

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 \$17.7 million in the first quarter of fiscal 2017. The

adjusted financial measures for the first quarter of fiscal 2017 exclude these charges and their related tax effects. The results for the first quarter of fiscal 2018 did not include any costs related to the restructuring of our ivivva operations.

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

- Net revenue increased 25% to \$649.7 million. On a constant dollar basis, net revenue increased 23%.
- 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 8%, or increased 6% on a constant dollar basis.
 - Direct to consumer net revenue increased 62%, or increased 60% on a constant dollar basis.
- Gross profit increased 34% to \$344.7 million. It increased 31% compared to adjusted gross profit for the first quarter of fiscal 2017.
- Gross margin increased 370 basis points to 53.1%. It increased 270 basis points compared to adjusted gross margin for the first quarter of fiscal 2017.
- Income from operations increased 130% to \$104.3 million. It increased 65% compared to adjusted income from operations for the first quarter of fiscal 2017.
- Operating margin increased 740 basis points to 16.1%. It increased 400 basis points compared to adjusted operating margin for the first quarter of fiscal 2017.
- Income tax expense increased 113% to \$32.1 million. Our effective tax rate for the first quarter of fiscal 2018 was 29.9% compared to 32.6% for the first quarter of fiscal 2017. The adjusted effective tax rate was 30.8% in the first quarter of fiscal 2017.
- Diluted earnings per share were \$0.55 compared to \$0.23 in the first quarter of fiscal 2017. Adjusted diluted earnings per share were \$0.32 for the first 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

First Quarter Results

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

	Quarter Ended			
	April 29, 2018	April 30, 2017	April 29, 2018	April 30, 2017
	<i>(In thousands)</i>		<i>(Percentages)</i>	
Net revenue	\$ 649,706	\$ 520,307	100.0%	100.0%
Cost of goods sold	304,973	263,412	46.9	50.6
Gross profit	344,733	256,895	53.1	49.4
Selling, general and administrative expenses	240,428	199,141	37.0	38.3
Asset impairment and restructuring costs	—	12,331	—	2.4
Income from operations	104,305	45,423	16.1	8.7
Other income (expense), net	2,918	907	0.4	0.2
Income before income tax expense	107,223	46,330	16.5	8.9
Income tax expense	32,070	15,084	4.9	2.9
Net income	<u>\$ 75,153</u>	<u>\$ 31,246</u>	<u>11.6%</u>	<u>6.0%</u>

Net Revenue

Net revenue increased \$129.4 million, or 25%, to \$649.7 million for the first quarter of fiscal 2018 from \$520.3 million for the first quarter of fiscal 2017. On a constant dollar basis, assuming the average exchange rates for the first quarter of fiscal 2018 remained constant with the average exchange rates for the first quarter of fiscal 2017, net revenue increased \$120.3 million, or 23%.

The increase in net revenue was primarily due 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 quarter of fiscal 2018 compared to the first quarter of fiscal 2017. Total comparable sales increased 19% on a constant dollar basis.

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

	Quarter Ended			
	April 29, 2018	April 30, 2017	April 29, 2018	April 30, 2017
	<i>(In thousands)</i>		<i>(Percentages)</i>	
Company-operated stores	\$ 433,131	\$ 379,099	66.7%	72.9%
Direct to consumer	157,843	97,223	24.3	18.7
Other	58,732	43,985	9.0	8.5
Net revenue	<u>\$ 649,706</u>	<u>\$ 520,307</u>	<u>100.0%</u>	<u>100.0%</u>

Company-Operated Stores. Net revenue from our company-operated stores segment increased \$54.0 million, or 14%, to \$433.1 million in the first quarter of fiscal 2018 from \$379.1 million in the first 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 April 30, 2017, and therefore not included in comparable store sales, contributed \$42.7 million to the increase. We opened 48 net new lululemon branded company-operated stores since the first quarter of fiscal 2017, including 28 stores in North America, 14 stores in Asia, three stores in Australia/New Zealand, and three stores in Europe.
- A comparable store sales increase of 8% in the first quarter of fiscal 2018 compared to the first quarter of fiscal 2017 resulted in a \$22.9 million increase to net revenue. Comparable store sales increased 6%, or \$18.5 million on a constant dollar basis. The increase in comparable store sales was primarily a result of improved conversion rates and increased store traffic. This was partially offset by a decrease in 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 first quarter of fiscal 2018 by \$11.6 million compared to the first quarter of fiscal 2017.

Direct to Consumer. Net revenue from our direct to consumer segment increased \$60.6 million, or 62%, to \$157.8 million in the first quarter of fiscal 2018 from \$97.2 million in the first quarter of fiscal 2017. Direct to consumer net revenue increased 60% on a constant dollar basis. This was primarily a result of increased website traffic, improved conversion, and increased dollar value per transaction.

Other. Net revenue from our other segment increased \$14.7 million, or 34%, to \$58.7 million in the first quarter of fiscal 2018 from \$44.0 million in the first quarter of fiscal 2017. This increase was primarily the result of an increased number of outlets and increased net revenue at existing outlets during the first quarter of fiscal 2018 compared to the first quarter of fiscal 2017. There was also an increase in net revenue from temporary locations, including seasonal stores. 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 quarter of fiscal 2018 compared to the first quarter of fiscal 2017.

Gross Profit

Gross profit increased \$87.8 million, or 34%, to \$344.7 million for the first quarter of fiscal 2018 from \$256.9 million for the first quarter of fiscal 2017.

Gross profit as a percentage of net revenue, or gross margin, increased 370 basis points to 53.1% in the first quarter of fiscal 2018 from 49.4% in the first quarter of fiscal 2017. The increase in gross margin was primarily the result of:

- an increase in product margin of 120 basis points, which was primarily due to a favorable mix of higher margin product and lower product costs, lower markdowns, and lower inventory provision expense;
- a decrease in fixed costs as a percentage of revenue, including occupancy and depreciation costs and costs related to our product and supply chain departments, of 120 basis points;
- a favorable impact of foreign exchange rates of 30 basis points; and
- the costs incurred in the first quarter of fiscal 2017 in connection with the restructuring of our ivivva operations, which reduced gross margin in that quarter by 100 basis points.

During the first quarter of fiscal 2017, as a result of the restructuring of our ivivva operations, we recognized costs totaling \$5.4 million within costs of goods sold, as outlined in Note 6 to the unaudited interim consolidated financial statements included in Item 1 of Part I of this report. Excluding these charges from the comparatives for the first quarter of fiscal 2017, gross profit increased 31% and gross margin increased 270 basis points.

Selling, General and Administrative Expenses

Selling, general and administrative expenses increased \$41.3 million, or 21%, to \$240.4 million in the first quarter of fiscal 2018 from \$199.1 million in the first 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 \$20.6 million, comprised of:
 - an increase in employee costs of \$6.0 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 as a result of higher net revenues;
 - an increase in variable costs of \$8.7 million primarily due to an increase in distribution costs, packaging costs, and credit card fees as a result of increased net revenue; and
 - an increase in other costs of \$5.9 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 \$14.4 million, comprised of:
 - an increase in employee costs of \$10.9 million primarily due to additional employees to support the growth in our business; and
 - an increase in other costs of \$3.5 million primarily due to increases in brand and community costs, partially offset by a decrease in professional fees and other head office costs.
- a decrease in net foreign exchange and derivative revaluation gains of \$6.2 million. There were net foreign exchange and derivative revaluation losses of \$0.4 million in the first quarter of fiscal 2018 compared to net foreign exchange revaluation gains of \$5.8 million in the first 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 130 basis points, to 37.0% in the first quarter of fiscal 2018 from 38.3% in the first quarter of fiscal 2017.

Asset Impairment and Restructuring Costs

During the first quarter of fiscal 2017, we incurred asset impairment and restructuring costs totaling \$12.3 million in connection with the restructuring of our ivivva operations. This included long-lived asset impairment charges of \$11.6 million and severance costs of \$0.7 million. Please refer to Note 6 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 quarter of fiscal 2018.

Income from Operations

Income from operations increased \$58.9 million, or 130%, to \$104.3 million in the first quarter of fiscal 2018 from \$45.4 million in the first quarter of fiscal 2017. Operating margin increased 740 basis points to 16.1% compared to 8.7% in the first quarter of fiscal 2017.

In connection with the restructuring of our ivivva operations, we recognized pre-tax costs totaling \$17.7 million in the first quarter of fiscal 2017. This included costs of \$5.4 million recognized in cost of goods sold, and asset impairment and restructuring costs totaling \$12.3 million. Excluding these charges from the comparatives for the first quarter of fiscal 2017, income from operations increased 65% and operating margin increased 400 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 April 29, 2018 and April 30, 2017 is summarized below. The percentages are presented as a percentage of net revenue of the respective operating segments.

	Quarter Ended			
	April 29, 2018	April 30, 2017	April 29, 2018	April 30, 2017
	<i>(In thousands)</i>		<i>(Percentages)</i>	
Company-operated stores	\$ 99,287	\$ 77,499	22.9%	20.4%
Direct to consumer	62,267	34,098	39.4	35.1
Other	11,223	2,836	19.1	6.4
Segmented income from operations	<u>172,777</u>	<u>114,433</u>		
General corporate expense	68,472	51,260		
Restructuring and related costs	—	17,750		
Income from operations	<u>\$ 104,305</u>	<u>\$ 45,423</u>		

Company-Operated Stores. Income from operations from our company-operated stores segment increased \$21.8 million, or 28%, to \$99.3 million for the first quarter of fiscal 2018 from \$77.5 million for the first quarter of fiscal 2017. The increase was primarily the result of increased gross profit of \$31.9 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 an increase in store employee costs, and increased store operating expenses including higher credit card fees, and distribution costs as a result of higher net revenues. Income from operations as a percentage of company-operated stores net revenue increased 250 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 \$28.2 million, or 83%, to \$62.3 million for the first quarter of fiscal 2018 from \$34.1 million for the first quarter of fiscal 2017. The increase was primarily the result of increased gross profit of \$41.1 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 and credit card fees 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 430 basis points due to leverage on selling, general and administrative expenses and increased gross margin.

Other. Other income from operations increased \$8.4 million, or 296%, to \$11.2 million for the first quarter of fiscal 2018 from \$2.8 million for the first quarter of fiscal 2017. The increase was primarily the result of increased gross profit of \$9.4 million which was primarily due to increased net revenue and higher gross margin. The increase in gross profit was partially offset by an increase in selling, general and administrative expenses, including increased employee costs and increased brand and community costs. Income from operations as a percentage of other net revenue increased 1270 basis points due to leverage on selling, general and administrative expenses and increased gross margin.

General Corporate Expense. General corporate expense increased \$17.2 million, or 34%, to \$68.5 million for the first quarter of fiscal 2018 from \$51.3 million for the first quarter of fiscal 2017. This increase was primarily due to increases in head office employee costs, increased brand and community costs, and a decrease in net foreign exchange and derivative revaluation gains of \$6.2 million. There were net foreign exchange and derivative revaluation losses of \$0.4 million in the first quarter of fiscal 2018 compared to net foreign exchange revaluation gains of \$5.8 million in the first 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. These cost increases were partially offset by decreased professional fees and other head office costs.

Other Income (Expense), Net

Other income, net increased \$2.0 million, or 222%, to \$2.9 million for the first quarter of fiscal 2018 from income of \$0.9 million for the first 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 equivalents, including money market funds, treasury bills, and term deposits, and due to an increase in cash and cash equivalents in the first quarter of fiscal 2018 compared to first quarter of fiscal 2017.

Income Tax Expense

Income tax expense increased \$17.0 million, or 113%, to \$32.1 million for the first quarter of fiscal 2018 from \$15.1 million for the first 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 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 7 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 during the first quarter of fiscal 2018. The results for the first quarter of fiscal 2018 did not include any discrete items related to the U.S. tax reform.

During the first quarter of fiscal 2017, we recognized in a net income tax recovery of \$4.7 million on the costs recognized in connection with the ivivva restructuring. Please refer to Note 6 to the unaudited interim consolidated financial statements included in Item 1 of Part I of this report.

The effective tax rate for the first quarter of fiscal 2018 was 29.9% compared to 32.6% for the first 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 30.8% for the first quarter of fiscal 2017. The decrease in the effective tax rate for the first quarter of fiscal 2018 compared to the adjusted effective tax rate for the first 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.

Net Income

Net income increased \$43.9 million, or 141%, to \$75.2 million for the first quarter of fiscal 2018 from \$31.2 million for the first quarter of fiscal 2017. This was primarily due to an increase in gross profit of \$87.8 million, an increase in other income (expense), net of \$2.0 million, and a reduction in asset impairment and restructuring costs of \$12.3 million, partially offset by an increase in selling, general and administrative expenses of \$41.3 million and an increase in income tax expense of \$17.0 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 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 April 29, 2018	
	<i>(In thousands)</i>	<i>(Percentages)</i>
Change in net revenue	\$ 129,399	25%
Adjustments due to foreign exchange rate changes	(9,141)	(2)
Change in net revenue in constant dollars	<u>\$ 120,258</u>	<u>23%</u>
		Quarter Ended April 29, 2018
Change in total comparable sales ^{(1),(2)}		20%
Adjustments due to foreign exchange rate changes		(1)
Change in total comparable sales in constant dollars ^{(1),(2)}		<u>19%</u>
		Quarter Ended April 29, 2018
	<i>(In thousands)</i>	<i>(Percentages)</i>
Change in comparable store sales ⁽²⁾	\$ 22,896	8%
Adjustments due to foreign exchange rate changes	(4,390)	(2)
Change in comparable store sales in constant dollars ⁽²⁾	<u>\$ 18,506</u>	<u>6%</u>
		Quarter Ended April 29, 2018
Change in direct to consumer net revenue		62%
Adjustments due to foreign exchange rate changes		(2)
Change in direct to consumer net revenue in constant dollars		<u>60%</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 6 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 April 29, 2018			Quarter Ended April 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	\$ 344,733	\$ —	\$ 344,733	\$ 256,895	\$ 5,419	\$ 262,314
Gross margin	53.1%	—%	53.1%	49.4%	1.0 %	50.4%
Income from operations . . .	104,305	—	104,305	45,423	17,750	63,173
Operating margin	16.1%	—%	16.1%	8.7%	3.4 %	12.1%
Income before income tax expense	107,223	—	107,223	46,330	17,750	64,080
Income tax expense	32,070	—	32,070	15,084	4,684	19,768
Effective tax rate	29.9%	—%	29.9%	32.6%	(1.8)%	30.8%
Diluted earnings per share .	\$ 0.55	\$ —	\$ 0.55	\$ 0.23	\$ 0.09	\$ 0.32

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 April 29, 2018, our working capital, excluding cash and cash equivalents, was \$218.9 million, our cash and cash equivalents were \$966.6 million, and our capacity under our revolving facility was \$148.7 million.

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

	Quarter Ended	
	April 29, 2018	April 30, 2017
<i>(In thousands)</i>		
Total cash provided by (used in):		
Operating activities	\$ 35,837	\$ 19,400
Investing activities	(34,314)	(19,879)
Financing activities	1,900	(14,487)
Effect of exchange rate changes on cash	(27,353)	(21,591)
Decrease in cash and cash equivalents	<u>\$ (23,930)</u>	<u>\$ (36,557)</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 \$16.4 million, to \$35.8 million for the first quarter of fiscal 2018 compared to \$19.4 million for the first quarter of fiscal 2017, primarily as a result of the following:

Net income and non-cash items

- an increase of \$43.9 million in net income, and an increase of \$1.6 million in non-cash expenses primarily related to an increase in deferred income taxes, 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

- a decrease of \$29.1 million in the change in operating assets and liabilities, primarily due to the following:
 - an increase of \$45.5 million related to inventory, primarily due to an increase in inventory purchases;
 - partially offset by a decrease of \$15.1 million related to accounts payable, other prepaid expenses and other current and non-current assets.

Investing Activities

Cash flows used in investing activities relate entirely to capital expenditures. 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 \$14.4 million to \$34.3 million for the first quarter of fiscal 2018 from \$19.9 million for the first quarter 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, as well as an increased number of new company-operated 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 and certain cash flows related to stock-based compensation.

Cash used in financing activities decreased \$16.4 million, to cash provided of \$1.9 million for the first quarter of fiscal 2018 compared to cash used of \$14.5 million for the first quarter of fiscal 2017. The decrease was primarily the result of our stock repurchase programs.

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.

Our cash used in financing activities for the first quarter of fiscal 2018 included \$7.5 thousand to repurchase 100 shares of our common stock compared to \$12.8 million to repurchase 0.2 million shares for the first quarter of fiscal 2017. The common stock was repurchased in the open market at prevailing market prices, including under plans complying with the provisions of Rule 10b5-1 and Rule 10b-18 of the Securities Exchange Act of 1934, with the timing and actual number of shares repurchased depending upon market conditions, eligibility to trade, and other factors.

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

Revolving Credit Facility

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

As of April 29, 2018, aside from letters of credit of \$1.3 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 April 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, 4, and 5 included in Item 1 of Part I of this Quarterly Report on Form 10-Q.

Operating Locations

Our company-operated stores by country as of April 29, 2018 and January 28, 2018, are summarized in the table below.

	April 29, 2018	January 28, 2018
United States ⁽¹⁾	274	274
Canada	60	60
Australia	29	28
China ⁽²⁾	16	15
United Kingdom	10	9
New Zealand	6	6
Japan	4	2
South Korea	4	3
Germany	3	2
Singapore	3	3
Ireland	1	1
Switzerland	1	1
Total company-operated stores	<u>411</u>	<u>404</u>

⁽¹⁾ Included within the United States as of April 29, 2018 and January 28, 2018, was one company-operated store in the Commonwealth of Puerto Rico.

⁽²⁾ Included within China as of April 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 April 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 April 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 5 to the unaudited interim consolidated financial statements included in Item 1 of Part I of this report for further information, including details of the notional amounts outstanding.

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

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

- the following impacts to the consolidated statements of operations:

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

During the first quarter of fiscal 2018, the change in the relative value of the U.S. dollar against the Canadian dollar resulted in a \$45.8 million increase in accumulated other comprehensive loss within stockholders' equity. During the first quarter of fiscal 2017, the change in the relative value of the U.S. dollar against the Canadian dollar resulted in a \$32.7 million increase 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 quarter of fiscal 2018 would have resulted in additional income from operations of approximately \$2.0 million in the first quarter of fiscal 2018. This assumes a consistent 10% depreciation in the U.S. dollar against the Canadian dollar throughout the first quarter 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 \$150.0 million in the aggregate. Because our revolving credit facility bears interest at a variable rate, we will be exposed to market risks relating to changes in interest rates, if we have a meaningful outstanding balance. As of April 29, 2018, aside from letters of credit of \$1.3 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 April 29, 2018. Based on that evaluation, our principal executive officer and principal financial and accounting officer concluded that, at April 29, 2018, our disclosure controls and procedures were effective.

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