring of our ivivva operations, we recognized pre-tax costs totaling \$22.2 million, and a related tax recovery of \$5.8 million. The adjusted financial measures for the third quarters of fiscal 2018 and 2017 exclude these items.

For the third quarter of fiscal 2018, compared to the third quarter of fiscal 2017:

- Net revenue increased 21% to \$747.7 million. On a constant dollar basis, net revenue increased 22%.
- Total comparable sales, which includes comparable store sales and direct to consumer, increased 17%. On a constant dollar basis, total comparable sales increased 18%.
  - Comparable store sales increased 6%, or increased 7% on a constant dollar basis.
  - Direct to consumer net revenue increased 44%, or increased 46% on a constant dollar basis.
- Gross profit increased 26% to \$406.8 million. It increased 26% compared to adjusted gross profit for the third quarter of fiscal 2017.
- Gross margin increased 240 basis points to 54.4%. It increased 220 basis points compared to adjusted gross margin for the third quarter of fiscal 2017.
- Income from operations increased 59% to \$135.9 million. It increased 26% compared to adjusted income from operations for the third quarter of fiscal 2017.
- Operating margin increased 440 basis points to 18.2%. It increased 80 basis points compared to adjusted operating margin for the third quarter of fiscal 2017.
- Income tax expense increased 57% to \$43.5 million. Our effective tax rate for the third quarter of fiscal 2018 was 31.6% compared to 32.0% for the third quarter of fiscal 2017. The adjusted effective tax rate was 27.8% compared to 30.8% in the third quarter of fiscal 2017.
- Diluted earnings per share were \$0.71 compared to \$0.43 in the third quarter of fiscal 2017. Adjusted diluted earnings per share were \$0.75 compared to \$0.56 for the third quarter of fiscal 2017.

Refer to the non-GAAP reconciliation tables contained in the "Non-GAAP Financial Measures" 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, income tax expense, 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 28, 2018 and October 29, 2017. The percentages are presented as a percentage of net revenue.

	Quarter Ended			
	October 28, 2018	October 29, 2017	October 28, 2018	October 29, 2017
	<i>(In thousands)</i>		<i>(Percentages)</i>	
Net revenue	\$ 747,655	\$ 619,018	100.0%	100.0%
Cost of goods sold	340,878	297,056	45.6	48.0
Gross profit	406,777	321,962	54.4	52.0
Selling, general and administrative expenses	270,874	215,367	36.2	34.8
Asset impairment and restructuring costs	—	21,007	—	3.4
Income from operations	135,903	85,588	18.2	13.8
Other income (expense), net	2,044	1,052	0.3	0.2
Income before income tax expense	137,947	86,640	18.5	14.0
Income tax expense	43,534	27,696	5.8	4.5
Net income	<u>\$ 94,413</u>	<u>\$ 58,944</u>	<u>12.6%</u>	<u>9.5%</u>

## Net Revenue

Net revenue increased \$128.6 million, or 21%, to \$747.7 million for the third quarter of fiscal 2018 from \$619.0 million for the third quarter of fiscal 2017. On a constant dollar basis, assuming the average exchange rates for the third quarter of fiscal 2018 remained constant with the average exchange rates for the third quarter of fiscal 2017, net revenue increased \$138.0 million, or 22%.

The increase in net revenue was primarily due to increased direct to consumer net revenue, increased company-operated store net revenue, including from new company-operated stores as well as an increase in comparable store sales, and an increase in net revenue from our other retail locations. Total comparable sales, which includes comparable store sales and direct to consumer, increased 17% in the third quarter of fiscal 2018 compared to the third quarter of fiscal 2017. Total comparable sales increased 18% on a constant dollar basis.

Net revenue on a segment basis for the quarters ended October 28, 2018 and October 29, 2017 is summarized below. The percentages are presented as a percentage of total net revenue.

	Quarter Ended			
	October 28, 2018	October 29, 2017	October 28, 2018	October 29, 2017
	<i>(In thousands)</i>		<i>(Percentages)</i>	
Company-operated stores . . . . .	\$ 476,877	\$ 425,084	63.8%	68.7%
Direct to consumer . . . . .	189,375	131,181	25.3	21.2
Other . . . . .	81,403	62,753	10.9	10.1
Net revenue . . . . .	<u>\$ 747,655</u>	<u>\$ 619,018</u>	<u>100.0%</u>	<u>100.0%</u>

*Company-Operated Stores.* Net revenue from our company-operated stores segment increased \$51.8 million, or 12%, to \$476.9 million in the third quarter of fiscal 2018 from \$425.1 million in the third quarter of fiscal 2017. 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 29, 2017, and therefore not included in comparable store sales, contributed \$41.3 million to the increase. We opened 38 net new lululemon branded company-operated stores since the third quarter of fiscal 2017, including 18 stores in North America, 11 stores in Asia, seven stores in Europe, and two stores in Australia/New Zealand.
- A comparable store sales increase of 6% in the third quarter of fiscal 2018 compared to the third quarter of fiscal 2017 resulted in a \$16.7 million increase to net revenue. Comparable store sales increased 7%, or \$21.4 million on a constant dollar basis. The increase in comparable store sales was primarily a result of increased store traffic and improved conversion rates. This was partially offset by a decrease in dollar value per transaction.

The increase in net revenue was partially offset by the closure of 48 of our ivivva branded company-operated stores as part of the restructuring of our ivivva operations. These closures reduced our net revenue from company-operated stores for the third quarter of fiscal 2018 by \$6.2 million compared to the third quarter of fiscal 2017.

*Direct to Consumer.* Net revenue from our direct to consumer segment increased \$58.2 million, or 44%, to \$189.4 million in the third quarter of fiscal 2018 from \$131.2 million in the third quarter of fiscal 2017. Direct to consumer net revenue increased 46% on a constant dollar basis. This was primarily a result of increased website traffic and improved conversion rates. This was partially offset by a decrease in dollar value per transaction.

*Other.* Net revenue from our other segment increased \$18.7 million, or 30%, to \$81.4 million in the third quarter of fiscal 2018 from \$62.7 million in the third quarter of fiscal 2017. This increase was primarily the result of an increased number of temporary locations, including seasonal stores, open during the third quarter of fiscal 2018 compared to the third quarter of fiscal 2017.

## Gross Profit

Gross profit increased \$84.8 million, or 26%, to \$406.8 million for the third quarter of fiscal 2018 from \$322.0 million for the third quarter of fiscal 2017.

Gross profit as a percentage of net revenue, or gross margin, increased 240 basis points to 54.4% in the third quarter of fiscal 2018 from 52.0% in the third quarter of fiscal 2017. The increase in gross margin was primarily the result of:

- an increase in product margin of 280 basis points, which was primarily due to lower product costs, a favorable mix of higher margin product, lower markdowns, and lower inventory provision expense; and
- the costs incurred in the third quarter of fiscal 2017 in connection with the restructuring of our ivivva operations, which reduced gross margin in that quarter by 20 basis points.

This was partially offset by an increase in costs as a percentage of revenue related to our distribution centers and additional costs related to our product departments of 30 basis points, and an unfavorable impact of foreign exchange rates of 30 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 7 to the unaudited interim consolidated financial statements included in Item 1 of Part I of this report. Excluding these charges from the comparatives for the third quarter of fiscal 2017, gross profit increased 26% and gross margin increased 220 basis points.

### **Selling, General and Administrative Expenses**

Selling, general and administrative expenses increased \$55.5 million, or 26%, to \$270.9 million in the third quarter of fiscal 2018 from \$215.4 million in the third quarter of fiscal 2017. The increase in selling, general and administrative expenses was primarily due to:

- an increase in costs related to our operating channels of \$28.6 million, comprised of:
  - an increase in employee costs of \$12.9 million primarily from a growth in labor hours and benefits, mainly associated with new company-operated stores and other new operating locations, and due to higher retail bonus expenses;
  - an increase in variable costs of \$10.8 million primarily due to an increase in distribution costs, credit card fees, and packaging costs as a result of increased net revenue; and
  - an increase in other costs of \$5.0 million primarily due to an increase in digital marketing expenses and other costs associated with our operating locations;
- an increase in head office costs of \$22.9 million, comprised of:
  - an increase in employee costs of \$10.0 million primarily due to additional employees to support the growth in our business and increased incentive and stock-based compensation expense; and
  - an increase in other costs of \$12.8 million primarily due to increases in brand and community costs, information technology costs, professional fees, depreciation, and other head office costs; and
- an increase in net foreign exchange and derivative revaluation losses of \$4.1 million.

As a percentage of net revenue, selling, general and administrative expenses increased 140 basis points, to 36.2% in the third quarter of fiscal 2018 from 34.8% in the third quarter of fiscal 2017.

### **Asset Impairment and Restructuring Costs**

During the third quarter of fiscal 2017, we incurred asset impairment and restructuring costs totaling \$21.0 million in connection with the restructuring of our ivivva operations. This included lease termination costs of \$19.4 million, employee related costs of \$0.8 million, and other restructuring costs of \$0.8 million. Please refer to Note 7 to the unaudited interim consolidated financial statements included in Item 1 of Part I of this report.

We did not have any asset impairment and restructuring costs in the third quarter of fiscal 2018.

### **Income from Operations**

Income from operations increased \$50.3 million, or 59%, to \$135.9 million in the third quarter of fiscal 2018 from \$85.6 million in the third quarter of fiscal 2017. Operating margin increased 440 basis points to 18.2% compared to 13.8% in the third quarter of fiscal 2017.

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 included costs of \$1.2 million recognized in cost of goods sold, and asset impairment and restructuring costs totaling \$21.0 million. Excluding these charges from the comparatives for the third quarter of fiscal 2017, income from operations increased 26% and operating margin increased 80 basis points.

On a segment basis, we determine income from operations without taking into account our general corporate expenses and the costs we incurred in connection with the restructuring of our ivivva operations. In the first quarter of fiscal 2018, we reviewed our general corporate expenses and determined certain costs which were previously classified as general corporate expenses are more appropriately classified within our direct to consumer segment. Accordingly, comparative figures have been reclassified to conform to the financial presentation adopted for the current year.

Segmented income from operations for the quarters ended October 28, 2018 and October 29, 2017 is summarized below. The percentages are presented as a percentage of net revenue of the respective operating segments.

	Quarter Ended			
	October 28, 2018	October 29, 2017	October 28, 2018	October 29, 2017
	<i>(In thousands)</i>		<i>(Percentage of segment revenue)</i>	
Segmented income from operations:				
Company-operated stores . . . . .	\$ 117,804	\$ 97,015	24.7%	22.8%
Direct to consumer . . . . .	76,435	50,229	40.4	38.3
Other . . . . .	15,019	9,319	18.5	14.9
	<u>209,258</u>	<u>156,563</u>		
General corporate expense . . . . .	73,355	48,790		
Restructuring and related costs . . . . .	—	22,185		
Income from operations . . . . .	<u>\$ 135,903</u>	<u>\$ 85,588</u>		

*Company-Operated Stores.* Income from operations from our company-operated stores segment increased \$20.8 million, or 21%, to \$117.8 million for the third quarter of fiscal 2018 from \$97.0 million for the third quarter of fiscal 2017. The increase was primarily the result of increased gross profit of \$32.3 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, primarily due to an increase in employee costs as well as increased store operating expenses including higher credit card fees, distribution costs, and packaging costs as a result of higher net revenue. Income from operations as a percentage of company-operated stores net revenue increased 190 basis points due to higher gross margin and leverage on selling, general and administrative expenses.

*Direct to Consumer.* Income from operations from our direct to consumer segment increased \$26.2 million, or 52%, to \$76.4 million for the third quarter of fiscal 2018 from \$50.2 million for the third quarter of fiscal 2017. The increase was primarily the result of increased gross profit of \$38.3 million which was primarily due to increased net revenue. This was partially offset by an increase in selling, general and administrative expenses primarily due to higher variable costs including distribution costs and credit card fees as a result of higher net revenue, as well as higher digital marketing expenses and increased employee costs. Income from operations as a percentage of direct to consumer net revenue increased 210 basis points primarily due to leverage on selling, general and administrative expenses.

*Other.* Other income from operations increased \$5.7 million, or 61%, to \$15.0 million for the third quarter of fiscal 2018 from \$9.3 million for the third quarter of fiscal 2017. The increase was primarily the result of increased gross profit of \$13.1 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, primarily due to increased employee costs, increased operating expenses including increases in professional fees, repairs and maintenance costs, security costs, and higher distribution costs and credit card fees as a result of higher net revenue, and higher community costs. Income from operations as a percentage of other net revenue increased 360 basis points due to higher gross margin and leverage on selling, general and administrative expenses.

*General Corporate Expense.* General corporate expense increased \$24.6 million, or 50%, to \$73.4 million for the third quarter of fiscal 2018 from \$48.8 million for the third quarter of fiscal 2017. This increase was primarily due to increases in head office employee costs, brand and community costs, information technology costs, professional fees, depreciation, and an increase in net foreign exchange and derivative revaluation losses of \$4.1 million.

### Other Income (Expense), Net

Other income, net increased \$1.0 million, or 94%, to \$2.0 million for the third quarter of fiscal 2018 from income of \$1.1 million for the third quarter of fiscal 2017. The increase was primarily due to an increase in net interest income, primarily due to higher rates of return on our cash and cash equivalents, including money market funds, treasury bills, and term deposits, and due to an increase in cash and cash equivalents in the third quarter of fiscal 2018 compared to third quarter of fiscal 2017. This

was partially offset by an increase in interest expense primarily related to borrowings on our revolving credit facility during the third quarter of fiscal 2018. We repaid the outstanding balance on our revolving credit facility during the third quarter of fiscal 2018 and had no borrowings outstanding under this credit facility as of October 28, 2018.

### Income Tax Expense

Income tax expense increased \$15.8 million, or 57%, to \$43.5 million for the third quarter of fiscal 2018 from \$27.7 million for the third quarter of fiscal 2017.

The U.S. Tax Cuts and Jobs Act ("U.S. tax reform") was enacted on December 22, 2017 and introduced significant changes to U.S. income tax law. We recorded certain provisional amounts in the fourth quarter of fiscal 2017. During the third quarter of fiscal 2018, we adjusted the provisional amount recorded for the mandatory one-time transition tax on the deemed repatriation of accumulated undistributed earnings of foreign subsidiaries. This resulted in the recognition of an additional tax expense of \$5.2 million. We expect the accounting for the income tax effects of the U.S. tax reform to be completed in fiscal 2018. Please refer to Note 8 to the unaudited interim consolidated financial statements included in Item 1 of Part I of this report.

During the third quarter of fiscal 2017, we recognized a net income tax recovery of \$5.8 million on the costs recognized in connection with the ivivva restructuring. Please refer to Note 7 to the unaudited interim consolidated financial statements included in Item 1 of Part I of this report.

The effective tax rate for the third quarter of fiscal 2018 was 31.6% compared to 32.0% for the third quarter of fiscal 2017. Excluding the above tax adjustments, the adjusted effective tax rate was 27.8% compared to 30.8% for the third quarter of fiscal 2017. The decrease in the adjusted effective tax rate was primarily due to the lower U.S. federal income tax rate as a result of the U.S. tax reform, partially offset by the amounts recognized for global intangible low-taxed income ("GILTI") taxes. During the third quarter of fiscal 2018 we reduced our expected effective tax rate for fiscal 2018 as a result of a more favorable mix of earnings amongst jurisdictions with differing statutory tax rates, certain adjustments resulting from the filing of tax returns, and higher than expected tax credits related to research and development. This reduced the effective tax rate for the third quarter of fiscal 2018.

### Net Income

Net income increased \$35.5 million, or 60%, to \$94.4 million for the third quarter of fiscal 2018 from \$58.9 million for the third quarter of fiscal 2017. This was primarily due to an increase in gross profit of \$84.8 million, a reduction in asset impairment and restructuring costs of \$21.0 million, and an increase in other income (expense), net of \$1.0 million, partially offset by an increase in selling, general and administrative expenses of \$55.5 million and an increase in income tax expense of \$15.8 million.

### First Three Quarters Results

The following table summarizes key components of our results of operations for the first three quarters ended October 28, 2018 and October 29, 2017. The percentages are presented as a percentage of net revenue.

	Three Quarters Ended			
	October 28, 2018	October 29, 2017	October 28, 2018	October 29, 2017
	<i>(In thousands)</i>		<i>(Percentages)</i>	
Net revenue	\$ 2,120,861	\$ 1,720,379	100.0%	100.0%
Cost of goods sold	973,157	844,100	45.9	49.1
Gross profit	1,147,704	876,279	54.1	50.9
Selling, general and administrative expenses	773,288	640,032	36.5	37.2
Asset impairment and restructuring costs	—	36,524	—	2.1
Income from operations	374,416	199,723	17.7	11.6
Other income (expense), net	6,553	2,771	0.3	0.2
Income before income tax expense	380,969	202,494	18.0	11.8
Income tax expense	115,633	63,593	5.5	3.7
Net income	\$ 265,336	\$ 138,901	12.5%	8.1%

## Net Revenue

Net revenue increased \$400.5 million, or 23%, to \$2.121 billion for the first three quarters of fiscal 2018 from \$1.720 billion for the first three quarters of fiscal 2017. On a constant dollar basis, assuming the average exchange rates for the first three quarters of fiscal 2018 remained constant with the average exchange rates for the first three quarters of fiscal 2017, net revenue increased \$397.9 million, or 23%.

The increase in net revenue was primarily due to increased direct to consumer net revenue, net revenue generated by new company-operated stores, and an increase in comparable store sales. Total comparable sales, which includes comparable store sales and direct to consumer, increased 19% in the first three quarters of fiscal 2018 compared to the first three quarters of fiscal 2017. Total comparable sales increased 19% on a constant dollar basis.

Net revenue on a segment basis for the first three quarters ended October 28, 2018 and October 29, 2017 is summarized below. The percentages are presented as a percentage of total net revenue.

	Three Quarters Ended			
	October 28, 2018	October 29, 2017	October 28, 2018	October 29, 2017
	<i>(In thousands)</i>		<i>(Percentages)</i>	
Company-operated stores . . . . .	\$ 1,396,376	\$ 1,218,127	65.8%	70.8%
Direct to consumer . . . . .	514,623	341,453	24.3	19.8
Other . . . . .	209,862	160,799	9.9	9.4
Net revenue . . . . .	<u>\$ 2,120,861</u>	<u>\$ 1,720,379</u>	<u>100.0%</u>	<u>100.0%</u>

*Company-Operated Stores.* Net revenue from our company-operated stores segment increased \$178.2 million, or 15%, to \$1.396 billion in the first three quarters of fiscal 2018 from \$1.218 billion in the first three quarters of fiscal 2017. 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 29, 2017, and therefore not included in comparable store sales, contributed \$134.5 million to the increase. We opened 38 net new lululemon branded company-operated stores since the third quarter of fiscal 2017, including 18 stores in North America, 11 stores in Asia, seven stores in Europe, and two stores in Australia/New Zealand.
- A comparable store sales increase of 8% in the first three quarters of fiscal 2018 compared to the first three quarters of fiscal 2017 resulted in a \$75.4 million increase to net revenue. Comparable store sales increased 8%, or \$74.5 million on a constant dollar basis. The increase in comparable store sales was primarily a result of increased store traffic and improved conversion rates.

The increase in net revenue was partially offset by the closure of 48 of our ivivva branded company-operated stores as part of the restructuring of our ivivva operations. These closures reduced our net revenue from company-operated stores for the first three quarters of fiscal 2018 by \$31.6 million compared to the first three quarters of fiscal 2017.

*Direct to Consumer.* Net revenue from our direct to consumer segment increased \$173.2 million, or 51%, to \$514.6 million in the first three quarters of fiscal 2018 from \$341.5 million in the first three quarters of fiscal 2017. Direct to consumer net revenue increased 50% on a constant dollar basis. This was primarily a result of increased website traffic and improved conversion rates, and due to increased dollar value per transaction. During the second quarter of fiscal 2017, we held an online warehouse sale 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 2018.

*Other.* Net revenue from our other segment increased \$49.1 million, or 31%, to \$209.9 million in the first three quarters of fiscal 2018 from \$160.8 million in the first three quarters of fiscal 2017. This increase was primarily the result of an increase in net revenue from new and existing outlets during the first three quarters of fiscal 2018 compared to the first three quarters of fiscal 2017. There was also an increased number of temporary locations, including seasonal stores, open during the first three quarters of fiscal 2018 compared to the first three quarters of fiscal 2017. 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 first three quarters of fiscal 2018 compared to the first three quarters of fiscal 2017.

## Gross Profit

Gross profit increased \$271.4 million, or 31%, to \$1.148 billion for the first three quarters of fiscal 2018 from \$876.3 million for the first three quarters of fiscal 2017.

Gross profit as a percentage of net revenue, or gross margin, increased 320 basis points, to 54.1% in the first three quarters of fiscal 2018 from 50.9% in the first three quarters of fiscal 2017. The increase in gross margin was primarily the result of:

- an increase in product margin of 230 basis points, which was primarily due to lower product costs, a favorable mix of higher margin product, lower markdowns, and lower inventory provision expense;
- a decrease in occupancy and depreciation costs as a percentage of revenue of 50 basis points; and
- the costs incurred in the first three quarters of fiscal 2017 in connection with the restructuring of our ivivva operations, which reduced gross margin in that quarter by 50 basis points.

This was partially offset by an increase in costs as a percentage of revenue related to our distribution centers of 10 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 7 to the unaudited interim consolidated financial statements included in Item 1 of Part I of this report. Excluding these charges from the comparatives for the first three quarters of fiscal 2017, gross profit increased 30% and gross margin increased 270 basis points.

### **Selling, General and Administrative Expenses**

Selling, general and administrative expenses increased \$133.3 million, or 21%, to \$773.3 million in the first three quarters of fiscal 2018 from \$640.0 million in the first three quarters of fiscal 2017. The increase in selling, general and administrative expenses was primarily due to:

- an increase in costs related to our operating channels of \$80.9 million, comprised of:
  - an increase in employee costs of \$35.3 million primarily from a growth in labor hours and benefits, mainly associated with new company-operated stores and other new operating locations, and due to higher retail bonus expenses;
  - an increase in variable costs of \$28.4 million primarily due to an increase in distribution costs, credit card fees, and packaging costs as a result of increased net revenue; and
  - an increase in other costs of \$17.1 million primarily due to an increase in digital marketing expenses, brand and community costs, and other costs associated with our operating locations including security and repairs and maintenance;
- an increase in head office costs of \$41.3 million, comprised of:
  - an increase in employee costs of \$22.8 million primarily due to additional employees to support the growth in our business and increased incentive and stock-based compensation expense; and
  - an increase in other costs of \$18.5 million primarily due to an increase in brand and community costs, information technology costs, depreciation, professional fees, and other head office costs; and
- an increase in net foreign exchange and derivative revaluation losses of \$11.2 million.

As a percentage of net revenue, selling, general and administrative expenses decreased 70 basis points, to 36.5% in the first three quarters of fiscal 2018 from 37.2% in the first three quarters of fiscal 2017.

### **Asset Impairment and Restructuring Costs**

During the first three quarters of fiscal 2017, we incurred asset impairment and restructuring costs totaling \$36.5 million in connection with the restructuring of our ivivva operations. This included 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. Please refer to Note 7 to the unaudited interim consolidated financial statements included in Item 1 of Part I of this report.

We did not have any asset impairment and restructuring costs in the first three quarters of fiscal 2018.

### **Income from Operations**

Income from operations increased \$174.7 million, or 87%, to \$374.4 million in the first three quarters of fiscal 2018 from \$199.7 million in the first three quarters of fiscal 2017. Operating margin increased 610 basis points to 17.7% compared to 11.6% in the first three quarters of fiscal 2017.

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 included costs of \$8.8 million recognized in cost of goods sold, and asset impairment and restructuring costs totaling \$36.5 million. Excluding these charges from the comparatives for the first three quarters of fiscal 2017, income from operations increased 53% and operating margin increased 350 basis points.

On a segment basis, we determine income from operations without taking into account our general corporate expenses and the costs we incurred in connection with the restructuring of our ivivva operations. In the first quarter of fiscal 2018, we reviewed our general corporate expenses and determined certain costs which were previously classified as general corporate expenses are more appropriately classified within our direct to consumer segment. Accordingly, comparative figures have been reclassified to conform to the financial presentation adopted for the current year.

Segmented income from operations for the first three quarters ended October 28, 2018 and October 29, 2017 is summarized below. The percentages are presented as a percentage of net revenue of the respective operating segments.

	Three Quarters Ended			
	October 28, 2018	October 29, 2017	October 28, 2018	October 29, 2017
	<i>(In thousands)</i>		<i>(Percentage of segment revenue)</i>	
Segmented income from operations:				
Company-operated stores . . . . .	\$ 342,959	\$ 267,178	24.6%	21.9%
Direct to consumer . . . . .	205,735	123,045	40.0	36.0
Other . . . . .	39,336	19,076	18.7	11.9
	<u>588,030</u>	<u>409,299</u>		
General corporate expense . . . . .	213,614	164,211		
Restructuring and related costs . . . . .	—	45,365		
Income from operations . . . . .	<u>\$ 374,416</u>	<u>\$ 199,723</u>		

*Company-Operated Stores.* Income from operations from our company-operated stores segment increased \$75.8 million, or 28%, to \$343.0 million for the first three quarters of fiscal 2018 from \$267.2 million for the first three quarters of fiscal 2017. The increase was primarily the result of increased gross profit of \$110.5 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, primarily due to increased employee costs, increased store operating expenses including higher credit card fees, distribution costs, and packaging costs as a result of higher net revenue, and due to increased community costs. Income from operations as a percentage of company-operated stores net revenue increased by 270 basis points, primarily due to an increase in gross margin and leverage on selling, general and administrative expenses.

*Direct to Consumer.* Income from operations from our direct to consumer segment increased \$82.7 million, or 67%, to \$205.7 million for the first three quarters of fiscal 2018 from \$123.0 million for the first three quarters of fiscal 2017. The increase was primarily the result of increased gross profit of \$118.9 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 primarily due to higher variable costs including distribution costs, credit card fees, and packaging costs as a result of higher net revenue, higher digital marketing expenses, and increased employee costs. Income from operations as a percentage of direct to consumer net revenue increased 400 basis points, primarily due to leverage on selling, general and administrative expenses and an increase in gross margin.

*Other.* Other income from operations increased \$20.3 million, or 106%, to \$39.3 million for the first three quarters of fiscal 2018 from \$19.1 million for the first three quarters of fiscal 2017. The increase was primarily the result of increased gross profit of \$33.2 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 operating expenses including higher distribution costs and higher credit card fees as a result of higher net revenue, and due to higher community costs. Income from operations as a percentage of other net revenue increased 680 basis points, primarily due to an increase in gross margin and leverage on selling, general and administrative expenses.

*General Corporate Expense.* General corporate expense increased \$49.4 million, or 30%, to \$213.6 million for the first three quarters of fiscal 2018 from \$164.2 million for the first three quarters of fiscal 2017. This increase was primarily due to increases in head office employee costs, brand and community costs, information technology costs, professional fees, and depreciation and an increase in net foreign exchange and derivative revaluation losses of \$11.2 million.

### **Other Income (Expense), Net**

Other income, net increased \$3.8 million, or 136%, to \$6.6 million for the first three quarters of fiscal 2018 from income of \$2.8 million for the first three quarters of fiscal 2017. The increase was primarily due to an increase in net interest income, primarily due to higher rates of return on our cash and cash equivalents, including money market funds, treasury bills, and term deposits, and due to an increase in cash and cash equivalents in the first three quarters of fiscal 2018 compared to the first three quarters of fiscal 2017. This was partially offset by an increase in interest expense, primarily related to borrowings on our revolving credit facility during the first three quarters of fiscal 2018. We repaid the outstanding balance on our revolving credit facility during the third quarter of fiscal 2018 and had no borrowings outstanding under this credit facility as of October 28, 2018.

### **Income Tax Expense**

Income tax expense increased \$52.0 million, or 82%, to \$115.6 million for the first three quarters of fiscal 2018 from \$63.6 million for the first three quarters of fiscal 2017.

U.S. tax reform was enacted on December 22, 2017 and introduced significant changes to U.S. income tax law. We recorded certain provisional amounts in the fourth quarter of fiscal 2017. During the third quarter of fiscal 2018, we adjusted the provisional amount recorded for the mandatory one-time transition tax on the deemed repatriation of accumulated undistributed earnings of foreign subsidiaries. This resulted in the recognition of an additional tax expense of \$5.2 million. We expect the accounting for the income tax effects of the U.S. tax reform to be completed in fiscal 2018. Please refer to Note 8 to the unaudited interim consolidated financial statements included in Item 1 of Part I of this report.

During the first three quarters of fiscal 2017, we recognized a net income tax recovery of \$11.9 million on the costs recognized in connection with the ivivva restructuring. Please refer to Note 7 to the unaudited interim consolidated financial statements included in Item 1 of Part I of this report.

The effective tax rate for the first three quarters of fiscal 2018 was 30.4% compared to 31.4% for the first three quarters of fiscal 2017. Excluding the above tax adjustments, the adjusted effective tax rate was 29.0% for the first three quarters of fiscal 2018 compared to 30.5% for the first three quarters of fiscal 2017. The decrease in the adjusted effective tax rate was primarily due to the lower U.S. federal income tax rate as a result of the U.S. tax reform, as well as increased tax deductions related to stock-based compensation and increased research and development tax credits. This was partially offset by the amounts recognized for GILTI taxes.

### **Net Income**

Net income increased \$126.4 million, or 91%, to \$265.3 million for the first three quarters of fiscal 2018 from \$138.9 million for the first three quarters of fiscal 2017. This was primarily due to an increase in gross profit of \$271.4 million, a reduction in long-lived asset impairment and restructuring costs of \$36.5 million, and an increase in other income (expense), net of \$3.8 million, partially offset by an increase in selling, general and administrative expenses of \$133.3 million and an increase in income tax expense of \$52.0 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, temporary locations, wholesale accounts, showrooms, warehouse sales, license and supply arrangements, 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, income tax expense, effective tax rates, and diluted earnings per share exclude the amounts recognized in connection with the U.S. tax reform and the costs and related tax effects recognized in connection with the restructuring of our ivivva operations. 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 28, 2018		Three Quarters Ended October 28, 2018	
	(In thousands)	(Percentages)	(In thousands)	(Percentages)
Change in net revenue	\$ 128,637	21%	\$ 400,482	23%
Adjustments due to foreign exchange rate changes	9,324	1	(2,567)	—
Change in net revenue in constant dollars	<u>\$ 137,961</u>	<u>22%</u>	<u>\$ 397,915</u>	<u>23%</u>
			<b>Quarter Ended October 28, 2018</b>	<b>Three Quarters Ended October 28, 2018</b>
Change in total comparable sales <sup>(1),(2)</sup>			17%	19%
Adjustments due to foreign exchange rate changes			1	—
Change in total comparable sales in constant dollars <sup>(1),(2)</sup>			<u>18%</u>	<u>19%</u>
			<b>Quarter Ended October 28, 2018</b>	<b>Three Quarters Ended October 28, 2018</b>
	(In thousands)	(Percentages)	(In thousands)	(Percentages)
Change in comparable store sales <sup>(2)</sup>	\$ 16,719	6%	\$ 75,376	8%
Adjustments due to foreign exchange rate changes	4,674	1	(847)	—
Change in comparable store sales in constant dollars <sup>(2)</sup>	<u>\$ 21,393</u>	<u>7%</u>	<u>\$ 74,529</u>	<u>8%</u>
			<b>Quarter Ended October 28, 2018</b>	<b>Three Quarters Ended October 28, 2018</b>
Change in direct to consumer net revenue			44%	51%
Adjustments due to foreign exchange rate changes			2	(1)
Change in direct to consumer net revenue in constant dollars			<u>46%</u>	<u>50%</u>

<sup>(1)</sup> Total comparable sales includes comparable store sales and direct to consumer sales.

<sup>(2)</sup> Comparable 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 the adjusted financial measures with the most directly comparable measures calculated in accordance with GAAP. The adjustments relate to U.S. tax reform and the restructuring of our ivivva operations and its related tax effects. Please refer to Notes 7 and 8 to the unaudited interim consolidated financial statements included in Item 1 of Part I of this report for further information on these adjustments.

	Quarter Ended October 28, 2018			Quarter Ended October 29, 2017		
	GAAP Results	U.S. Tax Reform	Adjusted Results (Non-GAAP)	GAAP Results	Restructuring of ivivva Operations Adjustments	Adjusted Results (Non-GAAP)
	<i>(In thousands, except per share amounts)</i>					
Gross profit . . . . .	\$ 406,777	\$ —	\$ 406,777	\$ 321,962	\$ 1,178	\$ 323,140
Gross margin . . . . .	54.4%	— %	54.4%	52.0%	0.2 %	52.2%
Income from operations . .	135,903	—	135,903	85,588	22,186	107,774
Operating margin . . . . .	18.2%	— %	18.2%	13.8%	3.6 %	17.4%
Income before income tax expense . . . . .	137,947	—	137,947	86,640	22,185	108,825
Income tax expense . . . . .	43,534	(5,163)	38,371	27,696	5,813	33,509
Effective tax rate . . . . .	31.6%	(3.8)%	27.8%	32.0%	(1.2)%	30.8%
Diluted earnings per share .	\$ 0.71	\$ 0.04	\$ 0.75	\$ 0.43	\$ 0.13	\$ 0.56

	Three Quarters Ended October 28, 2018			Three Quarters Ended October 29, 2017		
	GAAP Results	U.S. Tax Reform	Adjusted Results (Non-GAAP)	GAAP Results	Restructuring of ivivva Operations Adjustments	Adjusted Results (Non-GAAP)
	<i>(In thousands, except per share amounts)</i>					
Gross profit . . . . .	\$ 1,147,704	\$ —	\$ 1,147,704	\$ 876,279	\$ 8,841	\$ 885,120
Gross margin . . . . .	54.1%	— %	54.1%	50.9%	0.5 %	51.4%
Income from operations . .	374,416	—	374,416	199,723	45,365	245,088
Operating margin . . . . .	17.7%	— %	17.7%	11.6%	2.6 %	14.2%
Income before income tax expense . . . . .	380,969	—	380,969	202,494	45,365	247,859
Income tax expense . . . . .	115,633	(5,163)	110,471	63,593	11,886	75,479
Effective tax rate . . . . .	30.4%	(1.4)%	29.0%	31.4%	(0.9)%	30.5%
Diluted earnings per share .	\$ 1.97	\$ 0.04	\$ 2.01	\$ 1.02	\$ 0.24	\$ 1.26

## 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 56%, 47%, and 45% of our full year operating profit during the fourth quarters of fiscal 2017, fiscal 2016, and fiscal 2015, respectively. Excluding the costs we incurred in connection with the ivivva restructuring, we generated approximately 51% of our operating profit during the fourth quarter of fiscal 2017.

## 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 investments and 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 well as in money market funds, treasury bills, and term deposits.

As of October 28, 2018, our working capital, excluding cash and cash equivalents, was \$216.2 million, our cash and cash equivalents were \$703.6 million, and our capacity under our revolving facility was \$398.8 million.

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

	<b>Three Quarters Ended</b>	
	<b>October 28, 2018</b>	<b>October 29, 2017</b>
	<i>(In thousands)</i>	
Total cash provided by (used in):		
Operating activities	\$ 316,876	\$ 131,309
Investing activities	(165,914)	(120,051)
Financing activities	(406,361)	(100,707)
Effect of exchange rate changes on cash	(31,495)	4,657
Decrease in cash and cash equivalents	<u>\$ (286,894)</u>	<u>\$ (84,792)</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 \$185.6 million, to \$316.9 million for the first three quarters of fiscal 2018 compared to \$131.3 million for the first three quarters of fiscal 2017, primarily as a result of the following:

#### *Net income and non-cash items*

- an increase of \$126.4 million in net income, and an increase of \$12.9 million in non-cash expenses primarily related to an increase in deferred income taxes, depreciation, and stock-based compensation, partially offset by a decrease in asset impairment costs related to the restructuring of our ivivva operations and the settlement of derivatives not designated in a hedging relationship.

#### *Changes in operating assets and liabilities*

- an increase of \$46.3 million in the change in operating assets and liabilities, primarily due to the following:
  - an increase of \$140.8 million related to accounts payable, primarily due to a change in our payment terms;
  - partially offset by an increase of \$97.4 million related to inventory, primarily due to an increase in inventory purchases.

### **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 \$45.9 million to \$165.9 million for the first three quarters of fiscal 2018 from \$120.1 million for the first three quarters of fiscal 2017. The increase was primarily the result of an increase in corporate capital expenditures related to information technology and business systems. Increased capital expenditures related to our company-operated stores also contributed to the increase in cash used in investing activities, primarily as a result of an increase in renovations and relocations of existing stores. The increase in cash used in investing activities was partially offset by a decrease in direct to consumer capital expenditures.

### **Financing Activities**

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

Cash used in financing activities increased \$305.7 million to \$406.4 million for the first three quarters of fiscal 2018 compared to \$100.7 million for the first three quarters of fiscal 2017. The increase was primarily the result of our stock repurchases.

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. On November 29, 2017, our board of directors approved a program to repurchase shares of our common stock up to an aggregate value of \$200.0 million. On June 6, 2018, the board of directors approved an increase to this stock repurchase program, authorizing the repurchase of up to a total of \$600.0 million of our common shares on the open market or in privately negotiated transactions.

Our cash used in financing activities for the first three quarters of fiscal 2018 included \$414.3 million to repurchase 3.4 million shares of our common stock compared to \$99.3 million to repurchase 1.8 million shares for the first three quarters of fiscal 2017. During the second quarter of fiscal 2018, we repurchased 3.3 million shares in a private transaction. The other 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, if any, 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.

On June 6, 2018, we entered into Amendment No. 1 to the credit agreement. The Amendment amends the credit agreement to provide for (i) an increase in the aggregate commitments under the unsecured five-year revolving credit facility to \$400.0 million, with an increase of the sub-limits for the issuance of letters of credit and extensions of swing line loans to

\$50.0 million for each, (ii) an increase in the option, subject to certain conditions as set forth in the credit agreement, to request increases in commitments under the revolving facility from \$400.0 million to \$600.0 million and (iii) an extension in the maturity of the revolving facility from December 15, 2021 to June 6, 2023.

In addition, the Amendment decreases the applicable margins for LIBOR loans from 1.00%-1.75% to 1.00%-1.50% and for alternate base rate loans from 0.00%-0.75% to 0.00%-0.50%, reduces the commitment fee on average daily unused amounts under the revolving facility from 0.125%-0.200% to 0.10%-0.20%, and reduces fees for unused letters of credit from 1.00%-1.75% to 1.00%-1.50%.

As of October 28, 2018, aside from letters of credit of \$1.2 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 28, 2018, letters of credit and letters of guarantee totaling \$1.2 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 2017 Annual Report on Form 10-K filed with the SEC on March 27, 2018, and in Notes 2, 5, and 6 included in Item 1 of Part I of this Quarterly Report on Form 10-Q.

**Operating Locations**

Our company-operated stores by country as of October 28, 2018 and January 28, 2018 are summarized in the table below.

	October 28, 2018	January 28, 2018
United States <sup>(1)</sup> .....	282	274
Canada .....	61	60
Australia .....	29	28
China <sup>(2)</sup> .....	17	15
United Kingdom .....	12	9
New Zealand .....	6	6
Germany .....	4	2
Japan .....	4	2
South Korea .....	4	3
Singapore .....	3	3
France .....	1	—
Ireland .....	1	1
Sweden .....	1	—
Switzerland .....	1	1
Total company-operated stores .....	426	404

<sup>(1)</sup> Included within the United States as of January 28, 2018, was one company-operated store in the Commonwealth of Puerto Rico. This store permanently closed during the second quarter of fiscal 2018.

<sup>(2)</sup> Included within China as of October 28, 2018 and January 28, 2018, were three company-operated stores in the Hong Kong Special Administrative Region and one company-operated store in the Taiwan Province.

Retail locations operated by third parties under license and supply arrangements are not included in the above table. As of October 28, 2018, there were seven licensed locations, including three in Mexico, three in the United Arab Emirates, and one in Qatar.

**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 28, 2018, 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 6 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 2018, the change in the relative value of the U.S. dollar against the Canadian dollar resulted in a \$66.9 million increase in accumulated other comprehensive loss within stockholders' equity. 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 \$13.8 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 2018 would have resulted in additional income from operations of approximately \$4.6 million in the first three quarters of fiscal 2018. This assumes a consistent 10% depreciation in the U.S. dollar against the Canadian dollar throughout the first three quarters of fiscal 2018. 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 \$400.0 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 28, 2018, aside from letters of credit of \$1.2 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.

Our cash and cash equivalent balances are held in the form of cash on hand, bank balances, short-term deposits and treasury bills with original maturities of three months or less, and in money market funds. We do not believe these balances are subject to material interest rate risk.

*Credit Risk.* We have cash on deposit with various large, reputable financial institutions and have invested in U.S. and Canadian Treasury Bills, and in AAA-rated money market funds. The amount of cash and cash equivalents held with certain financial institutions exceeds government-insured limits. We are also exposed to credit-related losses in the event of nonperformance by the financial institutions that are counterparties to our 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. We have not experienced any losses related to these items, and we believe credit risk to be minimal. We seek to minimize our credit risk by entering into transactions with credit worthy and reputable financial institutions and by monitoring the credit standing of the financial institutions with whom we transact. We seek to limit the amount of exposure with any one counterparty.

### ***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 principal executive officer and principal financial and 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 principal executive officer and principal financial and accounting 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 28, 2018. Based on that evaluation, our principal executive officer and principal financial and accounting officer concluded that, at October 28, 2018, our disclosure controls and procedures were effective.

There were no changes in our internal control over financial reporting during the quarter ended October 28, 2018 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.