

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.

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 \$5.4 million in the second quarter of fiscal 2017. The adjusted financial measures for the second quarter of fiscal 2017 exclude these charges and their related tax effects.

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

- Net revenue increased 25% to \$723.5 million. On a constant dollar basis, net revenue increased 24%.
- Total comparable sales, which includes comparable store sales and direct to consumer, increased 20%. On a constant dollar basis, total comparable sales increased 19%.
 - Comparable store sales increased 10%, or increased 10% on a constant dollar basis.
 - Direct to consumer net revenue increased 48%, or increased 47% on a constant dollar basis.
- Gross profit increased 33% to \$396.2 million. It increased 32% compared to adjusted gross profit for the second quarter of fiscal 2017.
- Gross margin increased 360 basis points to 54.8%. It increased 320 basis points compared to adjusted gross margin for the second quarter of fiscal 2017.
- Income from operations increased 95% to \$134.2 million. It increased 81% compared to adjusted income from operations for the second quarter of fiscal 2017.
- Operating margin increased 670 basis points to 18.5%. It increased 570 basis points compared to adjusted operating margin for the second quarter of fiscal 2017.
- Income tax expense increased 92% to \$40.0 million. Our effective tax rate for the second quarter of fiscal 2018 was 29.5% compared to 29.9% for the second quarter of fiscal 2017. The adjusted effective tax rate was 29.6% in the second quarter of fiscal 2017.
- Diluted earnings per share were \$0.71 compared to \$0.36 in the second quarter of fiscal 2017. Adjusted diluted earnings per share were \$0.39 for the second 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

Second Quarter Results

The following table summarizes key components of our results of operations for the quarters ended July 29, 2018 and July 30, 2017. The percentages are presented as a percentage of net revenue.

| | Quarter Ended | | | |
|--|-----------------------|----------------------|----------------------|----------------------|
| | July 29, 2018 | July 30, 2017 | July 29, 2018 | July 30, 2017 |
| | <i>(In thousands)</i> | | <i>(Percentages)</i> | |
| Net revenue | \$ 723,500 | \$ 581,054 | 100.0% | 100.0% |
| Cost of goods sold | 327,306 | 283,632 | 45.2 | 48.8 |
| Gross profit | 396,194 | 297,422 | 54.8 | 51.2 |
| Selling, general and administrative expenses | 261,986 | 225,524 | 36.2 | 38.8 |
| Asset impairment and restructuring costs | — | 3,186 | — | 0.6 |
| Income from operations | 134,208 | 68,712 | 18.5 | 11.8 |
| Other income (expense), net | 1,591 | 812 | 0.2 | 0.2 |
| Income before income tax expense | 135,799 | 69,524 | 18.8 | 12.0 |
| Income tax expense | 40,029 | 20,813 | 5.5 | 3.6 |
| Net income | <u>\$ 95,770</u> | <u>\$ 48,711</u> | <u>13.2%</u> | <u>8.4%</u> |

Net Revenue

Net revenue increased \$142.4 million, or 25%, to \$723.5 million for the second quarter of fiscal 2018 from \$581.1 million for the second quarter of fiscal 2017. On a constant dollar basis, assuming the average exchange rates for the

second quarter of fiscal 2018 remained constant with the average exchange rates for the second quarter of fiscal 2017, net revenue increased \$139.7 million, or 24%.

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 20% in the second quarter of fiscal 2018 compared to the second quarter of fiscal 2017. Total comparable sales increased 19% on a constant dollar basis.

Net revenue on a segment basis for the quarters ended July 29, 2018 and July 30, 2017 is summarized below. The percentages are presented as a percentage of total net revenue.

| | Quarter Ended | | | |
|-----------------------------------|-----------------------|-------------------|----------------------|---------------|
| | July 29, 2018 | July 30, 2017 | July 29, 2018 | July 30, 2017 |
| | <i>(In thousands)</i> | | <i>(Percentages)</i> | |
| Company-operated stores | \$ 486,368 | \$ 413,944 | 67.2% | 71.2% |
| Direct to consumer | 167,405 | 113,049 | 23.1 | 19.5 |
| Other | 69,727 | 54,061 | 9.6 | 9.3 |
| Net revenue | <u>\$ 723,500</u> | <u>\$ 581,054</u> | <u>100.0%</u> | <u>100.0%</u> |

Company-Operated Stores. Net revenue from our company-operated stores segment increased \$72.4 million, or 17%, to \$486.4 million in the second quarter of fiscal 2018 from \$413.9 million in the second 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 July 30, 2017, and therefore not included in comparable store sales, contributed \$50.6 million to the increase. We opened 42 net new lululemon branded company-operated stores since the second quarter of fiscal 2017, including 22 stores in North America, 12 stores in Asia, six stores in Europe, and two stores in Australia/New Zealand.
- A comparable store sales increase of 10% in the second quarter of fiscal 2018 compared to the second quarter of fiscal 2017 resulted in a \$35.7 million increase to net revenue. Comparable store sales increased 10%, or \$34.6 million on a constant dollar basis. The increase in comparable store sales was primarily a result of increased store traffic, and due to improved conversion rates and increased dollar value per transaction.

These increases in net revenue were 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 second quarter of fiscal 2018 by \$13.8 million compared to the second quarter of fiscal 2017.

Direct to Consumer. Net revenue from our direct to consumer segment increased \$54.4 million, or 48%, to \$167.4 million in the second quarter of fiscal 2018 from \$113.0 million in the second quarter of fiscal 2017. Direct to consumer net revenue increased 47% 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 second quarter of fiscal 2018.

Other. Net revenue from our other segment increased \$15.7 million, or 29%, to \$69.7 million in the second quarter of fiscal 2018 from \$54.1 million in the second quarter of fiscal 2017. This increase was primarily the result of an increased number of outlets and temporary locations, including seasonal stores, open during the second quarter of fiscal 2018 compared to the second quarter of fiscal 2017. There was also an increase in net revenue at existing outlets during the second quarter of fiscal 2018 compared to the second quarter 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 second quarter of fiscal 2018 compared to the second quarter of fiscal 2017.

Gross Profit

Gross profit increased \$98.8 million, or 33%, to \$396.2 million for the second quarter of fiscal 2018 from \$297.4 million for the second quarter of fiscal 2017.

Gross profit as a percentage of net revenue, or gross margin, increased 360 basis points to 54.8% in the second quarter of fiscal 2018 from 51.2% in the second quarter of fiscal 2017. The increase in gross margin was primarily the result of:

- an increase in product margin of 260 basis points, which was primarily due to lower product costs, a favorable mix of higher margin product, and lower markdowns;
- a decrease in occupancy and depreciation costs as a percentage of revenue of 70 basis points;
- a favorable impact of foreign exchange rates of 20 basis points; and
- the costs incurred in the second quarter of fiscal 2017 in connection with the restructuring of our ivivva operations, which reduced gross margin in that quarter by 40 basis points.

This was partially offset by an increase in fixed costs as a percentage of revenue related to our product and supply chain departments of 30 basis points.

During the second quarter of fiscal 2017, as a result of the restructuring of our ivivva operations, we recognized costs totaling \$2.2 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 second quarter of fiscal 2017, gross profit increased 32% and gross margin increased 320 basis points.

Selling, General and Administrative Expenses

Selling, general and administrative expenses increased \$36.5 million, or 16%, to \$262.0 million in the second quarter of fiscal 2018 from \$225.5 million in the second 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 \$29.7 million, comprised of:
 - an increase in employee costs of \$14.6 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 \$9.0 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 \$6.1 million primarily due to an increase in digital marketing expenses, brand and community costs, and other costs associated with our operating locations;
- an increase in head office costs of \$5.9 million, comprised of:
 - an increase in employee costs of \$3.6 million primarily due to additional employees to support the growth in our business; and
 - an increase in other costs of \$2.2 million primarily due to increases in brand and community costs, information technology costs, and other head office costs; and
- an increase in net foreign exchange and derivative revaluation losses of \$0.9 million. There were net foreign exchange and derivative revaluation losses of \$2.6 million in the second quarter of fiscal 2018 compared to net foreign exchange and derivative revaluation losses of \$1.7 million in the second quarter of fiscal 2017. 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. During the second quarter of fiscal 2017, we began entering into forward currency contracts designed to economically hedge these foreign exchange revaluation gains and losses.

As a percentage of net revenue, selling, general and administrative expenses decreased 260 basis points, to 36.2% in the second quarter of fiscal 2018 from 38.8% in the second quarter of fiscal 2017.

Asset Impairment and Restructuring Costs

During the second quarter of fiscal 2017, we incurred asset impairment and restructuring costs totaling \$3.2 million in connection with the restructuring of our ivivva operations. This included employee related costs of \$2.5 million and lease termination and other restructuring costs of \$0.7 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 second quarter of fiscal 2018.

Income from Operations

Income from operations increased \$65.5 million, or 95%, to \$134.2 million in the second quarter of fiscal 2018 from \$68.7 million in the second quarter of fiscal 2017. Operating margin increased 670 basis points to 18.5% compared to 11.8% in the second quarter of fiscal 2017.

In connection with the restructuring of our ivivva operations, we recognized pre-tax costs totaling \$5.4 million in the second quarter of fiscal 2017. This included costs of \$2.2 million recognized in cost of goods sold, and asset impairment and restructuring costs totaling \$3.2 million. Excluding these charges from the comparatives for the second quarter of fiscal 2017, income from operations increased 81% and operating margin increased 570 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 July 29, 2018 and July 30, 2017 is summarized below. The percentages are presented as a percentage of net revenue of the respective operating segments.

| | Quarter Ended | | | |
|---|-----------------------|------------------|--|---------------|
| | July 29, 2018 | July 30, 2017 | July 29, 2018 | July 30, 2017 |
| | <i>(In thousands)</i> | | <i>(Percentage of segment revenue)</i> | |
| Segmented income from operations: | | | | |
| Company-operated stores | \$ 125,868 | \$ 92,609 | 25.9% | 22.4% |
| Direct to consumer | 67,033 | 38,748 | 40.0 | 34.3 |
| Other | 13,094 | 6,952 | 18.8 | 12.9 |
| | <u>205,995</u> | <u>138,309</u> | | |
| General corporate expense | 71,787 | 64,167 | | |
| Restructuring and related costs | — | 5,430 | | |
| Income from operations | <u>\$ 134,208</u> | <u>\$ 68,712</u> | | |

Company-Operated Stores. Income from operations from our company-operated stores segment increased \$33.3 million, or 36%, to \$125.9 million for the second quarter of fiscal 2018 from \$92.6 million for the second quarter of fiscal 2017. The increase was primarily the result of increased gross profit of \$46.3 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 store employee costs, increased store operating expenses including higher credit card fees, distribution costs and packaging costs as a result of higher net revenues, and due to increased brand and community costs. Income from operations as a percentage of company-operated stores net revenue increased 350 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 \$28.3 million, or 73%, to \$67.0 million for the second quarter of fiscal 2018 from \$38.8 million for the second quarter of fiscal 2017. The increase was primarily the result of increased gross profit of \$39.5 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 higher variable costs including distribution costs, credit card fees, and packaging costs as a result of higher net revenue, as well as higher digital marketing expenses. Income from operations as a percentage of direct to consumer net revenue increased 570 basis points due to higher gross margin and leverage on selling, general and administrative expenses.

Other. Other income from operations increased \$6.1 million, or 88%, to \$13.1 million for the second quarter of fiscal 2018 from \$7.0 million for the second quarter of fiscal 2017. The increase was primarily the result of increased gross profit of \$10.8 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, primarily due to increased employee costs and due to increased operating expenses including higher credit card fees and distribution costs as a result of higher net revenues. Income from operations as a percentage of other net revenue increased 590 basis points due to higher gross margin and leverage on selling, general and administrative expenses.

General Corporate Expense. General corporate expense increased \$7.6 million, or 12%, to \$71.8 million for the second quarter of fiscal 2018 from \$64.2 million for the second quarter of fiscal 2017. This increase was primarily due to increases in

head office employee costs, increased information technology costs, increased brand and community costs, and an increase in net foreign exchange and derivative revaluation losses of \$0.9 million. There were net foreign exchange and derivative revaluation losses of \$2.6 million in the second quarter of fiscal 2018 compared to net foreign exchange and derivative revaluation losses of \$1.7 million in the second quarter of fiscal 2017. 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 \$0.8 million, or 96%, to \$1.6 million for the second quarter of fiscal 2018 from income of \$0.8 million for the second 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 second quarter of fiscal 2018 compared to second quarter of fiscal 2017. This was partially offset by an increase in net interest expense primarily related to borrowings on our revolving credit facility during the second quarter of fiscal 2018.

Income Tax Expense

Income tax expense increased \$19.2 million, or 92%, to \$40.0 million for the second quarter of fiscal 2018 from \$20.8 million for the second quarter of fiscal 2017.

During the second quarter of fiscal 2017, we recognized a net income tax recovery of \$1.4 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 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 and 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. We recognized a provisional income tax expense relating to the global intangible low-taxed income ("GILTI") tax in our effective tax rate for fiscal 2018. The results for the second quarter of fiscal 2018 did not include any discrete items related to the U.S. tax reform.

The effective tax rate for the second quarter of fiscal 2018 was 29.5% compared to 29.9% for the second quarter of fiscal 2017. Excluding the costs and related tax recoveries which were recognized in connection with the ivivva restructuring, the adjusted effective tax rate was 29.6% for the second quarter of fiscal 2017. The decrease in the effective tax rate for the second quarter of fiscal 2018 compared to the adjusted effective tax rate for the second quarter of fiscal 2017 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 provisional income tax expense relating to the GILTI tax and other adjustments following the finalization of certain income tax returns.

Net Income

Net income increased \$47.1 million, or 97%, to \$95.8 million for the second quarter of fiscal 2018 from \$48.7 million for the second quarter of fiscal 2017. This was primarily due to an increase in gross profit of \$98.8 million, a reduction in asset impairment and restructuring costs of \$3.2 million, and an increase in other income (expense), net of \$0.8 million, partially offset by an increase in selling, general and administrative expenses of \$36.5 million and an increase in income tax expense of \$19.2 million.

First Two Quarters Results

The following table summarizes key components of our results of operations for the first two quarters ended July 29, 2018 and July 30, 2017. The percentages are presented as a percentage of net revenue.

| | Two Quarters Ended | | | |
|--|-----------------------|---------------|----------------------|---------------|
| | July 29, 2018 | July 30, 2017 | July 29, 2018 | July 30, 2017 |
| | <i>(In thousands)</i> | | <i>(Percentages)</i> | |
| Net revenue | \$ 1,373,206 | \$ 1,101,361 | 100.0% | 100.0% |
| Cost of goods sold | 632,279 | 547,044 | 46.0 | 49.7 |
| Gross profit | 740,927 | 554,317 | 54.0 | 50.3 |
| Selling, general and administrative expenses | 502,414 | 424,665 | 36.6 | 38.6 |
| Asset impairment and restructuring costs | — | 15,517 | — | 1.3 |
| Income from operations | 238,513 | 114,135 | 17.4 | 10.4 |
| Other income (expense), net | 4,509 | 1,719 | 0.3 | 0.1 |
| Income before income tax expense | 243,022 | 115,854 | 17.7 | 10.5 |
| Income tax expense | 72,099 | 35,897 | 5.3 | 3.2 |
| Net income | \$ 170,923 | \$ 79,957 | 12.4% | 7.3% |

Net Revenue

Net revenue increased \$271.8 million, or 25%, to \$1.373 billion for the first two quarters of fiscal 2018 from \$1.101 billion for the first two quarters of fiscal 2017. On a constant dollar basis, assuming the average exchange rates for the first two quarters of fiscal 2018 remained constant with the average exchange rates for the first two quarters of fiscal 2017, net revenue increased \$260.0 million, or 24%.

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 20% in the first two quarters of fiscal 2018 compared to the first two quarters of fiscal 2017. Total comparable sales increased 19% on a constant dollar basis.

Net revenue on a segment basis for the first two quarters ended July 29, 2018 and July 30, 2017 is summarized below. The percentages are presented as a percentage of total net revenue.

| | Two Quarters Ended | | | |
|-------------------------|-----------------------|---------------|----------------------|---------------|
| | July 29, 2018 | July 30, 2017 | July 29, 2018 | July 30, 2017 |
| | <i>(In thousands)</i> | | <i>(Percentages)</i> | |
| Company-operated stores | \$ 919,499 | \$ 793,043 | 67.0% | 72.0% |
| Direct to consumer | 325,248 | 210,272 | 23.7 | 19.1 |
| Other | 128,459 | 98,046 | 9.3 | 8.9 |
| Net revenue | \$ 1,373,206 | \$ 1,101,361 | 100.0% | 100.0% |

Company-Operated Stores. Net revenue from our company-operated stores segment increased \$126.5 million, or 16%, to \$919.5 million in the first two quarters of fiscal 2018 from \$793.0 million in the first two 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 July 30, 2017, and therefore not included in comparable store sales, contributed \$93.2 million to the increase. We opened 42 net new lululemon branded company-operated stores since the second quarter of fiscal 2017, including 22 stores in North America, 12 stores in Asia, six stores in Europe, and two stores in Australia/New Zealand.
- A comparable store sales increase of 9% in the first two quarters of fiscal 2018 compared to the first two quarters of fiscal 2017 resulted in a \$58.6 million increase to net revenue. Comparable store sales increased 8%, or \$53.1 million on a constant dollar basis. The increase in comparable store sales was primarily a result of increased store traffic and improved conversion rates.

These increases in net revenue were 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 two quarters of fiscal 2018 by \$25.4 million compared to the first two quarters of fiscal 2017.

Direct to Consumer. Net revenue from our direct to consumer segment increased \$115.0 million, or 55%, to \$325.2 million in the first two quarters of fiscal 2018 from \$210.3 million in the first two quarters of fiscal 2017. Direct to consumer net revenue increased 53% on a constant dollar basis. This was primarily a result of increased website traffic and increased conversion rates. 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 two quarters of fiscal 2018.

Other. Net revenue from our other segment increased \$30.4 million, or 31%, to \$128.5 million in the first two quarters of fiscal 2018 from \$98.0 million in the first two quarters of fiscal 2017. This increase was primarily the result of an increased number of outlets and temporary locations, including seasonal stores, open during the first two quarters of fiscal 2018 compared to the first two quarters of fiscal 2017. There was also an increase in net revenue at existing outlets during the first two quarters of fiscal 2018 compared to the first two 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 two quarters of fiscal 2018 compared to the first two quarters of fiscal 2017.

Gross Profit

Gross profit increased \$186.6 million, or 34%, to \$740.9 million for the first two quarters of fiscal 2018 from \$554.3 million for the first two quarters of fiscal 2017.

Gross profit as a percentage of net revenue, or gross margin, increased 370 basis points, to 54.0% in the first two quarters of fiscal 2018 from 50.3% in the first two quarters of fiscal 2017. The increase in gross margin was primarily the result of:

- an increase in product margin of 190 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 80 basis points;
- a favorable impact of foreign exchange rates of 30 basis points; and
- the costs incurred in the first two quarters of fiscal 2017 in connection with the restructuring of our ivivva operations, which reduced gross margin in that quarter by 70 basis points.

During the first two quarters of fiscal 2018, as a result of the restructuring of our ivivva operations, we recognized costs totaling \$7.7 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 second quarter of fiscal 2017, gross profit increased 32% and gross margin increased 300 basis points.

Selling, General and Administrative Expenses

Selling, general and administrative expenses increased \$77.7 million, or 18%, to \$502.4 million in the first two quarters of fiscal 2018 from \$424.7 million in the first two 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 \$52.2 million, comprised of:
 - an increase in employee costs of \$22.5 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 \$17.7 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 \$12.1 million, primarily due to an increase in digital marketing expenses, brand and community costs, and other costs associated with our operating locations; and
- an increase in head office costs of \$18.4 million, comprised of:
 - an increase in employee costs of \$12.7 million primarily due to additional employees to support the growth in our business; and

- an increase in other costs of \$5.7 million primarily due to an increase in brand and community costs, depreciation, and information technology related costs, partially offset by a decrease in professional fees.

The increase in selling, general and administrative expenses was partially offset by an increase in net foreign exchange and derivative revaluation losses of \$7.1 million. There were net foreign exchange and derivative revaluation losses of \$3.0 million in the first two quarters of fiscal 2018 compared to net foreign exchange and derivative revaluation gains of \$4.1 million in the first two quarters of fiscal 2017. 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. During the second quarter of fiscal 2017, we began entering into forward currency contracts designed to economically hedge these foreign exchange revaluation gains and losses.

As a percentage of net revenue, selling, general and administrative expenses decreased 200 basis points, to 36.6% in the first two quarters of fiscal 2018 from 38.6% in the first two quarters of fiscal 2017.

Asset Impairment and Restructuring Costs

During the first two quarters of fiscal 2017, we incurred asset impairment and restructuring costs totaling \$15.5 million in connection with the restructuring of our ivivva operations. This included long-lived asset impairment charges of \$11.6 million, employee related costs of \$3.2 million, and lease termination and other restructuring costs of \$0.7 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 two quarters of fiscal 2018.

Income from Operations

Income from operations increased \$124.4 million, or 109%, to \$238.5 million in the first two quarters of fiscal 2018 from \$114.1 million in the first two quarters of fiscal 2017. Operating margin increased 700 basis points to 17.4% compared to 10.4% in the first two quarters of fiscal 2017.

In connection with the restructuring of our ivivva operations, we recognized pre-tax costs totaling \$23.2 million in the first two quarters of fiscal 2017. This included costs of \$7.7 million recognized in cost of goods sold, and asset impairment and restructuring costs totaling \$15.5 million. Excluding these charges from the comparatives for the first two quarters of fiscal 2017, income from operations increased 74% and operating margin increased 490 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 two quarters ended July 29, 2018 and July 30, 2017 is summarized below. The percentages are presented as a percentage of net revenue of the respective operating segments.

| | Two Quarters Ended | | | |
|---|-----------------------|-------------------|--|---------------|
| | July 29, 2018 | July 30, 2017 | July 29, 2018 | July 30, 2017 |
| | <i>(In thousands)</i> | | <i>(Percentage of segment revenue)</i> | |
| Segmented income from operations: | | | | |
| Company-operated stores | \$ 225,155 | \$ 170,139 | 24.5% | 21.5% |
| Direct to consumer | 129,300 | 72,846 | 39.8 | 34.6 |
| Other | 24,317 | 9,760 | 18.9 | 10.0 |
| | <u>378,772</u> | <u>252,745</u> | | |
| General corporate expense | 140,259 | 115,430 | | |
| Restructuring and related costs | — | 23,180 | | |
| Income from operations | <u>\$ 238,513</u> | <u>\$ 114,135</u> | | |

Company-Operated Stores. Income from operations from our company-operated stores segment increased \$55.0 million, or 32%, to \$225.2 million for the first two quarters of fiscal 2018 from \$170.1 million for the first two quarters of fiscal 2017. The increase was primarily the result of increased gross profit of \$78.2 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 store employee costs, increased store operating expenses including higher credit card fees, distribution costs, and packaging costs as a result of higher net revenues, and due to increased brand and community costs. Income from operations as a percentage of company-operated stores net revenue increased by 300 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 \$56.5 million, or 77%, to \$129.3 million for the first two quarters of fiscal 2018 from \$72.8 million for the first two quarters of fiscal 2017. The increase was primarily the result of increased gross profit of \$80.7 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 digital marketing expenses, and higher variable costs including distribution costs, credit card fees, and packaging costs as a result of higher net revenue. Income from operations as a percentage of direct to consumer net revenue increased 520 basis points, primarily due to an increase in gross margin and leverage on selling, general and administrative expenses.

Other. Other income from operations increased \$14.6 million, or 149%, to \$24.3 million for the first two quarters of fiscal 2018 from \$9.8 million for the first two quarters of fiscal 2017. The increase was primarily the result of increased gross profit of \$20.1 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, including increased employee costs, and due to increased operating expenses including higher distribution costs and higher credit card fees as a result of higher net revenues. Income from operations as a percentage of other net revenue increased 890 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 \$24.8 million, or 22%, to \$140.3 million for the first two quarters of fiscal 2018 from \$115.4 million for the first two quarters of fiscal 2017. This increase was primarily due to increases in head office employee costs, increased brand and community costs, increased information technology costs, and an increase in net foreign exchange and derivative revaluation losses of \$7.1 million. There were net foreign exchange and derivative revaluation losses of \$3.0 million in the first two quarters of fiscal 2018 compared to net foreign exchange and derivative revaluation gains of \$4.1 million in the first two quarters of fiscal 2017. 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 \$2.8 million, or 162%, to \$4.5 million for the first two quarters of fiscal 2018 from income of \$1.7 million for the first two 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 two quarters of fiscal 2018 compared to the first two quarters of fiscal 2017. This was partially offset by an increase in net interest expense, primarily related to borrowings on our revolving credit facility during the second quarter of fiscal 2018.

Income Tax Expense

Income tax expense increased \$36.2 million, or 101%, to \$72.1 million for the first two quarters of fiscal 2018 from \$35.9 million for the first two quarters of fiscal 2017.

During the first two quarters of fiscal 2017, we recognized a net income tax recovery of \$6.1 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.

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 and 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. We recognized a provisional income tax expense relating to the GILTI tax in our effective tax rate for fiscal 2018. The results for the first two quarters of fiscal 2018 did not include any discrete items related to the U.S. tax reform.

The effective tax rate for the first two quarters of fiscal 2018 was 29.7% compared to 31.0% for the first two quarters of fiscal 2017. Excluding the costs and related tax recoveries which were recognized in connection with the ivivva restructuring, the adjusted effective tax rate was 30.2% for the first two quarters of fiscal 2017. The decrease in the effective tax rate for the first two quarters of fiscal 2018 compared to the adjusted effective tax rate for the first two quarters of fiscal 2017 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 provisional income tax expense relating to the GILTI tax and other adjustments following the finalization of certain income tax returns.

Net Income

Net income increased \$91.0 million, or 114%, to \$170.9 million for the first two quarters of fiscal 2018 from \$80.0 million for the first two quarters of fiscal 2017. This was primarily due to an increase in gross profit of \$186.6 million, a reduction in long-lived asset impairment and restructuring costs of \$15.5 million, and an increase in other income (expense), net of \$2.8 million, partially offset by an increase in selling, general and administrative expenses of \$77.7 million and an increase in income tax expense of \$36.2 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 costs recognized in connection with the restructuring of our ivivva operations and its related tax effects. 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 July 29, 2018 | | Two Quarters Ended July 29, 2018 | |
|---|--------------------------------|----------------------|--|---|
| | <i>(In thousands)</i> | <i>(Percentages)</i> | <i>(In thousands)</i> | <i>(Percentages)</i> |
| Change in net revenue | \$ 142,446 | 25% | \$ 271,845 | 25% |
| Adjustments due to foreign exchange rate changes | (2,751) | (1) | (11,892) | (1) |
| Change in net revenue in constant dollars | <u>\$ 139,695</u> | <u>24%</u> | <u>\$ 259,953</u> | <u>24%</u> |
| | | | Quarter Ended July 29, 2018 | Two Quarters Ended July 29, 2018 |
| Change in total comparable sales ^{(1),(2)} | | | 20% | 20% |
| Adjustments due to foreign exchange rate changes | | | (1) | (1) |
| Change in total comparable sales in constant dollars ^{(1),(2)} | | | <u>19%</u> | <u>19%</u> |
| | | | Quarter Ended July 29, 2018 | Two Quarters Ended July 29, 2018 |
| | <i>(In thousands)</i> | <i>(Percentages)</i> | <i>(In thousands)</i> | <i>(Percentages)</i> |
| Change in comparable store sales ⁽²⁾ | \$ 35,687 | 10% | \$ 58,623 | 9% |
| Adjustments due to foreign exchange rate changes | (1,131) | — | (5,521) | (1) |
| Change in comparable store sales in constant dollars ⁽²⁾ | <u>\$ 34,556</u> | <u>10%</u> | <u>\$ 53,102</u> | <u>8%</u> |
| | | | Quarter Ended July 29, 2018 | Two Quarters Ended July 29, 2018 |
| Change in direct to consumer net revenue | | | 48% | 55% |
| Adjustments due to foreign exchange rate changes | | | (1) | (2) |
| Change in direct to consumer net revenue in constant dollars | | | <u>47%</u> | <u>53%</u> |

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

⁽²⁾ 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 table reconciles adjusted financial measures with the most directly comparable measures calculated in accordance with GAAP. The adjustments relate to the restructuring of our ivivva operations and its related tax effects. Please refer to Note 7 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 July 29, 2018 | | | Quarter Ended July 30, 2017 | | |
|---|---|-------------|--------------------------------|-------------------------------------|---|--------------------------------|
| | GAAP Results | Adjustments | 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 | \$ 396,194 | \$ — | \$ 396,194 | \$ 297,422 | \$ 2,244 | \$ 299,666 |
| Gross margin | 54.8% | —% | 54.8% | 51.2% | 0.4 % | 51.6% |
| Income from operations . . . | 134,208 | — | 134,208 | 68,712 | 5,430 | 74,142 |
| Operating margin | 18.5% | —% | 18.5% | 11.8% | 1.0 % | 12.8% |
| Income before income tax expense | 135,799 | — | 135,799 | 69,524 | 5,430 | 74,954 |
| Income tax expense | 40,029 | — | 40,029 | 20,813 | 1,390 | 22,203 |
| Effective tax rate | 29.5% | —% | 29.5% | 29.9% | (0.3)% | 29.6% |
| Diluted earnings per share . | \$ 0.71 | \$ — | \$ 0.71 | \$ 0.36 | \$ 0.03 | \$ 0.39 |
| | Two Quarters Ended July 29, 2018 | | | Two Quarters Ended July 30, 2017 | | |
| | GAAP Results | Adjustments | 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 | \$ 740,927 | \$ — | \$ 740,927 | \$ 554,317 | \$ 7,663 | \$ 561,980 |
| Gross margin | 54.0% | —% | 54.0% | 50.3% | 0.7 % | 51.0% |
| Income from operations . . . | 238,513 | — | 238,513 | 114,135 | 23,180 | 137,315 |
| Operating margin | 17.4% | —% | 17.4% | 10.4% | 2.1 % | 12.5% |
| Income before income tax expense | 243,022 | — | 243,022 | 115,854 | 23,180 | 139,034 |
| Income tax expense | 72,099 | — | 72,099 | 35,897 | 6,073 | 41,970 |
| Effective tax rate | 29.7% | —% | 29.7% | 31.0% | (0.8)% | 30.2% |
| Diluted earnings per share . | \$ 1.26 | \$ — | \$ 1.26 | \$ 0.58 | \$ 0.13 | \$ 0.71 |

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 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 July 29, 2018, our working capital, excluding cash and cash equivalents, was \$81.0 million, our cash and cash equivalents were \$777.8 million, and our capacity under our revolving facility was \$298.7 million.

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

| | Two Quarters Ended | |
|---|-----------------------|--------------------|
| | July 29, 2018 | July 30, 2017 |
| | <i>(In thousands)</i> | |
| Total cash provided by (used in): | | |
| Operating activities | \$ 210,026 | \$ 102,038 |
| Investing activities | (89,292) | (49,889) |
| Financing activities | (300,239) | (91,910) |
| Effect of exchange rate changes on cash | (33,155) | 26,127 |
| Decrease in cash and cash equivalents | <u>\$ (212,660)</u> | <u>\$ (13,634)</u> |

Operating Activities

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

Cash provided by operating activities increased \$108.0 million, to \$210.0 million for the first two quarters of fiscal 2018 compared to \$102.0 million for the first two quarters of fiscal 2017, primarily as a result of the following:

Net income and non-cash items

- an increase of \$91.0 million in net income, and an increase of \$10.0 million in non-cash expenses primarily related to an increase in deferred income taxes, stock-based compensation, and depreciation, partially offset by a decrease in asset impairment costs related to the restructuring of our ivivva operations.

Changes in operating assets and liabilities

- an increase of \$7.0 million in the change in operating assets and liabilities, primarily due to the following:
 - an increase of \$93.7 million related to accounts payable, primarily due to a change in our payment terms;
 - partially offset by an increase of \$72.0 million related to inventory, primarily due to an increase in inventory purchases, and a decrease of \$19.0 million in income taxes.

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 \$39.4 million to \$89.3 million for the first two quarters of fiscal 2018 from \$49.9 million for the first two quarters of fiscal 2017. The increase was primarily the result of an increase in capital expenditures related to our company-operated stores, primarily as a result of an increase in renovations and relocations of existing stores. Increased corporate capital expenditures related to information technology and business systems also contributed to the increase in cash used in investing activities.

Financing Activities

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

Cash used in financing activities increased \$208.3 million to \$300.2 million for the first two quarters of fiscal 2018 compared to \$91.9 million for the first two quarters of fiscal 2017. The increase was primarily the result of our stock repurchases, partially offset by net borrowings on our revolving credit facility.

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 the Company's common shares on the open market or in privately negotiated transactions.

Our cash used in financing activities for the first two quarters of fiscal 2018 included \$406.2 million to repurchase 3.4 million shares of our common stock compared to \$90.8 million to repurchase 1.7 million shares for the first two 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.

The increase in cash used in financing activities was partially offset by net borrowings of \$100.0 million on our revolving credit facility for the first two quarters of fiscal 2018. We did not borrow from our revolving credit facility during the first two quarters of fiscal 2017.

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 July 29, 2018, we had borrowings of \$100.0 million outstanding under this credit facility as well as letters of credit of \$1.3 million.

Off-Balance Sheet Arrangements

We enter into standby letters of credit to secure certain of our obligations, including leases, taxes, and duties. As of July 29, 2018, letters of credit and letters of guarantee totaling \$1.3 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 July 29, 2018 and January 28, 2018 are summarized in the table below.

| | July 29, 2018 | January 28, 2018 |
|-------------------------------------|------------------|---------------------|
| United States ⁽¹⁾ | 275 | 274 |
| Canada | 60 | 60 |
| Australia | 29 | 28 |
| China ⁽²⁾ | 16 | 15 |
| United Kingdom | 11 | 9 |
| New Zealand | 6 | 6 |
| Germany | 4 | 2 |
| Japan | 4 | 2 |
| South Korea | 4 | 3 |
| Singapore | 3 | 3 |
| Ireland | 1 | 1 |
| Sweden | 1 | — |
| Switzerland | 1 | 1 |
| Total company-operated stores | <u>415</u> | <u>404</u> |

⁽¹⁾ 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.

⁽²⁾ Included within China as of July 29, 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 July 29, 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 July 29, 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 two quarters of fiscal 2018, the change in the relative value of the U.S. dollar against the Canadian dollar resulted in a \$62.6 million increase in accumulated other comprehensive loss within stockholders' equity. During the first two quarters of fiscal 2017, the change in the relative value of the U.S. dollar against the Canadian dollar resulted in a \$44.1 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 two quarters of fiscal 2018 would have resulted in additional income from operations of approximately \$4.1 million in the first two quarters of fiscal 2018. This assumes a consistent 10% depreciation in the U.S. dollar against the Canadian dollar throughout the first two 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 July 29, 2018, we had borrowings of \$100.0 million outstanding under this credit facility as well as letters of credit of \$1.3 million. 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 July 29, 2018. Based on that evaluation, our principal executive officer and principal financial and accounting officer concluded that, at July 29, 2018, our disclosure controls and procedures were effective.

There were no changes in our internal control over financial reporting during the quarter ended July 29, 2018 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.