

## **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 2018 Annual Report on Form 10-K filed with the SEC on March 27, 2019.

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 vision to be the experiential brand that ignites a community of people through sweat, grow, and connect, which we call "living the sweatlife." 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 "to elevate the world by unleashing the full potential within every one of us."

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 including athletic activities such as yoga, running, training, and most other sweaty pursuits. We also offer fitness-related accessories.

### ***Financial Highlights***

For the second quarter of fiscal 2019, compared to the second quarter of fiscal 2018:

- Net revenue increased 22% to \$883.4 million. On a constant dollar basis, net revenue increased 23%.
- Total comparable sales, which includes comparable store sales and direct to consumer, increased 15%. On a constant dollar basis, total comparable sales increased 17%.
  - Comparable store sales increased 10%, or increased 11% on a constant dollar basis.

- Direct to consumer net revenue increased 30%, or increased 31% on a constant dollar basis.

Due to the 53rd week in fiscal 2018, comparable sales are calculated on a one week shifted basis such that the 13 weeks and 26 weeks ended August 4, 2019 are compared to the 13 weeks and 26 weeks ended August 5, 2018 rather than July 29, 2018.

- Gross profit increased 23% to \$485.8 million.
- Gross margin increased 20 basis points to 55.0%.
- Income from operations increased 25% to \$168.0 million.
- Operating margin increased 50 basis points to 19.0%.
- Income tax expense increased 12% to \$44.8 million. Our effective tax rate for the second quarter of fiscal 2019 was 26.4% compared to 29.5% for the second quarter of fiscal 2018.
- Diluted earnings per share were \$0.96 compared to \$0.71 in the second quarter of fiscal 2018.

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 the most directly comparable measures calculated in accordance with GAAP.

## Results of Operations

### Second Quarter Results

The following table summarizes key components of our results of operations for the quarters ended August 4, 2019 and July 29, 2018. The percentages are presented as a percentage of net revenue.

|  | Quarter Ended         |                  |                      |               |
|--|-----------------------|------------------|----------------------|---------------|
|  | August 4, 2019        | July 29, 2018    | August 4, 2019       | July 29, 2018 |
|  | <i>(In thousands)</i> |                  | <i>(Percentages)</i> |               |
| Net revenue                                  | \$ 883,352            | \$ 723,500       | 100.0%               | 100.0%        |
| Cost of goods sold                           | 397,556               | 327,306          | 45.0                 | 45.2          |
| Gross profit                                 | 485,796               | 396,194          | 55.0                 | 54.8          |
| Selling, general and administrative expenses | 317,814               | 261,986          | 36.0                 | 36.2          |
| Income from operations                       | 167,982               | 134,208          | 19.0                 | 18.5          |
| Other income (expense), net                  | 1,850                 | 1,591            | 0.2                  | 0.2           |
| Income before income tax expense             | 169,832               | 135,799          | 19.2                 | 18.8          |
| Income tax expense                           | 44,842                | 40,029           | 5.1                  | 5.5           |
| Net income                                   | <u>\$ 124,990</u>     | <u>\$ 95,770</u> | <u>14.1%</u>         | <u>13.2%</u>  |

### Net Revenue

Net revenue increased \$159.9 million, or 22%, to \$883.4 million for the second quarter of fiscal 2019 from \$723.5 million for the second quarter of fiscal 2018. On a constant dollar basis, assuming the average exchange rates for the second quarter of fiscal 2019 remained constant with the average exchange rates for the second quarter of fiscal 2018, net revenue increased \$168.3 million, or 23%.

The increase in net revenue was primarily due to increased company-operated store net revenue, including from new company-operated stores as well as an increase in comparable store sales, increased direct to consumer net revenue, and an increase in net revenue from our other retail locations.

Based on a shifted calendar, total comparable sales, which includes comparable store sales and direct to consumer, increased 15% in the second quarter of fiscal 2019 compared to the second quarter of fiscal 2018. Total comparable sales increased 17% on a constant dollar basis.

Net revenue on a segment basis for the quarters ended August 4, 2019 and July 29, 2018 is summarized below. The percentages are presented as a percentage of total net revenue.

|                                   | Quarter Ended         |                   |                      |               |
|-----------------------------------|-----------------------|-------------------|----------------------|---------------|
|                                   | August 4, 2019        | July 29, 2018     | August 4, 2019       | July 29, 2018 |
|                                   | <i>(In thousands)</i> |                   | <i>(Percentages)</i> |               |
| Company-operated stores . . . . . | \$ 583,756            | \$ 486,368        | 66.1%                | 67.2%         |
| Direct to consumer . . . . .      | 217,636               | 167,405           | 24.6                 | 23.1          |
| Other . . . . .                   | 81,960                | 69,727            | 9.3                  | 9.6           |
| Net revenue . . . . .             | <u>\$ 883,352</u>     | <u>\$ 723,500</u> | <u>100.0%</u>        | <u>100.0%</u> |

*Company-Operated Stores.* Net revenue from our company-operated stores segment increased \$97.4 million, or 20%, to \$583.8 million in the second quarter of fiscal 2019 from \$486.4 million in the second quarter of fiscal 2018. The following contributed to the increase in net revenue from our company-operated stores segment:

- Net revenue from company-operated stores we opened or significantly expanded subsequent to July 29, 2018 contributed \$55.8 million to the increase. We opened 45 net new company-operated stores since the second quarter of fiscal 2018, including 21 stores in North America, 16 stores in Asia, five stores in Europe, and three stores in Australia/New Zealand.
- Based on a shifted calendar, a comparable store sales increase of 10% in the second quarter of fiscal 2019 compared to the second quarter of fiscal 2018. Comparable store sales increased 11% on a constant dollar basis. The increase in comparable store sales was primarily a result of increased store traffic and improved conversion rates.

*Direct to Consumer.* Net revenue from our direct to consumer segment increased \$50.2 million to \$217.6 million in the second quarter of fiscal 2019 from \$167.4 million in the second quarter of fiscal 2018. Based on a shifted calendar, direct to consumer net revenue increased 30%, or increased 31% on a constant dollar basis. This was primarily a result of increased website traffic, partially offset by a decrease in dollar value per transaction and lower conversion rates.

*Other.* Net revenue from our other segment increased \$12.2 million, or 18%, to \$82.0 million in the second quarter of fiscal 2019 from \$69.7 million in the second quarter of fiscal 2018. This increase was primarily the result of an increase in sales to wholesale accounts, and an increased number of temporary locations, including seasonal stores, open during the second quarter of fiscal 2019 compared to the second quarter of fiscal 2018.

## Gross Profit

Gross profit increased \$89.6 million, or 23%, to \$485.8 million for the second quarter of fiscal 2019 from \$396.2 million for the second quarter of fiscal 2018.

Gross profit as a percentage of net revenue, or gross margin, increased 20 basis points to 55.0% in the second quarter of fiscal 2019 from 54.8% in the second quarter of fiscal 2018. The increase in gross margin was primarily the result of an increase in product margin of 90 basis points which was primarily due to lower product costs, a favorable mix of higher margin product, and lower markdowns.

This was partially offset by an increase in costs as a percentage of revenue related to our distribution centers and our product departments of 30 basis points, an increase in occupancy and depreciation costs as a percentage of revenue of 20 basis points, and an unfavorable impact of foreign exchange rates of 20 basis points.

## Selling, General and Administrative Expenses

Selling, general and administrative expenses increased \$55.8 million, or 21%, to \$317.8 million in the second quarter of fiscal 2019 from \$262.0 million in the second quarter of fiscal 2018. The increase in selling, general and administrative expenses was primarily due to:

- an increase in costs related to our operating channels of \$32.3 million, comprised of:
  - an increase in employee costs of \$17.3 million primarily from a growth in labor hours and benefits, mainly associated with new company-operated stores and other new operating locations, and due to higher incentive compensation expenses;
  - an increase in variable costs of \$10.3 million primarily due to an increase in distribution costs, credit card fees, and packaging costs as a result of increased net revenue; and

- an increase in other costs of \$4.7 million primarily due to increases in information technology costs, repairs and maintenance, and other costs associated with our operating locations;
- an increase in head office costs of \$26.8 million, comprised of:
  - an increase in employee costs of \$15.4 million primarily due to additional employees to support the growth in our business, and due to increased incentive and stock-based compensation expense; and
  - an increase in other costs of \$11.3 million primarily due to increases in depreciation, brand and community costs, professional fees, information technology costs, and other head office costs; and
- an increase in net foreign exchange and derivative revaluation gains of \$3.2 million. There were net foreign exchange and derivative revaluation gains of \$0.7 million in the second quarter of fiscal 2019 compared to net foreign exchange revaluation losses of \$2.6 million in the second quarter of fiscal 2018.

As a percentage of net revenue, selling, general and administrative expenses decreased 20 basis points, to 36.0% in the second quarter of fiscal 2019 from 36.2% in the second quarter of fiscal 2018.

### Income from Operations

Income from operations increased \$33.8 million, or 25%, to \$168.0 million in the second quarter of fiscal 2019 from \$134.2 million in the second quarter of fiscal 2018. Operating margin increased 50 basis points to 19.0% compared to 18.5% in the second quarter of fiscal 2018.

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

Segmented income from operations for the quarters ended August 4, 2019 and July 29, 2018 is summarized below. The percentages are presented as a percentage of net revenue of the respective operating segments.

|                                   | Quarter Ended         |                   |  |               |
|-----------------------------------|-----------------------|-------------------|--|---------------|
|                                   | August 4, 2019        | July 29, 2018     | August 4, 2019                         | July 29, 2018 |
|                                   | <i>(In thousands)</i> |                   | <i>(Percentage of segment revenue)</i> |               |
| Segmented income from operations: |                       |                   |  |               |
| Company-operated stores           | \$ 154,332            | \$ 125,868        | 26.4%                                  | 25.9%         |
| Direct to consumer                | 86,081                | 67,033            | 39.6                                   | 40.0          |
| Other                             | 16,619                | 13,094            | 20.3                                   | 18.8          |
|                                   | <u>257,032</u>        | <u>205,995</u>    |  |               |
| General corporate expense         | <u>89,050</u>         | <u>71,787</u>     |  |               |
| Income from operations            | <u>\$ 167,982</u>     | <u>\$ 134,208</u> |  |               |

*Company-Operated Stores.* Income from operations from our company-operated stores segment increased \$28.5 million, or 23%, to \$154.3 million for the second quarter of fiscal 2019 from \$125.9 million for the second quarter of fiscal 2018. The increase was primarily the result of increased gross profit of \$52.4 million which was primarily due to increased net revenue and higher gross margin. This was partially offset by an increase in selling, general and administrative expenses, primarily due to an increase in employee costs, primarily due to an increased number of company-operated stores and higher incentive compensation expenses, increased store operating expenses including higher credit card fees, packaging costs, and distribution costs as a result of higher net revenue, as well as increases in repairs and maintenance costs, security, and information technology costs. Income from operations as a percentage of company-operated stores net revenue increased 50 basis points primarily 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 \$19.0 million, or 28%, to \$86.1 million for the second quarter of fiscal 2019 from \$67.0 million for the second quarter of fiscal 2018. The increase was primarily the result of increased gross profit of \$33.2 million which was primarily due to increased net revenue and higher gross margin. This was partially offset by an increase in selling, general and administrative expenses primarily due higher variable costs including distribution costs, credit card fees, and packaging costs as a result of higher net revenue, as well as higher professional fees, increased employee costs, and higher information technology costs. Income from operations as a percentage of direct to consumer net revenue decreased 40 basis points primarily due to deleverage on selling, general and administrative expenses, partially offset by higher gross margin.

*Other.* Other income from operations increased \$3.5 million, or 27%, to \$16.6 million for the second quarter of fiscal 2019 from \$13.1 million for the second quarter of fiscal 2018. The increase was primarily the result of increased gross profit

of \$4.0 million which was due to increased net revenue. The increase in gross profit was partially offset by an increase in selling, general and administrative expenses, primarily due to increased employee costs, primarily due to an increased number of temporary locations, and increased operating expenses including distribution costs and credit card fees as a result of higher net revenue, partially offset by a decrease in marketing costs. Income from operations as a percentage of other net revenue increased 150 basis points primarily due to leverage on selling, general and administrative expenses, partially offset by a decrease in gross margin.

*General Corporate Expense.* General corporate expense increased \$17.3 million, or 24%, to \$89.1 million for the second quarter of fiscal 2019 from \$71.8 million for the second quarter of fiscal 2018. This increase was primarily due to increases in head office employee costs, depreciation, professional fees, information technology costs, and an increase in net foreign exchange and derivative revaluation gains of \$3.2 million.

### Other Income (Expense), Net

Other income, net increased \$0.3 million, or 16%, to \$1.8 million for the second quarter of fiscal 2019 from income of \$1.6 million for the second quarter of fiscal 2018. The increase was primarily due to a decrease in interest expense primarily related to borrowings on our revolving credit facility during the second quarter of fiscal 2018. The increase in other income, net was partially offset by a decrease in net interest income.

### Income Tax Expense

Income tax expense increased \$4.8 million, or 12%, to \$44.8 million for the second quarter of fiscal 2019 from \$40.0 million for the second quarter of fiscal 2018. The effective tax rate for the second quarter of fiscal 2019 was 26.4% compared to 29.5% for the second quarter of fiscal 2018. The decrease in the effective tax rate was primarily due to changes in legislation and guidance related to global intangible low-taxed income ("GILTI") taxes which were released during the fourth quarter of fiscal 2018, and due to new regulations which resulted in additional foreign tax credits being recognized in the second quarter of fiscal 2019.

### Net Income

Net income increased \$29.2 million, or 31%, to \$125.0 million for the second quarter of fiscal 2019 from \$95.8 million for the second quarter of fiscal 2018. This was primarily due to an increase in gross profit of \$89.6 million, and an increase in other income (expense), net of \$0.3 million, partially offset by an increase in selling, general and administrative expenses of \$55.8 million, and an increase in income tax expense of \$4.8 million.

### First Two Quarters Results

The following table summarizes key components of our results of operations for the first two quarters ended August 4, 2019 and July 29, 2018. The percentages are presented as a percentage of net revenue.

|  | Two Quarters Ended    |               |                      |               |
|--|-----------------------|---------------|----------------------|---------------|
|  | August 4, 2019        | July 29, 2018 | August 4, 2019       | July 29, 2018 |
|  | <i>(In thousands)</i> |               | <i>(Percentages)</i> |               |
| Net revenue                                  | \$ 1,665,667          | \$ 1,373,206  | 100.0%               | 100.0%        |
| Cost of goods sold                           | 758,151               | 632,279       | 45.5                 | 46.0          |
| Gross profit                                 | 907,516               | 740,927       | 54.5                 | 54.0          |
| Selling, general and administrative expenses | 610,722               | 502,414       | 36.7                 | 36.6          |
| Income from operations                       | 296,794               | 238,513       | 17.8                 | 17.4          |
| Other income (expense), net                  | 4,229                 | 4,509         | 0.3                  | 0.3           |
| Income before income tax expense             | 301,023               | 243,022       | 18.1                 | 17.7          |
| Income tax expense                           | 79,430                | 72,099        | 4.8                  | 5.3           |
| Net income                                   | \$ 221,593            | \$ 170,923    | 13.3%                | 12.4%         |

### Net Revenue

Net revenue increased \$292.5 million, or 21%, to \$1.666 billion for the first two quarters of fiscal 2019 from \$1.373 billion for the first two quarters of fiscal 2018. On a constant dollar basis, assuming the average exchange rates for the first two quarters of fiscal 2019 remained constant with the average exchange rates for the first two quarters of fiscal 2018, net revenue increased \$313.4 million, or 23%.

The increase in net revenue was primarily due to increased company-operated store net revenue, including from new company-operated stores as well as an increase in comparable store sales, increased direct to consumer net revenue, and an increase in net revenue from our other retail locations.

Based on a shifted calendar, total comparable sales, which includes comparable store sales and direct to consumer, increased 15% in the first two quarters of fiscal 2019 compared to the first two quarters of fiscal 2018. Total comparable sales increased 16% on a constant dollar basis.

Net revenue on a segment basis for the first two quarters ended August 4, 2019 and July 29, 2018 is summarized below. The percentages are presented as a percentage of total net revenue.

|                                   | Two Quarters Ended    |                     |                      |               |
|-----------------------------------|-----------------------|---------------------|----------------------|---------------|
|                                   | August 4, 2019        | July 29, 2018       | August 4, 2019       | July 29, 2018 |
|                                   | <i>(In thousands)</i> |                     | <i>(Percentages)</i> |               |
| Company-operated stores . . . . . | \$ 1,090,178          | \$ 919,499          | 65.4%                | 67.0%         |
| Direct to consumer . . . . .      | 427,480               | 325,248             | 25.7                 | 23.7          |
| Other . . . . .                   | 148,009               | 128,459             | 8.9                  | 9.3           |
| Net revenue . . . . .             | <u>\$ 1,665,667</u>   | <u>\$ 1,373,206</u> | <u>100.0%</u>        | <u>100.0%</u> |

*Company-Operated Stores.* Net revenue from our company-operated stores segment increased \$170.7 million, or 19%, to \$1.090 billion in the first two quarters of fiscal 2019 from \$919.5 million in the first two quarters of fiscal 2018. The following contributed to the increase in net revenue from our company-operated stores segment:

- Net revenue from company-operated stores we opened or significantly expanded subsequent to July 29, 2018 contributed \$100.1 million to the increase. We opened 45 net new company-operated stores since the second quarter of fiscal 2018, including 21 stores in North America, 16 stores in Asia, five stores in Europe, and three stores in Australia/New Zealand.
- Based on a shifted calendar, a comparable store sales increase of 8% in the first two quarters of fiscal 2019 compared to the first two quarters of fiscal 2018. Comparable store sales increased 9% on a constant dollar basis. The increase in comparable store sales was primarily a result of increased store traffic and improved conversion rates.

*Direct to Consumer.* Net revenue from our direct to consumer segment increased \$102.2 million to \$427.5 million in the first two quarters of fiscal 2019 from \$325.2 million in the first two quarters of fiscal 2018. Based on a shifted calendar, direct to consumer net revenue increased 31%, or increased 33% on a constant dollar basis. This was primarily a result of increased website traffic, partially offset by a decrease in dollar value per transaction and lower conversion rates.

*Other.* Net revenue from our other segment increased \$19.6 million, or 15%, to \$148.0 million in the first two quarters of fiscal 2019 from \$128.5 million in the first two quarters of fiscal 2018. This increase was primarily the result of an increased number of temporary locations, including seasonal stores, open during the first two quarters of fiscal 2019 compared to the first two quarters of fiscal 2018 and an increase in net revenue from sales to wholesale accounts.

## Gross Profit

Gross profit increased \$166.6 million, or 22%, to \$907.5 million for the first two quarters of fiscal 2019 from \$740.9 million for the first two quarters of fiscal 2018.

Gross profit as a percentage of net revenue, or gross margin, increased 50 basis points, to 54.5% in the first two quarters of fiscal 2019 from 54.0% in the first two quarters of fiscal 2018. The increase in gross margin was primarily the result of an increase in product margin of 140 basis points which was primarily due to lower product costs, a favorable mix of higher margin product, and lower markdowns.

This was partially offset by an increase in costs as a percentage of revenue related to our distribution centers and our product departments of 40 basis points, an unfavorable impact of foreign exchange rates of 30 basis points, and an increase in occupancy and depreciation costs as a percentage of revenue of 10 basis points.

## Selling, General and Administrative Expenses

Selling, general and administrative expenses increased \$108.3 million, or 22%, to \$610.7 million in the first two quarters of fiscal 2019 from \$502.4 million in the first two quarters of fiscal 2018. The increase in selling, general and administrative expenses was primarily due to:

- an increase in costs related to our operating channels of \$65.4 million, comprised of:
  - an increase in employee costs of \$34.3 million primarily from a growth in labor hours and benefits, mainly associated with new company-operated stores and other new operating locations, and due to higher incentive compensation expenses;
  - an increase in variable costs of \$18.2 million primarily due to an increase in distribution costs, credit card fees, and packaging costs as a result of increased net revenue; and
  - an increase in other costs of \$12.9 million primarily due to an increase in digital marketing expenses, information technology costs, repairs and maintenance costs, security costs, and other costs associated with our operating locations;
- an increase in head office costs of \$45.6 million, comprised of:
  - an increase in employee costs of \$27.4 million primarily due to additional employees to support the growth in our business and increased incentive and stock-based compensation expense; and
  - an increase in other costs of \$18.2 million primarily due to an increase in professional fees, depreciation, brand and community costs, information technology costs, and other head office costs.

The increase in selling, general and administrative expenses was partially offset by a decrease in net foreign exchange and derivative revaluation losses of \$2.7 million.

As a percentage of net revenue, selling, general and administrative expenses increased 10 basis points, to 36.7% in the first two quarters of fiscal 2019 from 36.6% in the first two quarters of fiscal 2018.

## Income from Operations

Income from operations increased \$58.3 million, or 24%, to \$296.8 million in the first two quarters of fiscal 2019 from \$238.5 million in the first two quarters of fiscal 2018. Operating margin increased 40 basis points to 17.8% compared to 17.4% in the first two quarters of fiscal 2018.

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

Segmented income from operations for the first two quarters ended August 4, 2019 and July 29, 2018 is summarized below. The percentages are presented as a percentage of net revenue of the respective operating segments.

|                                     | Two Quarters Ended    |                   |  |               |
|-------------------------------------|-----------------------|-------------------|--|---------------|
|                                     | August 4, 2019        | July 29, 2018     | August 4, 2019                         | July 29, 2018 |
|                                     | <i>(In thousands)</i> |                   | <i>(Percentage of segment revenue)</i> |               |
| Segmented income from operations:   |                       |                   |  |               |
| Company-operated stores . . . . .   | \$ 275,239            | \$ 225,155        | 25.2%                                  | 24.5%         |
| Direct to consumer . . . . .        | 164,756               | 129,300           | 38.5                                   | 39.8          |
| Other . . . . .                     | 29,252                | 24,317            | 19.8                                   | 18.9          |
|                                     | <u>469,247</u>        | <u>378,772</u>    |  |               |
| General corporate expense . . . . . | 172,453               | 140,259           |  |               |
| Income from operations . . . . .    | <u>\$ 296,794</u>     | <u>\$ 238,513</u> |  |               |

*Company-Operated Stores.* Income from operations from our company-operated stores segment increased \$50.1 million, or 22%, to \$275.2 million for the first two quarters of fiscal 2019 from \$225.2 million for the first two quarters of fiscal 2018. The increase was primarily the result of increased gross profit of \$93.8 million which was primarily due to increased net revenue and higher gross margin. This was partially offset by an increase in selling, general and administrative expenses, primarily due to increased employee costs, primarily due to an increased number of company-operated stores and higher incentive compensation expenses, increased store operating expenses including higher credit card fees, distribution costs, and packaging costs as a result of higher net revenue, as well as increases in repairs and maintenance costs and security costs.

Income from operations as a percentage of company-operated stores net revenue increased by 70 basis points, primarily due to an increase in gross margin and leverage on selling, general and administrative expenses.

*Direct to Consumer.* Income from operations from our direct to consumer segment increased \$35.5 million, or 27%, to \$164.8 million for the first two quarters of fiscal 2019 from \$129.3 million for the first two quarters of fiscal 2018. The increase was primarily the result of increased gross profit of \$65.4 million which was primarily due to increased net revenue. This was partially offset by an increase in selling, general and administrative expenses primarily due to higher variable costs including distribution costs, credit card fees, and packaging costs as a result of higher net revenue, as well as higher digital marketing expenses, employee costs, professional fees, and information technology costs. Income from operations as a percentage of direct to consumer net revenue decreased 130 basis points, primarily due to deleverage on selling, general and administrative expenses and a decrease in gross margin.

*Other.* Other income from operations increased \$4.9 million, or 20%, to \$29.3 million for the first two quarters of fiscal 2019 from \$24.3 million for the first two quarters of fiscal 2018. The increase was primarily the result of increased gross profit of \$7.4 million which was primarily due to increased net revenue. The increase in gross profit was partially offset by an increase in selling, general and administrative expenses, including increased employee costs, increased operating expenses including higher credit card fees and higher distribution costs as a result of higher net revenue, partially offset by lower community costs. Income from operations as a percentage of other net revenue increased 90 basis points, primarily due to leverage on selling, general and administrative expenses, partially offset by a decrease in gross margin.

*General Corporate Expense.* General corporate expense increased \$32.2 million, or 23%, to \$172.5 million for the first two quarters of fiscal 2019 from \$140.3 million for the first two quarters of fiscal 2018. This increase was primarily due to increases in head office employee costs, professional fees, depreciation, information technology costs, and brand and community costs, partially offset by a decrease in net foreign exchange and derivative revaluation losses of \$2.7 million.

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

Other income, net decreased \$0.3 million, or 6%, to \$4.2 million for the first two quarters of fiscal 2019 from income of \$4.5 million for the first two quarters of fiscal 2018. The decrease was primarily due to a decrease in net interest income, primarily due to a decrease in cash and cash equivalents in the first two quarters of fiscal 2019 compared to the first two quarters of fiscal 2018. The decrease in other income, net was partially offset by a decrease in interest expense, primarily related to borrowings on our revolving credit facility during the first two quarters of fiscal 2018.

### **Income Tax Expense**

Income tax expense increased \$7.3 million, or 10%, to \$79.4 million for the first two quarters of fiscal 2019 from \$72.1 million for the first two quarters of fiscal 2018. The effective tax rate for the first two quarters of fiscal 2019 was 26.4% compared to 29.7% for the first two quarters of fiscal 2018. The decrease in the effective tax rate was primarily due to changes in legislation and guidance related to GILTI taxes which were released during the fourth quarter of fiscal 2018, new regulations which resulted in additional foreign tax credits, and due to an increase in tax deductions related to stock-based compensation.

### **Net Income**

Net income increased \$50.7 million, or 30%, to \$221.6 million for the first two quarters of fiscal 2019 from \$170.9 million for the first two quarters of fiscal 2018. This was primarily due to an increase in gross profit of \$166.6 million, partially offset by an increase in selling, general and administrative expenses of \$108.3 million, an increase in income tax expense of \$7.3 million, and a decrease in other income (expense), net of \$0.3 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 full fiscal months, or open for 12 full fiscal months after being significantly expanded. Comparable store sales exclude sales from our direct to consumer and other segments. Total comparable sales combines comparable store sales and direct to consumer sales. In fiscal years following a 53 week year, the prior year period is shifted by one week to compare similar calendar weeks.

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 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.

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.

**Constant dollar changes in net revenue**

The below changes in net revenue show the change compared to the corresponding period in the prior year.

|  | Quarter Ended<br>August 4, 2019 |               | Two Quarters Ended<br>August 4, 2019 |               |
|--|---------------------------------|---------------|--------------------------------------|---------------|
|  | (In thousands)                  | (Percentages) | (In thousands)                       | (Percentages) |
| Change . . . . .   | \$ 159,852                      | 22%           | \$ 292,461                           | 21%           |
| Adjustments due to foreign exchange rate changes . . . . . | 8,437                           | 1             | 20,968                               | 2             |
| Change in constant dollars . . . . .                       | <u>\$ 168,289</u>               | <u>23%</u>    | <u>\$ 313,429</u>                    | <u>23%</u>    |

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

Due to the 53rd week in fiscal 2018, the below changes in total comparable sales, comparable store sales, and direct to consumer net revenue are calculated on a one week shifted basis such that the 13 weeks and 26 weeks ended August 4, 2019 are compared to the 13 weeks and 26 weeks ended August 5, 2018 rather than July 29, 2018.

|   | Quarter Ended<br>August 4, 2019             |  |                                      | Two Quarters Ended<br>August 4, 2019        |  |                                      |
|---|---|--|--------------------------------------|---|--|--------------------------------------|
|   | Total<br>Comparable<br>Sales <sup>1,2</sup> | Comparable<br>Store Sales <sup>2</sup> | Direct to<br>Consumer Net<br>Revenue | Total<br>Comparable<br>Sales <sup>1,2</sup> | Comparable<br>Store Sales <sup>2</sup> | Direct to<br>Consumer Net<br>Revenue |
| Change . . . . .  | 15%   | 10%                                    | 30%                                  | 15%   | 8%                                     | 31%                                  |
| Adjustments due to foreign<br>exchange rate changes . . . . . | 2   | 1                                      | 1                                    | 1   | 1                                      | 2                                    |
| Change in constant dollars . . . . .                          | <u>17%</u>                                  | <u>11%</u>                             | <u>31%</u>                           | <u>16%</u>                                  | <u>9%</u>                              | <u>33%</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 full fiscal months, or open for at least 12 full fiscal months after being significantly expanded.

**Seasonality**

Our business is affected by the general seasonal trends common to the retail apparel industry. Our annual net revenue is weighted more heavily toward our fourth fiscal quarter, reflecting our historical strength in sales during the holiday season, while our operating expenses are more equally distributed throughout the year. As a result, a substantial portion of our operating profits are generated in the fourth quarter of our fiscal year. For example, we generated approximately 47%, 56%, and 47% of our full year operating profit during the fourth quarters of fiscal 2018, fiscal 2017, and fiscal 2016, respectively. Excluding the costs we incurred in connection with the ivivva restructuring, we generated approximately 51% of our operating profit during the fourth quarter of fiscal 2017.

### **Liquidity and Capital Resources**

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

As of August 4, 2019, our working capital, excluding cash and cash equivalents, was \$156.7 million, our cash and cash equivalents were \$623.7 million, and our capacity under our revolving facility was \$398.2 million.

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

|   | <b>Two Quarters Ended</b> |                      |
|---|---------------------------|----------------------|
|   | <b>August 4, 2019</b>     | <b>July 29, 2018</b> |
|   | <i>(In thousands)</i>     |                      |
| Total cash provided by (used in):       |                           |                      |
| Operating activities                    | \$ 50,042                 | \$ 210,026           |
| Investing activities                    | (131,969)                 | (89,292)             |
| Financing activities                    | (170,985)                 | (300,239)            |
| Effect of exchange rate changes on cash | (4,670)                   | (33,155)             |
| Decrease in cash and cash equivalents   | <u>\$ (257,582)</u>       | <u>\$ (212,660)</u>  |

### **Operating Activities**

Cash flows provided by or used in 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 decreased \$160.0 million, to \$50.0 million for the first two quarters of fiscal 2019 compared to \$210.0 million for the first two quarters of fiscal 2018, primarily as a result of the following:

- an increase in cash used in operating activities of \$231.0 million as a result of the change in operating assets and liabilities, primarily due to the following:
  - \$89.4 million related to income taxes, primarily due to payments for withholding taxes on repatriated foreign earnings, as well as timing of tax installments;
  - \$71.1 million related to accounts payable, primarily due to a change in our payment terms in the prior fiscal year;
  - \$40.0 million related to other prepaid expenses and other current and non-current assets; and
  - \$28.0 million related to inventory, primarily due to an increase in inventory purchases.

This was partially offset by an increase of \$50.7 million in net income, and an increase of \$20.3 million in non-cash expenses primarily related to an increase in depreciation and stock-based compensation expense.

### **Investing Activities**

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

Cash used in investing activities increased \$42.7 million to \$132.0 million for the first two quarters of fiscal 2019 from \$89.3 million for the first two quarters of fiscal 2018. The increase was primarily the result of an increase in capital expenditures related to our company-operated stores, primarily as a result of an increased number of new company-operated stores as well as an increase in renovations and relocations of existing stores. Increased capital expenditures related to our direct to consumer channel, as well as increased corporate capital expenditures primarily related to information technology and business systems, also contributed to the increase in cash used in investing activities.

## Financing Activities

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

Cash used in financing activities decreased \$129.3 million to \$171.0 million for the first two quarters of fiscal 2019 compared to \$300.2 million for the first two quarters of fiscal 2018. The decrease was primarily the result of a decrease in our stock repurchases, partially offset by a decrease of net borrowings on our revolving credit facility.

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, and on June 6, 2018, the board of directors approved an increase to this stock repurchase program, authorizing the repurchase of up to a total of \$600.0 million of our common shares. On January 31, 2019, our board of directors approved an additional stock repurchase program for up to \$500.0 million of our common shares on the open market or in privately negotiated transactions.

Our cash used in financing activities for the first two quarters of fiscal 2019 included \$165.1 million to repurchase 1.0 million shares of our common stock compared to \$406.2 million to repurchase 3.4 million shares for the first two quarters of fiscal 2018. During the first quarter of fiscal 2019, we repurchased 1.0 million shares in a private transaction, and during the second quarter of fiscal 2018, we repurchased 3.3 million shares in a private transaction. The other common stock was repurchased in the open market at prevailing market prices, including under plans complying with the provisions of Rule 10b5-1 and Rule 10b-18 of the Securities Exchange Act of 1934, with the timing and actual number of shares repurchased depending upon market conditions, eligibility to trade, and other factors.

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

### *Revolving Credit Facility*

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

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

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

We are also required to maintain a consolidated rent-adjusted leverage ratio of not greater than 3.50:1.00 and we are not permitted to allow the ratio of consolidated EBITDAR to consolidated interest charges (plus rent) to be less than 2.00:1.00. The credit agreement also contains certain customary representations, warranties, affirmative covenants, and events of default

(including, among others, an event of default upon the occurrence of a change of control). If an event of default occurs, the credit agreement may be terminated and the maturity of any outstanding amounts may be accelerated.

On June 6, 2018, we entered into Amendment No. 1 to the credit agreement. The Amendment amended the credit agreement to provide for (i) an increase in the aggregate commitments under the unsecured five-year revolving credit facility to \$400.0 million, with an increase of the sub-limits for the issuance of letters of credit and extensions of swing line loans to \$50.0 million for each, (ii) an increase in the option, subject to certain conditions as set forth in the credit agreement, to request increases in commitments under the revolving facility from \$400.0 million to \$600.0 million and (iii) an extension in the maturity of the revolving facility from December 15, 2021 to June 6, 2023.

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

As of August 4, 2019, aside from letters of credit of \$1.8 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 August 4, 2019, letters of credit and letters of guarantee totaling \$1.8 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 2018 Annual Report on Form 10-K filed with the SEC on March 27, 2019, and in Notes 2, 5, 6, and 7 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 August 4, 2019 and February 3, 2019 are summarized in the table below.

|   | August 4,<br>2019 | February 3,<br>2019 |
|---|-------------------|---------------------|
| United States . . . . .                 | 292               | 285                 |
| Canada . . . . .                        | 64                | 64                  |
| Australia . . . . .                     | 31                | 29                  |
| China <sup>(1)</sup> . . . . .          | 28                | 22                  |
| United Kingdom . . . . .                | 13                | 12                  |
| New Zealand . . . . .                   | 7                 | 7                   |
| Japan . . . . .                         | 6                 | 5                   |
| Germany . . . . .                       | 5                 | 5                   |
| South Korea . . . . .                   | 5                 | 4                   |
| Singapore . . . . .                     | 4                 | 3                   |
| France . . . . .                        | 1                 | 1                   |
| Ireland . . . . .                       | 1                 | 1                   |
| Netherlands . . . . .                   | 1                 | —                   |
| Sweden . . . . .                        | 1                 | 1                   |
| Switzerland . . . . .                   | 1                 | 1                   |
| Total company-operated stores . . . . . | <u>460</u>        | <u>440</u>          |

<sup>(1)</sup> Included within China as of August 4, 2019, were six company-operated stores in the Hong Kong Special Administrative Region, one company-operated store in the Macao Special Administration Region, and one company-operated store in the Taiwan Province. As of February 3, 2019, there were five company-operated stores in the Hong Kong Special Administrative Region, one company-operated store in the Macao Special Administration 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 August 4, 2019, there were eight licensed locations, including four 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 August 4, 2019, we had certain forward currency contracts outstanding in order to hedge a portion of the foreign currency exposure that arises on translation of a Canadian subsidiary into U.S. dollars. We also had certain forward currency contracts outstanding in an effort to reduce our exposure to the foreign exchange revaluation gains and losses that are recognized by our Canadian subsidiaries on U.S. dollar denominated monetary assets and liabilities. Please refer to Note 6 to the unaudited interim consolidated financial statements included in Item 1 of Part I of this report for further information, including details of the notional amounts outstanding.

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

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

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

During the first two quarters of fiscal 2019, the change in the relative value of the U.S. dollar against the Canadian dollar resulted in a \$4.7 million increase in accumulated other comprehensive loss within stockholders' equity. During the first two quarters of fiscal 2018, the change in the relative value of the U.S. dollar against the Canadian dollar resulted in a \$62.6 million increase in accumulated other comprehensive loss within stockholders' equity.

A 10% appreciation in the relative value of the U.S. dollar against the Canadian dollar compared to the exchange rates in effect for the first two quarters of fiscal 2019 would have resulted in lower income from operations of approximately \$1.2 million in the first two quarters of fiscal 2019. This assumes a consistent 10% appreciation in the U.S. dollar against the Canadian dollar throughout the first two quarters of fiscal 2019. The timing of changes in the relative value of the U.S. dollar combined with the seasonal nature of our business, can affect the magnitude of the impact that fluctuations in foreign exchange rates have on our income from operations.

*Interest Rate Risk.* Our revolving credit facility provides us with available borrowings in an amount up to \$400.0 million in the aggregate. Because our revolving credit facility bears interest at a variable rate, we will be exposed to market risks relating to changes in interest rates, if we have a meaningful outstanding balance. As of August 4, 2019, aside from letters of credit of \$1.8 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 August 4, 2019. Based on that evaluation, our principal executive officer and principal financial and accounting officer concluded that, at August 4, 2019, our disclosure controls and procedures were effective.

There were no changes in our internal control over financial reporting during the quarter ended August 4, 2019 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.