

## **ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

Our fiscal year ends on the Sunday closest to January 31 of the following year, typically resulting in a 52 week year, but occasionally giving rise to an additional week, resulting in a 53 week year.

Fiscal 2017, fiscal 2016, and fiscal 2015 were 52 week years. The following discussion and analysis should be read in conjunction with our consolidated financial statements and the related notes included elsewhere in this Annual Report on Form 10-K.

This discussion and analysis contains forward-looking statements based on current expectations that involve risks, uncertainties and assumptions, such as our plans, objectives, expectations, and intentions set forth in the "Special Note Regarding Forward-Looking Statements." Our actual results and the timing of events may differ materially from those anticipated in these forward looking statements as a result of various factors, including those set forth in the "Item 1A. Risk Factors" section and elsewhere in this Annual Report on Form 10-K.

### **Overview**

Fiscal 2017 was a strong year for our company. New stores and new store formats, product innovations, and an enhanced e-commerce offering, combined with successful community and brand initiatives helped drive a 13% increase in net revenue. We had a 7% increase in total comparable sales.

Our product design and development teams launched a number of new category innovations this year. For women, our newest fabric Everlux was created for high intensity, indoor workouts and the Enlite bra offers guests proprietary technology for running and high impact training. For men, we expanded our popular ABC pant franchise to include slim and jogger styles, and all of our men's fixed waist bottoms now feature our ABC construction. We look forward to delivering on a strong pipeline of innovation and product rollouts in fiscal 2018.

During the year, we opened 46 net new lululemon branded company-operated stores, including 30 in North America, 14 in Asia Pacific, and two in Europe. Our multiple formats now include standard, co-located, local, and select flagship locations, which allow us to cater to our guests where they live, work, and sweat.

As of January 28, 2018, we had 57 stores in Asia Pacific and 13 stores in Europe, including our European flagship on London's Regent Street which showcases the fullest expression of our brand to both local and travelling guests. We expanded in Germany in fiscal 2017 with a new location in Munich. In Asia, we opened nine new stores in China during fiscal 2017, in addition to growing our local e-commerce presence via Tmall, and opening company-operated stores in Japan.

We relaunched our websites at the end of the third quarter of fiscal 2017, improving the online experience through upgraded visuals, added video content, more intuitive navigation, enhanced storytelling, and the integration of ivivva. The sales performance of our e-commerce business, which accelerated throughout the year, culminated in a 44% increase in direct to consumer net revenue in the fourth quarter of fiscal 2017 compared to the fourth quarter of fiscal 2016. In fiscal 2018 we plan to continue to develop our omni-channel experience to serve guests wherever and however they choose to shop, including launching a WeChat store in China.

Our grassroots approach to brand-building - locally led by stores and store associates, who we call educators - enables us to connect with and uniquely understand our guest. We hosted several events during the year, including our annual SeaWheeze half marathon in Vancouver, The Ghost Race in 15 cities in North America, the Sweatlife Festival in London, and Unroll China across multiple cities. We complemented our local efforts with our first global marketing campaign "This Is Yoga", followed by men's focused "Strength To Be" and finally, for holiday, "Breathe It All In".

We look forward to continuing this strong momentum into fiscal 2018, focusing on our four key strategic growth pillars: Digital, Men's, North America, and International, underpinned by innovations in product, our distinctive brand and community approach, and our vertically-integrated model.

### **Financial Highlights**

The summary below provides both GAAP and non-GAAP financial measures. In connection with the restructuring of our ivivva operations, we recognized pre-tax costs totaling \$47.2 million in fiscal 2017, and a related income tax recovery of \$12.7 million. We recognized a provisional income tax expense of \$59.3 million in fiscal 2017 related to the U.S. Tax Cuts and Jobs Act. The adjusted financial measures exclude these items, and also exclude certain discrete items related to our transfer pricing arrangements and taxes on repatriation of foreign earnings which were recognized during the fiscal 2016.

For the fiscal year ended January 28, 2018, compared to the fiscal year ended January 29, 2017:

- Net revenue increased 13% to \$2.6 billion. On a constant dollar basis, net revenue increased 12%.

- Total comparable sales, which includes comparable store sales and direct to consumer, increased 7%. On a constant dollar basis, total comparable sales increased 7%.
  - Comparable store sales increased 1%, or increased 1% on a constant dollar basis.
  - Direct to consumer net revenue increased 27%, or increased 27% on a constant dollar basis.
- Gross profit increased 17% to \$1.4 billion. Adjusted gross profit increased 17% to \$1.4 billion.
- Gross margin increased 160 basis points to 52.8%. Adjusted gross margin increased 190 basis points to 53.1%.
- Income from operations increased 8% to \$456.0 million. Adjusted income from operations increased 19% to \$503.2 million.
- Operating margin decreased 80 basis points to 17.2%. Adjusted operating margin increased 100 basis points to 19.0%.
- Income tax expense increased 69% to \$201.3 million. Our effective tax rate for fiscal 2017 was 43.8% compared to 28.2% for fiscal 2016. The adjusted effective tax rate was 30.5% for fiscal 2017 compared to 30.7% for fiscal 2016.
- Diluted earnings per share were \$1.90 for fiscal 2017 compared to \$2.21 in fiscal 2016. Adjusted diluted earnings per share were \$2.59 for fiscal 2017 compared to \$2.14 for fiscal 2016.

Refer to the non-GAAP reconciliation tables contained in the "Non-GAAP Financial Measures" section of this "Item 7. 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.

## General

*Net revenue* is comprised of company-operated store sales, direct to consumer sales through www.lululemon.com, other country and region specific websites, and mobile apps, including mobile apps on in-store devices that allow demand to be fulfilled via our distribution centers, and other net revenue, which includes outlet sales, sales from temporary locations, sales to wholesale accounts, showroom sales, warehouse sales, and license and supply arrangement net revenue, which consists of royalties as well as sales of our products to licensees.

*Cost of goods sold* includes the cost of purchased merchandise, including freight, duty, and nonrefundable taxes incurred in delivering the goods to our distribution centers. It also includes occupancy costs and depreciation expense for our company-operated store locations, all costs incurred in operating our distribution centers and production, design, distribution, and merchandise departments, hemming, shrink, and inventory provision expense. The primary drivers of the costs of individual products are the costs of raw materials and labor in the countries where we source our merchandise.

*Selling, general and administrative expenses* consist of all operating costs not otherwise included in cost of goods sold or asset impairment and restructuring costs. We expect selling, general and administrative expenses to increase in fiscal 2018 as we incur additional operating expenses to support our store and direct to consumer growth, while also making strategic investments to support the long term growth of the business.

*Asset impairment and restructuring costs* consist of the lease termination, impairment of property and equipment, employee related costs, and other restructuring costs recognized in connection with the restructuring of our ivivva operations.

*Income tax expense* depends on the statutory tax rates in the countries where we sell our products and the proportion of taxable income earned in those jurisdictions. To the extent the relative proportion of taxable income in the jurisdictions fluctuates, or the tax legislation in the respective jurisdictions changes, so will our effective tax rate. We also anticipate that, in the future, we may start to sell our products through retail locations in countries in which we have not yet operated, in which case, we would become subject to taxation based on the foreign statutory rates in the countries where these sales take place and our effective tax rate could fluctuate accordingly.

## Results of Operations

The following tables summarize key components of our results of operations for the periods indicated, both in dollars and as a percentage of net revenue:

	Fiscal Year Ended		
	January 28, 2018	January 29, 2017	January 31, 2016
	<i>(In thousands)</i>		
Net revenue . . . . .	\$ 2,649,181	\$ 2,344,392	\$ 2,060,523
Cost of goods sold . . . . .	1,250,391	1,144,775	1,063,357
Gross profit . . . . .	1,398,790	1,199,617	997,166
Selling, general and administrative expenses . . . . .	904,264	778,465	628,090
Asset impairment and restructuring costs . . . . .	38,525	—	—
Income from operations . . . . .	456,001	421,152	369,076
Other income (expense), net . . . . .	3,997	1,577	(581)
Income before income tax expense . . . . .	459,998	422,729	368,495
Income tax expense . . . . .	201,336	119,348	102,448
Net income . . . . .	<u>\$ 258,662</u>	<u>\$ 303,381</u>	<u>\$ 266,047</u>
	<i>(Percentages)</i>		
Net revenue . . . . .	100.0%	100.0%	100.0%
Cost of goods sold . . . . .	47.2	48.8	51.6
Gross profit . . . . .	52.8	51.2	48.4
Selling, general and administrative expenses . . . . .	34.1	33.2	30.5
Asset impairment and restructuring costs . . . . .	1.5	—	—
Income from operations . . . . .	17.2	18.0	17.9
Other income (expense), net . . . . .	0.2	—	—
Income before income tax expense . . . . .	17.4	18.0	17.9
Income tax expense . . . . .	7.6	5.1	5.0
Net income . . . . .	<u>9.8%</u>	<u>12.9%</u>	<u>12.9%</u>

## Comparison of Fiscal 2017 to Fiscal 2016

### Net Revenue

Net revenue increased \$304.8 million, or 13%, to \$2.6 billion in fiscal 2017 from \$2.3 billion in fiscal 2016. On a constant dollar basis, assuming the average exchange rates in fiscal 2017 remained constant with the average exchange rates in fiscal 2016, net revenue increased \$290.6 million, or 12%.

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

Our net revenue on a segment basis for fiscal 2017 and fiscal 2016 is summarized below. Net revenue is expressed in dollar amounts. The percentages are presented as a percentage of total net revenue.

	Fiscal Years Ended January 28, 2018 and January 29, 2017			
	2017	2016	2017	2016
	<i>(In thousands)</i>		<i>(Percentages)</i>	
Company-operated stores . . . . .	\$ 1,837,065	\$ 1,704,357	69.3%	72.7%
Direct to consumer . . . . .	577,590	453,287	21.8	19.3
Other . . . . .	234,526	186,748	8.9	8.0
Net revenue . . . . .	<u>\$ 2,649,181</u>	<u>\$ 2,344,392</u>	<u>100.0%</u>	<u>100.0%</u>

*Company-Operated Stores.* Net revenue from our company-operated stores segment increased \$132.7 million, or 8%, to \$1.8 billion in fiscal 2017 from \$1.7 billion in fiscal 2016. The following contributed to the increase in net revenue from our company-operated stores segment:

- Net revenue from company-operated stores we opened or significantly expanded subsequent to January 29, 2017, and are therefore not included in comparable store sales, increased net revenue by \$146.5 million. During fiscal 2017 we opened 46 net new lululemon branded company-operated stores, including 30 stores in North America, 14 stores in Asia Pacific, and two stores in Europe.
- A comparable store sales increase of 1% in fiscal 2017 compared to fiscal 2016 resulted in a \$12.8 million increase to net revenue. Comparable store sales increased 1%, or \$5.4 million on a constant dollar basis. The increase in comparable store sales was primarily a result of improved conversion rates and increased dollar value per transaction. This was partially offset by a decrease in store traffic, due in part to shifting retail traffic trends from in-store to online.

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 fiscal 2017 net revenue from company-operated stores by \$26.6 million compared to fiscal 2016.

*Direct to Consumer.* Net revenue from our direct to consumer segment increased \$124.3 million, or 27%, to \$577.6 million in fiscal 2017 from \$453.3 million in fiscal 2016. Direct to consumer net revenue increased 27% on a constant dollar basis. The increase in net revenue from our direct to consumer segment was primarily the result of increased traffic on our e-commerce websites, improved conversion rates, and increased dollar value per transaction. During the second quarter of fiscal 2017, we held online warehouse sales in the United States and Canada which generated net revenue of \$12.3 million. We did not hold any online warehouse sales during fiscal 2016. Excluding the impact of the online warehouse sales, direct to consumer net revenue increased 25%.

*Other.* Net revenue from our other segment increased \$47.8 million, or 26%, to \$234.5 million in fiscal 2017 from \$186.7 million in fiscal 2016. This increase was primarily the result of an increase in the number of outlets, increased net revenue at existing outlets, and an increase in the number of temporary locations. The increase in net revenue from our other segment was partially offset by lower net revenue from showrooms, primarily due a decrease in the number of showrooms open during fiscal 2017 compared to fiscal 2016.

### **Gross Profit**

Gross profit increased \$199.2 million, or 17%, to \$1.4 billion in fiscal 2017 from \$1.2 billion in fiscal 2016.

Gross profit as a percentage of net revenue, or gross margin, increased 160 basis points, to 52.8% in fiscal 2017 from 51.2% in fiscal 2016. The increase in gross margin was primarily the result of:

- an increase in product margin of 200 basis points which was primarily due to lower product costs and a favorable mix of higher margin product, partially offset by higher markdowns, and higher shrink and damages; and
- a favorable impact of foreign exchange rates of 10 basis points.

This was partially offset by an increase in fixed costs related to our product and supply chain departments of 20 basis points, and costs incurred in connection with the restructuring of our ivivva operations of 30 basis points.

During fiscal 2017, as a result of the restructuring of our ivivva operations, we recognized costs totaling \$8.7 million within costs of goods sold, as outlined in Note 13 to the audited consolidated financial statements included in Item 8 of Part II

of this report. Excluding these charges, adjusted gross profit increased 17.3% to \$1.4 billion and adjusted gross margin increased 190 basis points to 53.1% compared to fiscal 2016.

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

Selling, general and administrative expenses increased \$125.8 million, or 16%, to \$904.3 million in fiscal 2017 from \$778.5 million in fiscal 2016. The increase in selling, general and administrative expenses was primarily due to:

- an increase in costs related to our operating channels of \$91.4 million, comprised of:
  - an increase in employee costs of \$32.8 million primarily from a growth in labor hours and benefits, mainly associated with new company-operated stores and other new operating locations;
  - an increase in variable costs such as distribution costs and credit card fees of \$16.4 million primarily as a result of increased net revenue; and
  - an increase in other costs of \$42.2 million primarily due to an increase in digital marketing expenses, website related costs including photography costs, brand and community costs, information technology related costs, and other costs associated with our operating locations;
- an increase in head office costs of \$50.0 million, comprised of:
  - an increase in employee costs of \$19.3 million primarily due to additional employees to support the growth in our business; and
  - an increase in other costs of \$30.7 million primarily due to increases in information technology related costs, brand and community costs, and professional fees.

The increase in selling, general, and administrative expenses was partially offset by an increase in net foreign exchange and derivative gains of \$15.6 million. There were net foreign exchange and derivative gains of \$7.3 million in fiscal 2017 compared to net foreign exchange losses of \$8.3 million in fiscal 2016. The net foreign exchange gains and losses primarily relate to the revaluation of U.S. dollar denominated monetary assets and liabilities held by Canadian subsidiaries. During fiscal 2017, we began entering into forward currency contracts designed to economically hedge these foreign exchange revaluation gains and losses. We have not applied hedge accounting to these instruments and the change in fair value of these derivatives is recorded within selling, general and administrative expenses.

As a percentage of net revenue, selling, general and administrative expenses increased 90 basis points, to 34.1% in fiscal 2017 from 33.2% in fiscal 2016.

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

As a result of the restructuring of our ivivva operations, we recognized asset impairment and restructuring costs of \$38.5 million in fiscal 2017. This includes lease termination costs of \$21.1 million, long-lived asset impairment charges of \$11.6 million, employee related costs of \$4.2 million, and other restructuring costs of \$1.6 million. We did not have any asset impairment and restructuring costs in fiscal 2016. Please refer to Note 13 to the audited consolidated financial statements included in Item 8 of Part II of this report for further information on these adjustments.

### ***Income from Operations***

Income from operations increased \$34.8 million, or 8%, to \$456.0 million in fiscal 2017 from \$421.2 million in fiscal 2016. Operating margin decreased 80 basis points to 17.2% compared to 18.0% in fiscal 2016.

In connection with the restructuring of our ivivva operations, we recognized pre-tax costs totaling \$47.2 million in fiscal 2017. This includes asset impairment and restructuring costs of \$38.5 million and costs recognized in cost of goods sold totaling \$8.7 million. Excluding these charges, adjusted income from operations increased 19% to \$503.2 million and adjusted operating margin increased 100 basis points to 19.0%.

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

Income from operations before general corporate expenses and restructuring related costs for fiscal 2017 and fiscal 2016 is summarized below and is expressed in dollar amounts. The percentages are presented as a percentage of net revenue of the respective operating segments.

	Fiscal Years Ended January 28, 2018 and January 29, 2017			
	2017		2016	
	(In thousands)		(Percentages)	
Company-operated stores . . . . .	\$ 464,321	\$ 415,635	25.3%	24.4%
Direct to consumer . . . . .	231,295	186,178	40.0	41.1
Other . . . . .	35,580	22,312	15.2	11.9
Income from operations before general corporate expenses . . .	731,196	624,125		
General corporate expenses . . . . .	227,972	202,973		
Restructuring and related costs . . . . .	47,223	—		
Income from operations . . . . .	\$ 456,001	\$ 421,152		

**Company-Operated Stores.** Income from operations from our company-operated stores segment increased \$48.7 million, or 12%, to \$464.3 million for fiscal 2017 from \$415.6 million for fiscal 2016. The increase was primarily the result of an increase in gross profit of \$89.4 million, which was primarily due to increased net revenue and higher gross margin. The increase in gross profit was partially offset by an increase in selling, general and administrative expenses, including increased store employee costs, increased brand and community costs, and increased operating expenses associated with higher net revenues and new stores. Income from operations as a percentage of company-operated stores net revenue increased by 90 basis points primarily due to increased gross margin, partially offset by deleverage of selling, general and administrative expenses.

**Direct to Consumer.** Income from operations from our direct to consumer segment increased \$45.1 million, or 24%, to \$231.3 million in fiscal 2017 from \$186.2 million in fiscal 2016. The increase was primarily the result of an increase in gross profit of \$88.7 million, which was primarily due to increased net revenue and higher gross margin. The increase in gross profit was partially offset by an increase in selling, general and administrative expenses including higher digital marketing expenses, website related costs, and higher variable costs such as packaging, distribution and credit card fees as a result of higher net revenue. Income from operations as a percentage of direct to consumer net revenue has decreased by 110 basis points primarily due to deleverage of selling, general and administrative expenses, partially offset by an increase in gross margin.

**Other.** Income from operations from our other segment increased \$13.3 million, or 59%, to \$35.6 million in fiscal 2017 from \$22.3 million in fiscal 2016. The increase was primarily the result of increased gross profit of \$29.8 million, which was primarily due to increased net revenue and higher gross margin. The increase in gross profit was partially offset by an increase in selling, general and administrative expenses, including increased employee costs, increased brand and community costs, and increased operating expenses associated with new locations and higher net revenues. Income from operations as a percentage of other net revenue increased 330 basis points primarily due to an increase in gross margin partially offset by deleverage of selling, general and administrative expenses as a percentage of other net revenue.

**General Corporate Expenses.** General corporate expenses increased \$25.0 million, or 12%, to \$228.0 million in fiscal 2017 from \$203.0 million in fiscal 2016. This increase was primarily due to increased head office employee costs, a global brand campaign, increases in other brand and community costs, professional fees, depreciation, and information technology related costs. These increases were partially offset by an increase in net foreign exchange and derivative gains of \$15.6 million. There were net foreign exchange and derivative gains of \$7.3 million in fiscal 2017 compared to net foreign exchange losses of \$8.3 million in fiscal 2016. We expect general corporate expenses to continue to increase in future years as we grow our overall business and require increased efforts at our head office to support our company-operated stores, direct to consumer and other segments.

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

There was net other income of \$4.0 million in fiscal 2017 compared to \$1.6 million in fiscal 2016. The increase was primarily due to increased net interest income in fiscal 2017 compared to fiscal 2016. The increase in net interest income was primarily due to a net interest expense of \$1.7 million which was recorded in fiscal 2016 in relation to certain tax adjustments that are outlined in Note 14 to the audited consolidated financial statements included in Item 8 of Part II of this report, as well as interest earned on our increased cash and cash equivalents in fiscal 2017 compared to fiscal 2016.

**Income Tax Expense**

Income tax expense increased \$82.0 million, or 69%, to \$201.3 million in fiscal 2017 from \$119.3 million in fiscal 2016.

In fiscal 2017 we recorded certain discrete tax adjustments which resulted in a net \$46.6 million increase in income tax expense. These adjustments related to the U.S. Tax Cuts and Jobs Act and to the ivivva restructuring. In fiscal 2016 we recorded certain separate tax adjustments related to the Company's transfer pricing arrangements between Canada and the U.S. The adjustments in fiscal 2016 resulted in an income tax recovery of \$10.7 million.

On December 22, 2017, legislation commonly referred to as the U.S. Tax Cuts and Jobs Act ("U.S. tax reform") was enacted. The U.S. tax reform made significant changes to corporate income tax in the United States, including reducing the federal income tax rate from 35% to 21% and imposing a mandatory transition tax on accumulated foreign subsidiary earnings which have not previously been subject to U.S. income tax. As a result of these tax legislation changes we have recognized a provisional income tax expense of \$58.9 million for the mandatory transition tax and we have remeasured our deferred income assets and liabilities, resulting in a provisional deferred income tax expense of \$0.4 million. In fiscal 2017 we also recognized an income tax recovery of \$12.7 million related to the tax effect of the costs recognized in connection with the ivivva restructuring.

In fiscal 2016 we recognized an income tax recovery of \$10.7 million as a result of the finalization of an Advance Pricing Arrangement with the Internal Revenue Service and the Canada Revenue Agency. This agreement determines the amount of income which is taxable in each respective jurisdiction, and the final terms of the arrangement resulted in an increased amount of income tax recoverable in the United States.

Further information on the adjustments recognized in both fiscal 2017 and fiscal 2016 is outlined in Notes 13 and 14 to the audited consolidated financial statements included in Item 8 of Part II of this report.

Our effective tax rate for fiscal 2017 was 43.8% compared to 28.2% for fiscal 2016. Our effective tax rate excluding the above tax and related interest adjustments was 30.5% for fiscal 2017 compared to 30.7% for fiscal 2016. The decrease in our adjusted effective tax rate was primarily due to the lower U.S. federal income tax rate which was effective January 1, 2018, a decrease in state taxes, and certain other adjustments.

**Net Income**

Net income decreased \$44.7 million, or 15%, to \$258.7 million in fiscal 2017 from \$303.4 million in fiscal 2016. The decrease in net income in fiscal 2017 was primarily due to an increase of \$125.8 million in selling, general and administrative expenses, an increase of \$82.0 million in income tax expense, and asset impairment and restructuring costs of \$38.5 million recognized in fiscal 2017, partially offset by a \$199.2 million increase in gross profit and an increase in other income (expense), net of \$2.4 million.

**Comparison of Fiscal 2016 to Fiscal 2015****Net Revenue**

Net revenue increased \$283.9 million, or 14%, to \$2.3 billion in fiscal 2016 from \$2.1 billion in fiscal 2015. On a constant dollar basis, assuming the average exchange rates in fiscal 2016 remained constant with the average exchange rates in fiscal 2015, net revenue increased \$292.9 million, or 14%.

Net revenue increased across all segments. The increase in net revenue was primarily due to the addition of 43 net new company-operated stores during fiscal 2016, as well as increased comparable store sales and the growth of our direct to consumer segment. Total comparable sales, which includes comparable store sales and direct to consumer, increased 6% in fiscal 2016 compared to fiscal 2015. Total comparable sales increased 7% on a constant dollar basis.

Our net revenue on a segment basis for fiscal 2016 and fiscal 2015 is summarized below. Net revenue is expressed in dollar amounts. The percentages are presented as a percentage of total net revenue.

	Fiscal Years Ended January 29, 2017 and January 31, 2016			
	2016	2015	2016	2015
	<i>(In thousands)</i>		<i>(Percentages)</i>	
Company-operated stores . . . . .	\$ 1,704,357	\$ 1,516,323	72.7%	73.6%
Direct to consumer . . . . .	453,287	401,525	19.3	19.5
Other . . . . .	186,748	142,675	8.0	6.9
Net revenue . . . . .	<u>\$ 2,344,392</u>	<u>\$ 2,060,523</u>	<u>100.0%</u>	<u>100.0%</u>

*Company-Operated Stores.* Net revenue from our company-operated stores segment increased \$188.0 million, or 12%, to \$1.7 billion in fiscal 2016 from \$1.5 billion in fiscal 2015. 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 January 31, 2016, and therefore not included in comparable store sales, contributed \$126.7 million to the increase. During fiscal 2016 we opened 43 net new company-operated stores, including 31 stores in North America, eight stores in Asia Pacific, and four stores in Europe.
- A comparable store sales increase of 4% in fiscal 2016 compared to fiscal 2015 resulted in a \$61.3 million increase to net revenue. Comparable store sales increased 5%, or \$66.4 million on a constant dollar basis. The increase in comparable store sales was primarily as a result of increased dollar value per transaction and improved conversion rates.

*Direct to Consumer.* Net revenue from our direct to consumer segment increased \$51.8 million, or 13%, to \$453.3 million in fiscal 2016 from \$401.5 million in fiscal 2015. Direct to consumer net revenue increased 13% on a constant dollar basis. The increase in net revenue from our direct to consumer segment was primarily the result of increased traffic on our e-commerce websites, increased dollar value per transaction and improved conversion rates.

*Other.* Net revenue from our other segment increased \$44.1 million, or 31%, to \$186.7 million in fiscal 2016 from \$142.7 million in fiscal 2015. This increase was primarily the result of an increased number of outlets which were open for the full year in fiscal 2016, increased net revenue at other existing outlets, and an increase in the number of temporary locations.

### **Gross Profit**

Gross profit increased \$202.5 million, or 20%, to \$1.2 billion in fiscal 2016 from \$997.2 million in fiscal 2015.

Gross profit as a percentage of net revenue, or gross margin, increased 280 basis points, to 51.2% in fiscal 2016 from 48.4% in fiscal 2015. The increase in gross margin was primarily the result of an increase in product margin of 330 basis points, primarily due to lower product costs, improved average retail prices, and lower costs related to our raw material commitments.

The increase in gross margin was partially offset by an increase in expenses related to our product and supply chain departments of 20 basis points, an increase in occupancy costs and depreciation of 20 basis points, and an unfavorable impact of foreign exchange rates of 10 basis points.

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

Selling, general and administrative expenses increased \$150.4 million, or 24%, to \$778.5 million in fiscal 2016 from \$628.1 million in fiscal 2015. The increase in selling, general and administrative expenses was principally comprised of:

- an increase in employee costs for our operating locations of \$47.0 million, primarily from a growth in labor hours and bonuses, mainly associated with new company-operated stores;
- an increase in head office employee costs of \$35.4 million to support the growth in our business;
- an increase in head office costs other than employee costs of \$21.2 million primarily as a result of increased brand and community costs, increased depreciation, and increased information technology costs;
- an increase in net foreign exchange losses of \$20.3 million, primarily related to the revaluation of U.S. dollar cash and receivables held in Canadian subsidiaries. There were net foreign exchange losses of \$8.3 million in fiscal 2016 compared to net foreign exchange gains of \$12.0 million in fiscal 2015;
- an increase in other costs of \$18.5 million for our operating channels such as digital marketing expenses, repairs and maintenance costs, and increased depreciation; and
- an increase in variable costs such as credit card fees and distribution costs of \$8.1 million primarily as a result of increased sales.

As a percentage of net revenue, selling, general and administrative expenses increased 270 basis points, to 33.2% in fiscal 2016 from 30.5% in fiscal 2015.

**Income from Operations**

Income from operations increased \$52.1 million, or 14%, to \$421.2 million in fiscal 2016 from \$369.1 million in fiscal 2015. The increase was a result of increased gross profit of \$202.5 million, partially offset by increased selling, general and administrative costs of \$150.4 million.

On a segment basis, we determine income from operations without taking into account our general corporate expenses.

Income from operations before general corporate expenses for fiscal 2016 and fiscal 2015 is summarized below and is expressed in dollar amounts. The percentages are presented as a percentage of net revenue of the respective operating segments.

	Fiscal Years Ended January 29, 2017 and January 31, 2016			
	2016		2015	
	<i>(In thousands)</i>		<i>(Percentages)</i>	
Company-operated stores . . . . .	\$ 415,635	\$ 346,802	24.4%	22.9%
Direct to consumer . . . . .	186,178	166,418	41.1	41.4
Other . . . . .	22,312	5,826	11.9	4.1
Income from operations before general corporate expenses . . .	624,125	519,046		
General corporate expenses . . . . .	202,973	149,970		
Income from operations . . . . .	<u>\$ 421,152</u>	<u>\$ 369,076</u>		

*Company-Operated Stores.* Income from operations from our company-operated stores segment increased \$68.8 million, or 20%, to \$415.6 million for fiscal 2016 from \$346.8 million for fiscal 2015. The increase was primarily the result of an increase in gross profit of \$132.8 million, which was primarily due to increased net revenue and higher gross margin. Net revenue increased as a result of new stores as well as increased comparable store sales, which was primarily a result of increased dollar value per transaction and improved conversion rates. This was partially offset by an increase in selling, general and administrative expenses, including increased store employee costs and increased operating expenses associated with new stores and increased net revenue at existing stores. Income from operations as a percentage of company-operated stores net revenue increased by 150 basis points primarily due to increased gross margin, partially offset by deleverage of selling, general and administrative expenses.

*Direct to Consumer.* Income from operations from our direct to consumer segment increased \$19.8 million, or 12%, to \$186.2 million in fiscal 2016 from \$166.4 million in fiscal 2015. The increase was primarily the result of increased gross profit of \$43.2 million primarily due to increased net revenue resulting from an increase in traffic on our e-commerce websites, increased dollar value per transaction, and improved conversion rates. This was partially offset by an increase in selling, general and administrative expenses including higher digital marketing expenses and higher variable costs such as distribution costs and credit card fees as a result of increased net revenue. Income from operations as a percentage of direct to consumer net revenue has decreased by 30 basis points primarily due to deleverage of selling, general and administrative expenses, partially offset by an increase in gross margin.

*Other.* Income from operations from our other segment increased \$16.5 million, or 283%, to \$22.3 million in fiscal 2016 from \$5.8 million in fiscal 2015. The increase was primarily the result of increased gross profit of \$26.4 million, partially offset by increased selling, general and administrative expenses primarily due to increased employee costs. Income from operations as a percentage of other net revenue increased by 780 basis points primarily due to an increase in gross margin and decreased selling, general and administrative expenses as a percentage of other net revenue.

*General Corporate Expenses.* General corporate expenses increased \$53.0 million, or 35%, to \$203.0 million in fiscal 2016 from \$150.0 million in fiscal 2015. This increase was primarily due to increased head office employee costs, brand and community costs, depreciation, and information technology costs. There was also a \$20.3 million increase in foreign exchange losses. We expect general corporate expenses to continue to increase in future years as we grow our overall business and require increased efforts at our head office to support our company-operated stores, direct to consumer and other segments.

**Other Income (Expense), Net**

There was net other income of \$1.6 million in fiscal 2016 compared to net other expense of \$0.6 million in fiscal 2015. This was primarily the result of a \$1.8 million reduction in net interest expense related to certain tax adjustments that are outlined in Note 14 to the audited consolidated financial statements included in Item 8 of Part II of this report, as well as interest earned on our increased cash and cash equivalents in fiscal 2016 compared to fiscal 2015.

### ***Income Tax Expense***

Income tax expense increased \$16.9 million, or 16%, to \$119.3 million in fiscal 2016 from \$102.4 million in fiscal 2015. Fiscal 2016 and fiscal 2015 included certain tax adjustments which resulted in net income tax recoveries of \$10.7 million and \$7.4 million, respectively, as outlined in Note 14 to the audited consolidated financial statements included in Item 8 of Part II of this report.

Our effective tax rate for fiscal 2016 was 28.2% compared to 27.8% for fiscal 2015. Our effective tax rate excluding the above tax and related interest adjustments was 30.7% for fiscal 2016 compared to 29.5% for fiscal 2015.

### ***Net Income***

Net income increased \$37.4 million, or 14%, to \$303.4 million in fiscal 2016 from \$266.0 million in fiscal 2015. The increase in net income in fiscal 2016 was primarily due to a \$202.5 million increase in gross profit and an increase in other income (expense), net of \$2.2 million, partially offset by an increase of \$150.4 million in selling, general and administrative expenses and an increase of \$16.9 million in income tax expense.

### **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. We are evolving towards an omni-channel approach to support the shopping behavior of our guests. This involves country and region specific websites, mobile apps, including mobile apps on in-store devices that allow demand to be fulfilled via our distribution centers, social media, product notification emails, and online order fulfillment through stores. We therefore believe that reporting total comparable sales with comparable store sales and direct to consumer sales combined provides a relevant performance metric.

Various factors affect comparable sales, including:

- the location of new stores relative to existing stores;
- consumer preferences, buying trends, and overall economic trends;
- our ability to anticipate and respond effectively to customer preferences for technical athletic apparel;
- competition;
- changes in our merchandise mix;
- pricing;
- the timing of our releases of new merchandise and promotional events;
- the effectiveness of our marketing efforts;
- the design and ease of use of our websites and mobile apps;
- the level of customer service that we provide in our stores and on our websites and mobile apps;
- our ability to source and distribute products efficiently; and
- the number of stores we open, close (including for temporary renovations), and expand in any period.

Opening new stores is an important part of our growth strategy. Accordingly, total comparable sales has limited utility for assessing the success of our growth strategy insofar as comparable sales do not reflect the performance of stores open less than 12 months. 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, the amounts recognized in connection with the U.S. tax reform, and certain discrete items related to our transfer pricing arrangements and taxes on repatriation of foreign earnings. We believe these adjusted financial measures are useful to investors as the adjustments do not directly relate to our ongoing business operations and therefore do not contribute to a meaningful evaluation of the trend in our operating performance. Furthermore, we do not believe the adjustments are reflective of our expectations of our future operating performance and believe these non-GAAP measures are useful to investors because of their comparability to our historical information.

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

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

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

	Fiscal Year Ended January 28, 2018		Fiscal Year Ended January 29, 2017	
	(In thousands)	(Percentages)	(In thousands)	(Percentages)
Change in net revenue . . . . .	\$ 304,789	13%	\$ 283,869	14%
Adjustments due to foreign exchange rate changes . . . . .	(14,221)	(1)	8,983	—
Change in net revenue in constant dollars . . . . .	<u>\$ 290,568</u>	<u>12%</u>	<u>\$ 292,852</u>	<u>14%</u>

	Fiscal Year Ended	
	January 28, 2018	January 29, 2017
Change in total comparable sales <sup>(1),(2)</sup> . . . . .	7%	6%
Adjustments due to foreign exchange rate changes . . . . .	—	1
Change in total comparable sales in constant dollars <sup>(1),(2)</sup> . . . . .	<u>7%</u>	<u>7%</u>

	Fiscal Year Ended January 28, 2018		Fiscal Year Ended January 29, 2017	
	(In thousands)	(Percentages)	(In thousands)	(Percentages)
Change in comparable store sales <sup>(2)</sup> . . . . .	\$ 12,820	1%	\$ 61,341	4%
Adjustments due to foreign exchange rate changes . . . . .	(7,395)	—	5,036	1
Change in comparable store sales in constant dollars <sup>(2)</sup> . . . . .	<u>\$ 5,425</u>	<u>1%</u>	<u>\$ 66,377</u>	<u>5%</u>

	Fiscal Year Ended	
	January 28, 2018	January 29, 2017
Change in direct to consumer net revenue . . . . .	27%	13%
Adjustments due to foreign exchange rate changes . . . . .	—	—
Change in direct to consumer net revenue in constant dollars . . . . .	<u>27%</u>	<u>13%</u>

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

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

**Adjusted financial measures**

The following tables reconcile 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, the amounts recognized in connection with the U.S. tax reform, and certain discrete items related to our transfer pricing arrangements and taxes on repatriation of foreign earnings. Please refer to Notes 13 and 14 to the audited consolidated financial statements included in Item 8 of Part II of this report for further information on these adjustments.

	<b>Fiscal Year Ended January 28, 2018</b>			
	<b>Adjustments</b>			<b>Adjusted Results (Non-GAAP)</b>
	<b>GAAP Results</b>	<b>Restructuring of ivivva Operations</b>	<b>U.S. Tax Reform</b>	
	<i>(In thousands, except per share amounts)</i>			
Gross profit	\$ 1,398,790	\$ 8,698	\$ —	\$ 1,407,488
Gross margin	52.8%	0.3 %	— %	53.1%
Income from operations	456,001	47,223	—	503,224
Operating margin	17.2%	1.8 %	— %	19.0%
Income before income tax expense	459,998	47,223	—	507,221
Income tax expense	201,336	12,741	(59,294)	154,783
Effective tax rate	43.8%	(0.4)%	(12.9)%	30.5%
Diluted earnings per share	\$ 1.90	\$ 0.25	\$ 0.44	\$ 2.59

	<b>Fiscal Year Ended January 29, 2017</b>		
	<b>GAAP Results</b>	<b>Transfer Pricing and Repatriation Tax Adjustments</b>	<b>Adjusted Results (Non-GAAP)</b>
		<i>(In thousands, except per share amounts)</i>	
Income before income tax expense	\$ 422,729	\$ 1,695	\$ 424,424
Income tax expense	119,348	10,744	130,092
Effective tax rate	28.2%	2.5%	30.7%
Diluted earnings per share	\$ 2.21	\$ (0.07)	\$ 2.14

	<b>Fiscal Year Ended January 31, 2016</b>		
	<b>GAAP Results</b>	<b>Transfer Pricing and Repatriation Tax Adjustments</b>	<b>Adjusted Results (Non-GAAP)</b>
		<i>(In thousands, except per share amounts)</i>	
Income before income tax expense	\$ 368,495	\$ 3,467	\$ 371,962
Income tax expense	102,448	7,443	109,891
Effective tax rate	27.8%	1.7%	29.5%
Diluted earnings per share	\$ 1.89	\$ (0.03)	\$ 1.86

**Liquidity and Capital Resources**

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

As of January 28, 2018, our working capital (excluding cash and cash equivalents) was \$153.2 million, our cash and cash equivalents were \$990.5 million and our capacity under our revolving credit facility was \$148.8 million.

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

	Fiscal Year Ended		
	January 28, 2018	January 29, 2017	January 31, 2016
	<i>(In thousands)</i>		
Total cash provided by (used in):			
Operating activities	\$ 489,337	\$ 386,392	\$ 297,538
Investing activities	(173,392)	(149,511)	(143,487)
Financing activities	(97,862)	(26,611)	(272,491)
Effect of exchange rate changes on cash	37,572	23,094	(44,557)
Increase (decrease) in cash and cash equivalents	<u>\$ 255,655</u>	<u>\$ 233,364</u>	<u>\$ (162,997)</u>

### ***Operating Activities***

Cash flows provided by operating activities consist primarily of net income adjusted for certain items including depreciation and amortization, asset impairments costs relating to the restructuring of our ivivva operations, stock-based compensation expense, and the effect of changes in operating assets and liabilities.

Net cash provided by operating activities increased \$102.9 million in fiscal 2017 compared to fiscal 2016, primarily as a result of the following:

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

- an increase of \$104.0 million in the change in operating assets and liabilities, primarily due to the following:
  - \$62.5 million related to income taxes, primarily due to income taxes payable in relation to the U.S. tax reform;
  - \$31.8 million related to other accrued and non-current liabilities, primarily due to changes in accrued operating expenses, forward currency contract liabilities, and tenant inducements.

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

- a decrease of \$44.7 million in net income, partially offset by an increase of \$43.6 million in non-cash expenses primarily related to asset impairment costs related to the restructuring of our ivivva operations, and an increase in depreciation.

In fiscal 2016, cash provided by operating activities increased \$88.9 million, to \$386.4 million compared to cash provided by operating activities of \$297.5 million in fiscal 2015. The increase was primarily a result of a decrease in inventory purchases, a decrease in the change in prepaid and receivable income taxes, and an increase in net income. This was partially offset by a decrease in the change in income taxes payable, deferred income taxes, and accrued inventory liabilities. Inventory purchases decreased during fiscal 2016 primarily as a result of actions taken to align inventory levels with forward sales trends.

### ***Investing Activities***

Cash flows used in investing activities relate to capital expenditures, the settlement of net investment hedges, and other investing activities. Cash used in investing activities increased \$23.9 million, to \$173.4 million in fiscal 2017 from \$149.5 million in fiscal 2016. Cash used in investing activities increased \$6.0 million, to \$149.5 million in fiscal 2016 from \$143.5 million in fiscal 2015.

Capital expenditures for our company-operated stores segment were \$80.2 million, \$75.3 million, \$85.8 million in fiscal 2017, fiscal 2016, and fiscal 2015, respectively. The capital expenditures for our company-operated stores segment in each period were primarily for the remodeling or relocation of certain stores, and ongoing store refurbishment. The capital expenditures for our company-operated stores segment also included \$29.3 million to open 49 company-operated stores, \$30.6 million to open 46 company-operated stores, and \$49.2 million to open 62 new company-operated stores, in fiscal 2017, fiscal 2016, and fiscal 2015, respectively.

Capital expenditures for our direct to consumer segment were \$19.9 million, \$11.5 million, and \$8.3 million in fiscal 2017, fiscal 2016, and fiscal 2015, respectively. The capital expenditures for our direct to consumer segment were primarily related to our global and region specific websites as well as mobile apps.

Capital expenditures related to corporate activities and other were \$57.7 million, \$62.7 million, and \$49.4 million in fiscal 2017, fiscal 2016, and fiscal 2015, respectively. The capital expenditures in each fiscal year were primarily related to investments in information technology and business systems, improvements at our head office and other corporate buildings, and for capital expenditures related to opening retail locations other than company-operated stores.

In fiscal 2017 we redeveloped and relaunched our enhanced website. We also undertook various information technology infrastructure and corporate system initiatives and continued with the development of our new enterprise resource planning system that will help improve our merchandising, costing, allocation, and inventory platforms.

The increase in corporate capital expenditures in fiscal 2016 compared to fiscal 2015 was primarily related to a parcel of land that we purchased in Vancouver, BC for general corporate purposes for \$19.7 million.

Capital expenditures are expected to range between \$240 million and \$250 million in fiscal 2018.

### ***Financing Activities***

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

Cash used in financing activities increased \$71.3 million, to \$97.9 million in fiscal 2017 from \$26.6 million in fiscal 2016. Cash used in financing activities decreased \$245.9 million, to \$26.6 million in fiscal 2016 from \$272.5 million in fiscal 2015. The primary cause of these changes in cash used in financing activities was our stock repurchase programs.

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

During the fiscal years ended January 28, 2018, January 29, 2017, and January 31, 2016, 1.9 million, 0.5 million, and 5.0 million shares, respectively, were repurchased under the programs at a total cost of \$100.3 million, \$29.3 million, and \$274.2 million, respectively. 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 1A. Risk Factors". 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 January 28, 2018, aside from letters of credit of \$1.2 million, we had no other borrowings outstanding under this credit facility.

### Contractual Obligations and Commitments

*Leases.* We lease certain store and other retail locations, distribution centers, offices, and equipment under non-cancelable operating leases. Our leases generally have initial terms of between five and 10 years, and generally can be extended in five-year increments, if at all. A substantial number of our leases include renewal options and certain of our leases include rent escalation clauses, rent holidays and leasehold rental incentives, none of which are reflected in the table below. The majority of our leases for store premises also include contingent rental payments based on sales, the impact of which also are not reflected in the table below.

*Product purchase obligations.* The amounts listed for product purchase obligations in the table below represent agreements (including open purchase orders) to purchase products in the ordinary course of business that are enforceable and legally binding and that specify all significant terms. In some cases, prices are subject to change throughout the production process. The reported amounts exclude product purchase liabilities included in accounts payable and accrued inventory liabilities as of January 28, 2018.

*One-time transition tax.* As outlined in Note 14 to our audited consolidated financial statements included in Item 8 of Part II of this report, the U.S. tax reform imposed a mandatory transition tax on accumulated foreign subsidiary earnings which have not previously been subject to U.S. income tax. The one-time transition tax is payable over eight years. We recognized a provisional income tax expense of \$58.9 million in fiscal 2017 for the mandatory transition tax. The one-time transition tax payable is net of foreign tax credits, and the table below outlines the expected payments due by fiscal year.

The following table summarizes our contractual arrangements as of January 28, 2018, and the timing and effect that such commitments are expected to have on our liquidity and cash flows in future periods:

	Payments Due by Fiscal Year						Thereafter
	Total	2018	2019	2020	2021	2022	
	<i>(In thousands)</i>						
Operating leases (minimum rent) . . .	\$ 611,817	\$ 143,428	\$ 127,641	\$ 105,720	\$ 81,595	\$ 59,058	\$ 94,375
Product purchase obligations . . . . .	159,679	159,679	—	—	—	—	—
One-time transition tax payable . . . .	56,969	8,701	4,197	4,197	4,197	4,197	31,480

### Off-Balance Sheet Arrangements

We enter into standby letters of credit to secure certain of our obligations, including leases, taxes and duties. As of January 28, 2018, letters of credit totaling \$1.2 million had been issued.

We have not entered into any transactions, agreements or other contractual arrangements to which an entity unconsolidated with us is a party and under which we have (i) any obligation under a guarantee, (ii) any retained or contingent interest in assets transferred to an unconsolidated entity that serves as credit, liquidity or market risk support to such entity, (iii) any obligation under derivative instruments that are indexed to our shares and classified as equity in our consolidated balance sheets, or (iv) any obligation arising out of a variable interest in any unconsolidated entity that provides financing, liquidity, market risk or credit support to us or engages in leasing, hedging or research and development services with us.

## Critical Accounting Policies and Estimates

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions. Predicting future events is inherently an imprecise activity and, as such, requires the use of judgment. Actual results may vary from our estimates in amounts that may be material to the financial statements. An accounting policy is deemed to be critical if it requires an accounting estimate to be made based on assumptions about matters that are highly uncertain at the time the estimate is made, and if different estimates that reasonably could have been used or changes in the accounting estimates that are reasonably likely to occur periodically, could materially impact our consolidated financial statements.

We believe that the following critical accounting policies affect our more significant estimates and judgments used in the preparation of our consolidated financial statements:

*Revenue Recognition.* Net revenue is recognized net of sales taxes, discounts, and an estimated allowance for sales returns. Sales to customers through company-operated stores and other retail locations are recognized at the point of sale, net of an estimated allowance for sales returns. Direct to consumer sales are recognized once delivery has occurred and collection is reasonably assured, net of an estimated allowance for sales returns. Other net revenue includes outlet sales, sales from temporary locations, sales to wholesale accounts, showroom sales, warehouse sales, and license and supply arrangement net revenue, which consists of royalties as well as sales of our product to licensees. Revenue is recognized when these sales occur. Employee discounts are classified as a reduction of net revenue.

Our estimated allowance for sales returns is a subjective critical estimate that has a direct impact on reported net revenue. This allowance is calculated based on a history of actual returns, estimated future returns and any significant future known or anticipated events. Consideration of these factors results in an estimated allowance for sales returns. Our standard terms for retail sales limit returns to approximately 30 days after the sale of the merchandise, however we accept returns after 30 days where the product fails to meet our guests' quality expectations.

Revenue from our gift cards is recognized when tendered for payment. Outstanding customer balances are included in "Unredeemed gift card liability" on the consolidated balance sheets. There are no expiration dates on our gift cards, and we do not charge any service fees that cause a decrement to customer balances.

While we will continue to honor all gift cards presented for payment, we may determine the likelihood of redemption to be remote for certain card balances due to, among other things, long periods of inactivity. In these circumstances, to the extent we determine there is no requirement for remitting card balances to government agencies under unclaimed property laws, the portion of card balances not expected to be redeemed are recognized in net revenue in proportion to the gift cards which have been redeemed.

*Inventory.* Inventory is valued at the lower of cost and net realizable value. We periodically review our inventories and make provisions as necessary to appropriately value goods that are obsolete, have quality issues, or are damaged. The amount of the provision is equal to the difference between the cost of the inventory and its net realizable value based upon assumptions about future demand, selling prices, and market conditions. If changes in market conditions result in reductions in the estimated net realizable value of our inventory below our previous estimate, we would increase our reserve in the period in which we made such a determination. In addition, we provide for inventory shrinkage as a percentage of sales, based on historical trends from actual physical inventories. Inventory shrinkage estimates are made to reduce the inventory value for lost or stolen items. We perform physical inventory counts and cycle counts throughout the year and adjust the shrink provision accordingly.

*Property and Equipment.* Property and equipment are recorded at cost less accumulated depreciation. Buildings are depreciated on a straight-line basis over the expected useful life of the asset, which is individually assessed, and estimated to be up to 20 years. Leasehold improvements are depreciated on a straight-line basis over the lesser of the length of the lease and the estimated useful life of the assets, up to a maximum of five years. All other property and equipment is depreciated using the declining balance method as follows:

Furniture and fixtures . . . . .	20%
Computer hardware and software . . . . .	20% - 30%
Equipment and vehicles . . . . .	30%

Changes in circumstances, such as technological advances, can result in differences between the actual and estimated useful lives. In those cases where we determine that the useful life of a long-lived asset should be shortened, we increase depreciation expense over the remaining useful life to depreciate the asset's net book value to its estimated salvage value.

*Long-Lived Assets.* Long-lived assets, including intangible assets with finite useful lives are evaluated for impairment when the occurrence of events or changes in circumstances indicates that the carrying value of the assets may not be recoverable as measured by comparing their net book value to the undiscounted estimated future cash flows generated by their use and eventual disposition. Impaired assets are recorded at fair value, determined principally by the present value of the estimated future cash flows expected from their use and eventual disposition.

*Income Taxes.* The U.S. tax reform enacted on December 22, 2017 introduces significant changes to the U.S. income tax laws. The accounting for the income tax effects of the U.S. tax reform is complex and requires significant judgement and estimates in the interpretation and calculations of its provisions.

We have recognized a provisional amount of \$59.3 million in income tax expense in fiscal 2017 in relation to the U.S. tax reform. This includes a provisional current income tax expense of \$58.9 million for the mandatory one-time transition tax on the deemed repatriation of accumulated undistributed earnings of foreign subsidiaries, and a provisional deferred income tax expense of \$0.4 million to reflect the reduced U.S. tax rate and other effects of the U.S. tax reform.

Further analysis will be required with respect to the method of computation and components of the foreign subsidiaries' earnings and profits, the definition of foreign cash positions, the computation and limitation of the use of foreign tax credits, the conformity of each state to the U.S. federal income tax laws on the mandatory deemed repatriation income inclusion for state income tax purposes, the impact that the U.S. tax reform has, if any, upon our reinvestment plans for the accumulated earnings of the Company's foreign subsidiaries, and the amount of tax that would apply in the event of any change in our reinvestment plans. We may make adjustments to the provisional amounts and those adjustments may materially impact our provision for income taxes and effective income tax rates in the period in which the adjustments are made, and in future periods.

Deferred income tax assets and liabilities are determined based on the temporary differences between the carrying amounts and the tax basis of assets and liabilities, and for tax losses, tax credit carryforwards, and other tax attributes, using the enacted tax rates that are to be in effect when these differences are expected to reverse. Our deferred income tax balances and income tax rates are significantly affected by the tax rates on our global operations and the extent to which the undistributed earnings of our foreign subsidiaries are indefinitely reinvested outside the U.S. Deferred income tax liabilities are recognized for U.S. federal and state income taxes and foreign withholding taxes on the undistributed earnings of foreign subsidiaries, unless those earnings are indefinitely reinvested outside of the U.S. Indefinite reinvestment is determined by management's judgment about, and intentions concerning, the future operations of the Company.

As of January 28, 2018, we have not changed our indefinite reinvestment plans as a result of the U.S. tax reform. Accordingly, no deferred income tax liabilities have been recognized on any of the undistributed earnings of the Company's foreign subsidiaries. We are continuing to evaluate the impact that the U.S. tax reform has upon the taxes which may become payable upon repatriation, our reinvestment plans, and the most efficient means of deploying our capital resources globally. As this analysis has not yet been completed, it is possible that amounts determined to be indefinitely reinvested outside of the U.S. may ultimately be repatriated, resulting in additional tax liabilities being recognized.

The cumulative undistributed earnings of our foreign subsidiaries as of January 28, 2018 were \$1.24 billion, including \$1.21 billion of accumulated undistributed earnings of a Canadian subsidiary. In the event we determine that all or a portion of such Canadian earnings will no longer be indefinitely reinvested outside of the United States, Canadian withholding taxes of 5% and U.S. state income taxes could apply to some portion of any distribution made. This is in addition to the one-time transition tax that is payable as a result of the U.S. tax reform. The amount of tax that would be payable upon repatriation is dependent on the elections available to us under Canadian withholding tax legislation, the extent to which such withholding tax would be recoverable through U.S. foreign tax credits, and the interaction between state and U.S. federal income tax laws as a result of the U.S. tax reform.

We evaluate our tax filing positions and recognize the largest amount of tax benefit that is considered more likely than not to be sustained upon examination by the relevant taxing authorities based on the technical merits of the position. This determination requires the use of significant judgment. Income tax expense is adjusted in the period in which an uncertain tax position is effectively settled, the statute of limitations expires, facts or circumstances change, tax laws change, or new information becomes available. Our tax positions include intercompany transfer pricing policies and the associated taxable income and deductions arising from intercompany charges between subsidiaries within the consolidated group. Although we believe that our intercompany transfer pricing policies and tax positions are reasonable, the final outcomes of tax audits or potential tax disputes may be materially different from that which is reflected in our income tax provisions and accruals.

*Goodwill and Intangible Assets.* Intangible assets are recorded at cost. Reacquired franchise rights are amortized on a straight-line basis over their estimated useful lives of 10 years. Goodwill represents the excess of the purchase price over the fair market value of identifiable net assets acquired and is not amortized. Goodwill is tested for impairment annually or more frequently when an event or circumstance indicates that goodwill might be impaired. Goodwill impairment testing requires us

to estimate the fair value of our reporting units. We generally base our measurement of the fair value on the present value of future cash flows. Our significant estimates in the discounted cash flows model include the discount rate and long-term rates of growth. We use our best estimates and judgment based on available evidence in conducting the impairment testing.

*Stock-Based Compensation.* We account for stock-based compensation using the fair value method. The fair value of awards granted is estimated at the date of grant and is recognized as employee compensation expense on a straight-line basis over the requisite service period. For awards with service and/or performance conditions, the amount of compensation expense recognized is based on the number of awards that are expected to vest.

The estimation of the number of stock awards that will ultimately vest requires judgment, and to the extent actual results differ from our estimates, such amounts will be recorded as a cumulative adjustment in the period estimates are revised. We consider several factors when estimating the number of awards which are expected to vest, including, future profit forecasts, types of awards, size of option holder group, and anticipated employee retention and estimated expected forfeitures. Actual results may differ substantially from these estimates.

The calculation of the grant-date fair value of stock options requires us to make certain estimates and assumptions, including, stock price volatility, and the expected life of the options. We evaluate and revise these estimates and assumptions as necessary, to reflect market conditions and our historical experience. The expected term of the options is based upon historical experience of similar awards, giving consideration to expectations of future employee behavior. Expected volatility is based upon the historical volatility of our common stock for the period corresponding with the expected term of the options. In the future, the expected volatility and expected term may change which could substantially change the grant-date fair value of future awards of stock options and, ultimately, the expense we record.

*Contingencies.* In the ordinary course of business, we are involved in legal proceedings regarding contractual and employment relationships and a variety of other matters. We record contingent liabilities resulting from claims against us, when a loss is assessed to be probable and the amount of the loss is reasonably estimable. Assessing probability of loss and estimating probable losses requires analysis of multiple factors, including in some cases judgments about the potential actions of third-party claimants and courts.

## **ITEM 7A. 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 January 28, 2018, we had certain forward currency contracts outstanding in order to hedge a portion of the foreign currency exposure that arises on translation of a Canadian subsidiary into U.S. dollars. We also had certain forward currency contracts outstanding in an effort to reduce our exposure to the foreign exchange revaluation gains and losses that are recognized by our Canadian subsidiaries on U.S. dollar denominated monetary assets and liabilities. Please refer to Note 12 to our audited consolidated financial statements included in Item 8 of Part II 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 subsidiaries into U.S. dollars for the purposes of consolidation;
  - an increase in our selling, general and administrative expenses incurred by our Canadian subsidiaries 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
  - 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 fiscal 2017, the change in the relative value of the U.S. dollar against the Canadian dollar resulted in a \$44.4 million reduction in accumulated other comprehensive loss within stockholders' equity. During fiscal 2016, the change in the relative value of the U.S. dollar against the Canadian dollar resulted in a \$41.7 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 fiscal 2017 would have resulted in additional income from operations of approximately \$1.0 million in fiscal 2017. This assumes a consistent 10% depreciation in the U.S. dollar against the Canadian dollar throughout the fiscal year. 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 January 28, 2018, aside from letters of credit of \$1.2 million, we had no other borrowings outstanding under this credit facility. We currently do not engage in any interest rate hedging activity and currently have no intention to do so. However, in the future, if we have a meaningful outstanding balance under our revolving facility, in an effort to mitigate losses associated with these risks, we may at times enter into derivative financial instruments, although we have not historically done so. These may take the form of forward contracts, option contracts, or interest rate swaps. We do not, and do not intend to, engage in the practice of trading derivative securities for profit.

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

*Credit Risk.* We have cash and cash equivalents on deposit with various large, reputable financial institutions. 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 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.