

**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, the impact of the COVID-19 pandemic on our business and results of operations, expectations related to our acquisition of MIRROR, 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 2019 Annual Report on Form 10-K filed with the SEC on March 26, 2020.

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 brand. We offer a comprehensive line of apparel and accessories for women and men. 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.

During the second quarter of fiscal 2020, we acquired Curiouser Products Inc., dba MIRROR, for a purchase price of approximately \$500.0 million, of which approximately \$57.1 million is due to certain continuing employees subject to their continued employment through various vesting dates up to three years after the closing date of the transaction. MIRROR is a leading in-home fitness company with an interactive workout platform that features live and on-demand classes. The acquisition of MIRROR bolsters our digital sweatlife offerings and brings immersive and personalized in-home sweat and mindfulness content to new and existing lululemon guests.

## ***COVID-19 Pandemic***

The outbreak of a novel strain of coronavirus ("COVID-19") was declared a global pandemic by the World Health Organization in March 2020. The spread of COVID-19 has caused public health officials to impose restrictions and to recommend precautions to mitigate the spread of the virus, especially when congregating in heavily populated areas, such as malls and lifestyle centers.

We continue to monitor the situation and work closely with local authorities to prioritize the safety of our people and guests. In February 2020, we temporarily closed all of our retail locations in Mainland China. In March 2020, we temporarily closed all of our retail locations in North America, Europe, and certain countries in Asia Pacific. The stores in Mainland China reopened during the first quarter of fiscal 2020, and stores in other markets began reopening in accordance with local government and public health authority guidelines during the second quarter of fiscal 2020 and almost all locations were open during the third quarter of fiscal 2020. Subsequent to November 1, 2020, while almost all of our retail locations have remained

open, we have experienced some temporary closures and are currently operating with tighter capacity restrictions in certain markets.

Our open retail locations and distribution centers are operating with restrictive and precautionary measures in place such as reduced operating hours, physical distancing, enhanced cleaning and sanitation, and limited occupancy levels. This pandemic has also impacted the operations of our third party logistics providers and our manufacturing and supply partners, including through the closure or reduced capacity of facilities, and operational changes to accommodate physical distancing. As the pandemic continues, we may face further disruptions or increased operational and logistics costs throughout our supply chain.

There is significant uncertainty regarding the extent and duration of the impact that the COVID-19 pandemic will have on our operations, the demand for our products, and on our supply chain. It had a material adverse impact on our results of operations for the first three quarters of fiscal 2020, and we expect it to continue to impact our results of operations and financial position. The extent to which COVID-19 impacts our results will depend on future developments, which are highly uncertain and cannot be predicted, including new information that may emerge concerning the severity of COVID-19 and the actions taken to contain it or treat its impact.

We remain confident in the long-term growth opportunities and our Power of Three growth plan and believe that we have sufficient cash and cash equivalents, and available capacity under our revolving credit facilities, to meet our liquidity needs. As of November 1, 2020, we had cash and cash equivalents of \$481.6 million and the capacity under our committed revolving credit facilities was \$697.3 million.

### ***Financial Highlights***

For the third quarter of fiscal 2020, compared to the third quarter of fiscal 2019:

- Net revenue increased 22% to \$1,117.4 million. On a constant dollar basis, net revenue increased 21%.
- Total comparable sales, which includes comparable store sales and direct to consumer, increased 19%. On a constant dollar basis, total comparable sales increased 18%.
  - Comparable store sales decreased 17%, or decreased 18% on a constant dollar basis.
  - Direct to consumer net revenue increased 94%, or increased 93% on a constant dollar basis.
- Gross profit increased 24% to \$627.4 million.
- Gross margin increased 100 basis points to 56.1%.
- Acquisition-related expenses of \$8.5 million were recognized.
- Income from operations increased 17% to \$204.9 million.
- Operating margin decreased 90 basis points to 18.3%.
- Income tax expense increased 17% to \$60.7 million. Our effective tax rate for the third quarter of fiscal 2020 was 29.7% compared to 29.1% for the third quarter of fiscal 2019.
- Diluted earnings per share were \$1.10 compared to \$0.96 in the third quarter of fiscal 2019. This includes \$7.6 million of after-tax costs related to the MIRROR acquisition, which reduced diluted earnings per share by \$0.06 for the third quarter of fiscal 2020.

As the temporary closures from COVID-19 resulted in a significant number of stores being removed from our comparable store base during the first two quarters of fiscal 2020, total comparable sales and comparable store sales for year-to-date periods are not currently representative of the underlying trends of our business. We do not believe these year-to-date metrics are currently useful to investors in understanding performance, therefore we have not included these metrics in our discussion and analysis of results of operations. As most of our stores were open during the third quarter of fiscal 2020, and our comparable store base therefore included the majority of our stores, we have included total comparable sales and comparable store sales on a quarter-to-date basis in our discussion and analysis of results of operations.

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

### Third Quarter Results

The following table summarizes key components of our results of operations for the quarters ended November 1, 2020 and November 3, 2019. The percentages are presented as a percentage of net revenue.

	Quarter Ended			
	November 1, 2020	November 3, 2019	November 1, 2020	November 3, 2019
	<i>(In thousands)</i>		<i>(Percentages)</i>	
Net revenue	\$ 1,117,426	\$ 916,138	100.0 %	100.0 %
Cost of goods sold	490,072	411,094	43.9	44.9
Gross profit	627,354	505,044	56.1	55.1
Selling, general and administrative expenses	411,662	329,208	36.8	35.9
Amortization of intangible assets	2,241	7	0.2	—
Acquisition-related expenses	8,531	—	0.8	—
Income from operations	204,920	175,829	18.3	19.2
Other income (expense), net	(580)	1,925	(0.1)	0.2
Income before income tax expense	204,340	177,754	18.3	19.4
Income tax expense	60,697	51,772	5.4	5.7
Net income	\$ 143,643	\$ 125,982	12.9 %	13.8 %

### Net Revenue

Net revenue increased \$201.3 million, or 22%, to \$1.1 billion for the third quarter of fiscal 2020 from \$916.1 million for the third quarter of fiscal 2019. On a constant dollar basis, assuming the average exchange rates for the third quarter of fiscal 2020 remained constant with the average exchange rates for the third quarter of fiscal 2019, net revenue increased \$194.6 million, or 21%.

The increase in net revenue was primarily due to increased direct to consumer net revenue, partially due to a shift in the way guests are shopping due to COVID-19, as well as an increase in net revenue from our other channels. This was partially offset by a decrease in company-operated store net revenue driven by reduced operating hours and restricted guest occupancy levels, as well as temporary closures as a result of COVID-19.

Total comparable sales, which includes comparable store sales and direct to consumer, increased 19% in the third quarter of fiscal 2020 compared to the third quarter of fiscal 2019. Total comparable sales increased 18% on a constant dollar basis.

Net revenue on a segment basis for the quarters ended November 1, 2020 and November 3, 2019 is summarized below. The percentages are presented as a percentage of total net revenue.

	Quarter Ended			
	November 1, 2020	November 3, 2019	November 1, 2020	November 3, 2019
	<i>(In thousands)</i>		<i>(Percentages)</i>	
Company-operated stores	\$ 511,756	\$ 579,521	45.8 %	63.3 %
Direct to consumer	478,263	246,697	42.8	26.9
Other	127,407	89,920	11.4	9.8
Net revenue	\$ 1,117,426	\$ 916,138	100.0 %	100.0 %

*Company-Operated Stores.* Net revenue from our company-operated stores segment decreased \$67.8 million, or 12%, to \$511.8 million in the third quarter of fiscal 2020 from \$579.5 million in the third quarter of fiscal 2019. The decrease in net revenue from our company-operated stores segment was primarily due to the impact of COVID-19, including reduced operating hours, occupancy restrictions, and temporary closures. Comparable store sales decreased 17%, or decreased 18% on a constant dollar basis. The decrease was primarily a result of COVID-19 restrictions, which resulted in decreased store traffic, partially offset by an increase in conversion rates.

The decrease in net revenue from our company-operated stores segment was partially offset by an increase in net revenue from company-operated stores we opened or significantly expanded subsequent to November 3, 2019 of \$18.7 million. We opened 36 net new company-operated stores since the third quarter of fiscal 2019, including 20 stores in Asia, 11 stores in North America, and five stores in Europe.

*Direct to Consumer.* Net revenue from our direct to consumer segment increased \$231.6 million, or 94%, to \$478.3 million in the third quarter of fiscal 2020 from \$246.7 million in the third quarter of fiscal 2019. Direct to consumer net revenue increased 93% on a constant dollar basis. The increase in net revenue from our direct to consumer segment was primarily a result of increased website traffic and improved conversion rate, partially offset by a decrease in dollar value per transaction. These changes were partially due to COVID-19, with more guests shopping online instead of in-store.

*Other channels.* Net revenue from our other segment increased \$37.5 million, or 42%, to \$127.4 million in the third quarter of fiscal 2020 from \$89.9 million in the third quarter of fiscal 2019. This increase was primarily the result of net revenue from MIRROR as well as an increased number of temporary locations, including seasonal stores, that were open during the third quarter of fiscal 2020 compared to the third quarter of fiscal 2019.

## **Gross Profit**

Gross profit increased \$122.3 million, or 24%, to \$627.4 million for the third quarter of fiscal 2020 from \$505.0 million for the third quarter of fiscal 2019.

Gross profit as a percentage of net revenue, or gross margin, increased 100 basis points to 56.1% in the third quarter of fiscal 2020 from 55.1% in the third quarter of fiscal 2019. The increase in gross margin was primarily the result of:

- a decrease in depreciation and occupancy costs as a percentage of revenue of 170 basis points, driven primarily by the increase in net revenue; and
- a favorable impact of foreign exchange rates of 10 basis points.

This was partially offset by a decrease in product margin of 80 basis points, primarily due to higher air freight costs as a result of COVID-19 capacity constraints and higher markdowns.

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

Selling, general and administrative expenses increased \$82.5 million, or 25%, to \$411.7 million in the third quarter of fiscal 2020 from \$329.2 million in the third quarter of fiscal 2019. The increase in selling, general and administrative expenses was primarily due to:

- an increase in costs related to our operating channels of \$63.4 million, comprised of:
  - an increase in variable costs of \$33.0 million primarily due to an increase in distribution costs, credit card fees and packaging costs as a result of increased direct to consumer net revenue; and
  - an increase in brand and community costs of \$29.3 million primarily due to an increase in digital marketing expenses; and
  - an increase in other operating costs of \$5.7 million primarily due to an increase in information technology costs and depreciation; and
  - a decrease in employee costs of \$4.6 million primarily due to lower incentive compensation expenses in our company-operated store channel; and
- an increase in head office costs of \$22.3 million, comprised of:
  - an increase of \$22.7 million primarily due to increases in professional fees, information technology costs, donations, and depreciation; and

- a decrease in employee costs of \$0.4 million primarily due to decreased incentive compensation expense, and decreased travel, partially offset by increased salaries and wages expense as a result of headcount growth, and stock-based compensation expense.

The increase in selling, general and administrative expenses was partially offset by an increase in net foreign exchange and derivative revaluation gains of \$3.2 million.

As a percentage of net revenue, selling, general and administrative expenses increased 90 basis points, to 36.8% in the third quarter of fiscal 2020 from 35.9% in the third quarter of fiscal 2019.

### Amortization of intangible assets

Amortization of intangible assets increased to \$2.2 million in the third quarter of fiscal 2020 from less than \$0.1 million in the third quarter of fiscal 2019. This increase was the result of amortization of intangible assets recognized upon the acquisition of MIRROR.

### Acquisition-related expenses

We recognized acquisition-related expenses of \$8.5 million in the third quarter of fiscal 2020. This included acquisition-related compensation of \$7.5 million for deferred consideration for certain continuing MIRROR employees. This also included transaction and integration related costs of \$1.0 million for advisory and professional services, and integration costs subsequent to the acquisition. We did not have acquisition-related expenses in the third quarter of fiscal 2019. Please refer to Note 3 to the unaudited interim consolidated financial statements included in Item 1 of Part I of this report for further information.

### Income from Operations

Income from operations increased \$29.1 million, or 17%, to \$204.9 million in the third quarter of fiscal 2020 from \$175.8 million in the third quarter of fiscal 2019. Operating margin decreased 90 basis points to 18.3% compared to 19.2% in the third quarter of fiscal 2019.

On a segment basis, we determine income from operations without taking into account our general corporate expenses. During the first quarter of fiscal 2020, we reviewed our segment and general corporate expenses and determined certain costs that are more appropriately classified in different categories. Accordingly, comparative figures have been reclassified to conform to the financial presentation adopted for the current year.

Segmented income from operations for the quarters ended November 1, 2020 and November 3, 2019 is summarized below. The percentages are presented as a percentage of net revenue of the respective operating segments.

	Quarter Ended			
	November 1, 2020	November 3, 2019	November 1, 2020	November 3, 2019
	<i>(In thousands)</i>		<i>(Percentage of segment revenue)</i>	
Segmented income from operations:				
Company-operated stores	\$ 111,780	\$ 147,720	21.8 %	25.5 %
Direct to consumer	209,610	103,599	43.8	42.0
Other	1,304	16,820	1.0	18.7
	<u>322,694</u>	<u>268,139</u>		
General corporate expense	107,002	92,303		
Amortization of intangible assets	2,241	7		
Acquisition-related expenses	8,531	—		
Income from operations	<u>\$ 204,920</u>	<u>\$ 175,829</u>		

*Company-Operated Stores.* Income from operations from our company-operated stores segment decreased \$35.9 million, or 24%, to \$111.8 million for the third quarter of fiscal 2020 from \$147.7 million for the third quarter of fiscal 2019. The decrease was primarily the result of decreased gross profit of \$50.7 million, which was primarily due to lower net revenue as a result of the impact of COVID-19 restrictions, as well as lower gross margin, which was primarily due to deleverage on occupancy and depreciation costs as a result of lower net revenue. The decrease in gross profit was partially offset by a decrease in selling, general and administrative expenses, primarily due to decreased store operating expenses including lower incentive compensation, brand and community costs, salaries and wages, and lower credit card fees as a result of lower net revenue.

Income from operations as a percentage of company-operated stores net revenue decreased primarily due to lower gross margin and deleverage on selling, general and administrative expenses.

*Direct to Consumer.* Income from operations from our direct to consumer segment increased \$106.0 million, or 102%, to \$209.6 million for the third quarter of fiscal 2020 from \$103.6 million for the third quarter of fiscal 2019. The increase was primarily the result of increased gross profit of \$156.1 million which was primarily due to increased net revenue, partially from the shift in guests shopping online instead of in-store. The increase in gross profit was partially offset by an increase in selling, general and administrative expenses, which was primarily due to higher variable costs including distribution costs, credit card fees, and packaging as a result of higher net revenue, as well as higher digital marketing expenses, employee costs and information technology expenses. Income from operations as a percentage of direct to consumer net revenue increased 180 basis points primarily due to leverage on selling, general and administrative expenses.

*Other channels.* Income from operations from our other channels decreased \$15.5 million, or 92%, to \$1.3 million for the third quarter of fiscal 2020 from \$16.8 million for the third quarter of fiscal 2019. The decrease was primarily the result of increased selling, general and administrative expenses which increased primarily due to MIRROR digital marketing expenses, and increased credit card fees and distribution costs as a result of higher net revenue. The increase in selling, general and administrative expenses was partially offset by an increase in gross profit of \$16.9 million, primarily due to increased net revenue. Income from operations as a percentage of other net revenue decreased primarily due to deleverage on selling, general and administrative expenses.

*General Corporate Expense.* General corporate expense increased \$14.7 million, or 16%, to \$107.0 million for the third quarter of fiscal 2020 from \$92.3 million for the third quarter of fiscal 2019. This increase was primarily due to increases in professional fees, information technology costs, donations, depreciation, stock based compensation expense, and salaries and wages as a result of headcount growth. The increase in general corporate expense was partially offset by a decrease in incentive compensation and an increase in net foreign exchange and derivative revaluation gains of \$3.2 million.

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

Other income, net decreased \$2.5 million, or 130%, to an expense of \$0.6 million for the third quarter of fiscal 2020 from income of \$1.9 million for the third quarter of fiscal 2019. The decrease was primarily due to a decrease in interest income as a result of lower cash balances and lower interest rates.

#### **Income Tax Expense**

Income tax expense increased \$8.9 million, or 17%, to \$60.7 million for the third quarter of fiscal 2020 from \$51.8 million for the third quarter of fiscal 2019. The effective tax rate for the third quarter of fiscal 2020 was 29.7% compared to 29.1% for the third quarter of fiscal 2019.

The increase in the effective tax rate was primarily due to certain non-deductible expenses related to the MIRROR acquisition which increased the effective tax rate by 80 basis points.

#### **Net Income**

Net income increased \$17.7 million, or 14%, to \$143.6 million for the third quarter of fiscal 2020 from \$126.0 million for the third quarter of fiscal 2019. This was primarily due to an increase in gross profit of \$122.3 million, partially offset by an increase in selling, general and administrative expenses of \$82.5 million, an increase in income tax expense of \$8.9 million, acquisition-related expenses of \$8.5 million, amortization of intangible assets of \$2.2 million, and a decrease in other income (expense), net of \$2.5 million.

**First Three Quarters Results**

The following table summarizes key components of our results of operations for the first three quarters ended November 1, 2020 and November 3, 2019. The percentages are presented as a percentage of net revenue.

	Three Quarters Ended			
	November 1, 2020	November 3, 2019	November 1, 2020	November 3, 2019
	<i>(In thousands)</i>		<i>(Percentages)</i>	
Net revenue	\$ 2,672,330	\$ 2,581,805	100.0 %	100.0 %
Cost of goods sold	1,221,073	1,169,245	45.7	45.3
Gross profit	1,451,257	1,412,560	54.3	54.7
Selling, general and administrative expenses	1,064,172	939,930	39.8	36.4
Amortization of intangible assets	2,965	7	0.1	—
Acquisition-related expenses	22,040	—	0.8	—
Income from operations	362,080	472,623	13.5	18.3
Other income (expense), net	250	6,154	—	0.2
Income before income tax expense	362,330	478,777	13.6	18.5
Income tax expense	103,254	131,202	3.9	5.1
Net income	<u>\$ 259,076</u>	<u>\$ 347,575</u>	<u>9.7 %</u>	<u>13.5 %</u>

**Net Revenue**

Net revenue increased \$90.5 million, or 4%, to \$2.672 billion for the first three quarters of fiscal 2020 from \$2.582 billion for the first three quarters of fiscal 2019. On a constant dollar basis, assuming the average exchange rates for the first three quarters of fiscal 2020 remained constant with the average exchange rates for the first three quarters of fiscal 2019, net revenue increased \$98.5 million, or 4%.

The increase in net revenue was primarily due to an increase in direct to consumer net revenue, partially due to a shift in the way guests are shopping due to COVID-19, partially offset by a decrease in company-operated store net revenue as well as a decrease in net revenue from our other retail locations driven by temporary closures as a result of COVID-19 as well as reduced operating hours and restricted guest occupancy levels.

Net revenue on a segment basis for the first three quarters ended November 1, 2020 and November 3, 2019 is summarized below. The percentages are presented as a percentage of total net revenue.

	Three Quarters Ended			
	November 1, 2020	November 3, 2019	November 1, 2020	November 3, 2019
	<i>(In thousands)</i>		<i>(Percentages)</i>	
Company-operated stores	\$ 1,058,927	\$ 1,669,699	39.6 %	64.7 %
Direct to consumer	1,384,604	674,177	51.8	26.1
Other	228,799	237,929	8.6	9.2
Net revenue	<u>\$ 2,672,330</u>	<u>\$ 2,581,805</u>	<u>100.0 %</u>	<u>100.0 %</u>

*Company-Operated Stores.* Net revenue from our company-operated stores segment decreased \$610.8 million, or 37%, to \$1.059 billion in the first three quarters of fiscal 2020 from \$1.670 billion in the first three quarters of fiscal 2019. The decrease in net revenue from our company-operated stores segment was primarily due to the impact of COVID-19. All of our stores in North America, Europe, and certain countries in Asia Pacific were temporarily closed for a significant portion of the first two quarters of fiscal 2020. COVID-19 restrictions, including reduced operating hours and occupancy limits, reduced net revenue from company-operated stores that have reopened.

*Direct to Consumer.* Net revenue from our direct to consumer segment increased \$710.4 million, or 105%, to \$1.385 billion in the first three quarters of fiscal 2020 from \$674.2 million in the first three quarters of fiscal 2019. Direct to consumer net revenue increased 106% on a constant dollar basis. The increase in net revenue from our direct to consumer segment was primarily a result of increased website traffic and improved conversion rates, partially offset by a decrease in dollar value per transaction. These changes were partially due to COVID-19, with more guests shopping online instead of in-store. During the

second quarter of fiscal 2020, we held an online warehouse sale in the United States and Canada which generated net revenue of \$43.3 million. We did not hold any warehouse sales during the first three quarters of fiscal 2019.

*Other channels.* Net revenue from our other segment decreased \$9.1 million, or 4%, to \$228.8 million in the first three quarters of fiscal 2020 from \$237.9 million in the first three quarters of fiscal 2019. This decrease was primarily the result of COVID-19, including temporary location closures, reduced operating hours, and occupancy restrictions, partially offset by net revenue from MIRROR.

### **Gross Profit**

Gross profit increased \$38.7 million, or 3%, to \$1.451 billion for the first three quarters of fiscal 2020 from \$1.413 billion for the first three quarters of fiscal 2019.

Gross profit as a percentage of net revenue, or gross margin, decreased 40 basis points, to 54.3% in the first three quarters of fiscal 2020 from 54.7% in the first three quarters of fiscal 2019. The decrease in gross margin was primarily the result of an increase in costs as a percentage of revenue related to our distribution centers of 90 basis points. This was partially offset by a decrease in costs related to our product departments of 30 basis points, and an increase in product margin of 20 basis points. The increase in product margin was primarily due to lower product costs and a favorable mix of higher margin product, partially offset by higher markdowns.

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

Selling, general and administrative expenses increased \$124.2 million, or 13%, to \$1.064 billion in the first three quarters of fiscal 2020 from \$939.9 million in the first three quarters of fiscal 2019. The increase in selling, general and administrative expenses was primarily due to:

- an increase in costs related to our operating channels of \$119.4 million, comprised of:
  - an increase in variable costs of \$80.3 million primarily due to an increase in distribution costs and credit card fees as a result of increased direct to consumer net revenue; and
  - an increase in brand and community costs of \$58.4 million primarily due to an increase in digital marketing expenses; and
  - a decrease in employee costs of \$26.6 million primarily due to lower incentive compensation expenses in our company-operated store and other channels. This was partially offset by an increase in salaries and wages as a result of increased headcount and labor hours in our direct to consumer channel; and
  - an increase in other operating costs of \$7.3 million primarily due to an increase in information technology costs; and
- an increase in head office costs of \$42.7 million, comprised of:
  - an increase of \$54.8 million primarily due to an increase in information technology costs, depreciation, and professional fees, as well as an increase in brand and community costs primarily due to donations; and
  - a decrease in employee costs of \$12.1 million primarily due to decreased incentive compensation expense and travel expenses, partially offset by increased salaries and wages expense as a result of headcount growth, and higher stock-based compensation expense.

The increase in selling, general and administrative expenses was partially offset by \$36.4 million of government payroll subsidies which were recognized during the first three quarters of fiscal 2020 and a decrease in net foreign exchange and derivative revaluation losses of \$1.4 million.

As a percentage of net revenue, selling, general and administrative expenses increased 340 basis points, to 39.8% in the first three quarters of fiscal 2020 from 36.4% in the first three quarters of fiscal 2019.

### **Amortization of intangible assets**

Amortization of intangible assets increased to \$3.0 million in the first three quarters of fiscal 2020 from less than \$0.1 million in the first three quarters of fiscal 2019. This increase was the result of amortization of intangible assets recognized upon the acquisition of MIRROR.

## Acquisition-related expenses

As a result of our acquisition of MIRROR in the second quarter of fiscal 2020, we recognized acquisition-related expenses of \$22.0 million in the first three quarters of fiscal 2020. This included acquisition-related compensation of \$12.6 million for deferred consideration for certain continuing MIRROR employees and the partial acceleration of vesting of certain options. This also included transaction and integration related costs of \$10.3 million for advisory and professional services, and integration costs subsequent to the acquisition. Acquisition-related expenses were partially offset by a \$0.8 million gain recognized on our existing investment. We did not have acquisition-related expenses in the first three quarters of fiscal 2019. Please refer to Note 3 to the unaudited interim consolidated financial statements included in Item 1 of Part I of this report for further information.

## Income from Operations

Income from operations decreased \$110.5 million, or 23%, to \$362.1 million in the first three quarters of fiscal 2020 from \$472.6 million in the first three quarters of fiscal 2019. Operating margin decreased 480 basis points to 13.5% compared to 18.3% in the first three quarters of fiscal 2019.

On a segment basis, we determine income from operations without taking into account our general corporate expenses. During the first quarter of fiscal 2020, we reviewed our segment and general corporate expenses and determined certain costs that are more appropriately classified in different categories. Accordingly, comparative figures have been reclassified to conform to the financial presentation adopted for the current year.

Segmented income from operations for the first three quarters ended November 1, 2020 and November 3, 2019 is summarized below. The percentages are presented as a percentage of net revenue of the respective operating segments.

	Three Quarters Ended			
	2020	2019	2020	2019
	<i>(In thousands)</i>		<i>(Percentage of segment revenue)</i>	
Segmented income operations:				
Company-operated stores	\$ 76,333	\$ 422,948	7.2 %	25.3 %
Direct to consumer	604,152	269,553	43.6	40.0
Other	3,622	45,860	1.6	19.3
	<u>684,107</u>	<u>738,361</u>		
General corporate expense	297,022	265,731		
Amortization of intangible assets	2,965	7		
Acquisition-related expenses	22,040	—		
Income from operations	<u>\$ 362,080</u>	<u>\$ 472,623</u>		

*Company-Operated Stores.* Income from operations from our company-operated stores segment decreased \$346.6 million, or 82%, to \$76.3 million for the first three quarters of fiscal 2020 from income of \$422.9 million for the first three quarters of fiscal 2019. The decrease was primarily the result of decreased gross profit of \$437.4 million which was primarily due to lower net revenue as a result of the impact of COVID-19, as well as lower gross margin, which was primarily due to deleverage on occupancy and depreciation costs as a result of lower net revenue. This decrease in gross profit was partially offset by a decrease in selling, general and administrative expenses, primarily due to decreased store operating expenses including lower incentive compensation, credit card fees, packaging costs, and distribution costs primarily as a result of lower net revenue, as well as decreases in security and repairs and maintenance costs, and the recognition of government payroll subsidies. Income from operations as a percentage of company-operated stores net revenue decreased, primarily due to lower gross margin and deleverage on selling, general and administrative expenses.

*Direct to Consumer.* Income from operations from our direct to consumer segment increased \$334.6 million, or 124%, to \$604.2 million for the first three quarters of fiscal 2020 from \$269.6 million for the first three quarters of fiscal 2019. The increase was primarily the result of increased gross profit of \$481.4 million which was primarily due to increased net revenue, partially from the shift in guests shopping online instead of in-store. The increase in gross profit 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 as a result of higher net revenue, as well as higher digital marketing expenses and employee costs. Income from operations as a percentage of direct to consumer net revenue increased 360 basis points, primarily due to leverage on selling, general and administrative expenses and higher gross margin.

*Other channels.* Income from operations from our other channels decreased \$42.2 million, or 92%, to \$3.6 million for the first three quarters of fiscal 2020 from \$45.9 million for the first three quarters of fiscal 2019. This was primarily due to increased selling, general and administrative expenses, primarily due to digital marketing expenses related to MIRROR, as well as distribution costs and credit card fees as a result of revenue generated from MIRROR, and a decrease in gross profit of \$5.3 million. Income from operations as a percentage of other net revenue decreased primarily due to deleverage on selling, general and administrative expenses.

*General Corporate Expense.* General corporate expense increased \$31.3 million, or 12%, to \$297.0 million for the first three quarters of fiscal 2020 from \$265.7 million for the first three quarters of fiscal 2019. This increase was primarily due to increases in information technology costs, salaries and wages as a result of headcount growth, depreciation, professional fees, donations, and stock based compensation expense. The increase in general corporate expense was partially offset by a decrease in incentive compensation, the recognition of government payroll subsidies, and a decrease in net foreign exchange and derivative revaluation losses of \$1.4 million.

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

Other income, net decreased \$5.9 million, or 96%, to \$0.3 million for the first three quarters of fiscal 2020 from \$6.2 million for the first three quarters of fiscal 2019. The decrease was primarily due to a decrease in net interest income as a result of lower cash balances and lower interest rates.

### **Income Tax Expense**

Income tax expense decreased \$27.9 million, or 21%, to \$103.3 million for the first three quarters of fiscal 2020 from \$131.2 million for the first three quarters of fiscal 2019. The effective tax rate for the first three quarters of fiscal 2020 was 28.5% compared to 27.4% for the first three quarters of fiscal 2019.

The increase in the effective tax rate was primarily due to certain non-deductible expenses related to the MIRROR acquisition which increased the effective tax rate by 90 basis points, new regulations which resulted in additional foreign tax credits being recognized in the first three quarters of fiscal 2019, and certain non-deductible expenses in foreign jurisdictions. This was partially offset by an increase in tax deductions related to stock-based compensation.

### **Net Income**

Net income decreased \$88.5 million, or 25%, to \$259.1 million for the first three quarters of fiscal 2020 from \$347.6 million for the first three quarters of fiscal 2019. This was primarily due to an increase in selling, general and administrative expenses of \$124.2 million, acquisition-related expenses of \$22.0 million, amortization of intangible assets of \$3.0 million, and a decrease in other income (expense), net of \$5.9 million, partially offset by an increase in gross profit of \$38.7 million, and a decrease in income tax expense of \$27.9 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, or open after being significantly expanded, for at least 12 full fiscal months. Net revenue from a store is included in comparable store sales beginning with the first fiscal month for which the store has a full fiscal month of sales in the prior year. Comparable store sales exclude sales from new stores that have not been open for at least 12 full fiscal months, from stores which have not been in their significantly expanded space for at least 12 full fiscal months, and from stores which have been temporarily relocated for renovations or temporarily closed for at least 30 days. Comparable store sales also exclude sales from direct to consumer and other segments, as well as 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 omnichannel 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.

In fiscal years with 53 weeks, the 53rd week of net revenue is excluded from the calculation of comparable sales. In the year 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.

We use comparable store sales to assess the performance of our existing stores as it allows us to monitor the performance of our business without the impact of recently opened or expanded stores. We use total comparable sales to evaluate the

performance of our business from an omni-channel perspective. We therefore believe investors would similarly find these metrics useful in assessing the performance of our business.

As the temporary closures from COVID-19 resulted in a significant number of stores being removed from our comparable store base during the first two quarters of fiscal 2020, total comparable sales and comparable store sales for year-to-date periods are not currently representative of the underlying trends of our business. We do not believe these year-to-date metrics are currently useful to investors in understanding performance, therefore we have not included these metrics in our discussion and analysis of results of operations. As most of our stores were open during the third quarter of fiscal 2020, and our comparable store base therefore included the majority of our stores, we have included total comparable sales and comparable store sales on a quarter-to-date basis in our discussion and analysis of results of operations.

### **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 our results to help investors understand the underlying growth rate of net revenue excluding the impact of changes in foreign exchange rates.

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 November 1, 2020		Three Quarters Ended November 1, 2020	
	(In thousands)	(Percentages)	(In thousands)	(Percentages)
Change	\$ 201,288	22 %	\$ 90,525	4 %
Adjustments due to foreign exchange rate changes	(6,656)	(1)	7,994	—
Change in constant dollars	\$ 194,632	21 %	\$ 98,519	4 %

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

The below changes in total comparable sales, comparable store sales, and direct to consumer net revenue show the change compared to the corresponding period in the prior year. As the temporary closures from COVID-19 resulted in a significant number of stores being removed from our comparable store base during the first two quarters of fiscal 2020, total comparable sales and comparable store sales are only reported on a quarter-to-date basis.

	Quarter Ended November 1, 2020		Three Quarters Ended November 1, 2020	
	Total Comparable Sales <sup>1,2</sup>	Comparable Store Sales <sup>2</sup>	Direct to Consumer Net Revenue	Direct to Consumer Net Revenue
Change	19 %	(17)%	94 %	105 %
Adjustments due to foreign exchange rate changes	(1)	(1)	(1)	1
Change in constant dollars	18 %	(18)%	93 %	106 %

<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% of our full year operating profit during each of the fourth quarters of fiscal 2019 and fiscal 2018.

**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 facilities. 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 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 November 1, 2020, our working capital, excluding cash and cash equivalents, was \$388.4 million, our cash and cash equivalents were \$481.6 million, and our capacity under our committed revolving credit facilities was \$697.3 million. On December 4, 2020, we gave notice to terminate our \$300.0 million 364-day unsecured revolving credit facility, which will reduce the available capacity under our committed revolving credit facilities to \$397.3 million.

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

	<b>Three Quarters Ended</b>	
	<b>November 1, 2020</b>	<b>November 3, 2019</b>
	<i>(In thousands)</i>	
<b>Total cash provided by (used in):</b>		
Operating activities	\$ 85,404	\$ 95,106
Investing activities	(616,544)	(212,475)
Financing activities	(81,404)	(179,555)
Effect of exchange rate changes on cash	620	1,757
Decrease in cash and cash equivalents	<u>\$ (611,924)</u>	<u>\$ (295,167)</u>

**Operating Activities**

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

Cash provided by operating activities decreased \$9.7 million, to \$85.4 million for the first three quarters of fiscal 2020 compared to \$95.1 million for the first three quarters of fiscal 2019, primarily as a result of the following:

- A decrease of \$88.5 million in net income, primarily due temporary closures as well as reduced operating hours and limited guest occupancy levels as a result of COVID-19.

The decrease in net income was partially offset by the following:

- an increase of \$65.5 million from changes in operating assets and liabilities, primarily due to the following:
  - an increase of \$63.0 million related to other accrued liabilities, primarily due to increases in accrued duty, freight, and other operating expenses as well as an increase in the sales return allowance as a result of COVID-19 reducing in-period returns;
  - an increase of \$52.5 million related to accounts payable;
  - an increase of \$17.2 million related to income taxes due to payments for withholding taxes on repatriated foreign earnings in the first quarter of fiscal 2019; and
  - an increase of \$1.2 million related to inventories.

The increase from changes in operating assets and liabilities was partially offset by the following:

- a decrease of \$40.1 million related to prepaid expenses and other current and non-current assets, including increases in cloud computing implementation costs; and

- a decrease of \$26.9 million related to accrued compensation.
- an increase of \$13.3 million from adjustments to reconcile net income to net cash provided by operating activities other than changes in operating assets and liabilities, primarily related to an increase in depreciation and amortization, partially offset by a decrease in the settlement of derivatives not designated in a hedging relationship.

### **Investing Activities**

Cash flows used in investing activities relate to the acquisition of MIRROR, capital expenditures, the settlement of net investment hedges, and other investing activities. Capital expenditures primarily relate to 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 \$404.1 million to \$616.5 million for the first three quarters of fiscal 2020 from \$212.5 million for the first three quarters of fiscal 2019. The increase was primarily the result of the acquisition of MIRROR, partially offset by a decrease in capital expenditures for our company-operated stores.

### **Financing Activities**

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

Cash used in financing activities decreased \$98.2 million to \$81.4 million for the first three quarters of fiscal 2020 compared to \$179.6 million for the first three quarters of fiscal 2019. The decrease was primarily the result of a decrease in stock repurchases.

Cash used in financing activities for the first three quarters of fiscal 2020 included \$63.7 million to repurchase 0.4 million shares of our common stock compared to \$173.1 million to repurchase 1.1 million shares for the first three quarters of fiscal 2019. During the first three quarters of fiscal 2019, 1.0 million shares were repurchased in a private transaction. We did not purchase any shares in a private transaction during the first three quarters of fiscal 2020. 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 the cash and cash equivalent balances, cash flows from operations, and borrowings available under the \$400.0 million unsecured revolving credit facility are adequate to meet our liquidity needs and capital expenditure requirements for at least the next 12 months. The cash from operations may be negatively impacted by a decrease in demand for our products, the continuing impact of COVID-19, as well as the other factors described in Item 1 of Part II of this Quarterly Report on Form 10-Q. In addition, discretionary capital improvements may be made with respect to the stores, distribution facilities, headquarters, or systems. Strategic investments or repurchase of shares under an approved stock repurchase program may be made, 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 expenditures out of our cash and cash equivalents and cash generated from operations.

### ***Revolving Credit Facilities***

#### **North America revolving credit facility**

On December 15, 2016, we entered into a credit agreement for \$150.0 million under a committed and 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 November 1, 2020, we were in compliance with the covenants of the credit facility.

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 November 1, 2020, aside from letters of credit of \$2.7 million, we had no other borrowings outstanding under this credit facility.

### **Mainland China revolving credit facility**

In December 2019, we entered into an uncommitted and unsecured 130.0 million Chinese Yuan revolving credit facility. The terms are reviewed on an annual basis. The facility includes a revolving loan of up to 100.0 million Chinese Yuan as well as a financial bank guarantee facility of up to 30.0 million Chinese Yuan, or its equivalent in another currency. In U.S. dollars, the uncommitted and unsecured revolving credit facility is equivalent to \$19.4 million, the revolving loan is equivalent of up to \$14.9 million, and the financial bank guarantee facility is equivalent of up to \$4.5 million. Loans are available in Chinese Yuan for a period not to exceed 12 months, and interest accrues on them at a rate equal to 105% of the applicable PBOC Benchmark Lending Rate. Guarantees have a commission equal to 1% per annum of the outstanding amount. We are required to follow certain covenants. As of November 1, 2020, we were in compliance with the covenants. As of November 1, 2020, there were no borrowings outstanding under this credit facility.

### **364-Day revolving credit facility**

On June 29, 2020, we entered into a 364-day credit agreement providing for a \$300.0 million committed and unsecured revolving credit facility. The credit agreement matures on June 28, 2021. Bank of America, N.A., is administrative agent and swing line lender. Borrowings under the credit facility may be prepaid and commitments may be reduced or terminated without premium or penalty (other than customary breakage costs).

Borrowings made under the credit facility bear interest at a rate per annum equal to, at our option, either (1) 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 (2) 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 1.50%-2.25% for LIBOR loans and 0.50%-1.25% for alternate base rate or Canadian prime rate loans. Additionally, a commitment fee of between 0.25%-0.55%, also determined by reference to the pricing grid, is payable on the average daily unused amounts under the 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 November 1, 2020, we were in compliance with the covenants. As of November 1, 2020, there were no borrowings outstanding under this credit facility.

On December 4, 2020, we gave notice to terminate this 364-day unsecured revolving credit facility. It will be terminated without penalty on December 11, 2020.

### ***Off-Balance Sheet Arrangements***

We enter into standby letters of credit to secure certain of our obligations, including leases, taxes, and duties. As of November 1, 2020, letters of credit and letters of guarantee totaling \$2.7 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 2019 Annual Report on Form 10-K filed with the SEC on March 26, 2020, and in Notes 1, 2, 3, 8, and 9, 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 November 1, 2020 and February 2, 2020 are summarized in the table below.

	November 1, 2020	February 2, 2020
United States	314	305
Canada	61	63
People's Republic of China <sup>(1)</sup>	50	38
Australia	31	31
United Kingdom	16	14
Japan	7	7
Germany	7	6
New Zealand	7	7
South Korea	7	5
Singapore	4	4
France	3	3
Malaysia	2	2
Sweden	2	2
Ireland	1	1
Netherlands	1	1
Norway	1	1
Switzerland	1	1
Total company-operated stores	515	491

<sup>(1)</sup> Included within PRC as of November 1, 2020, were seven company-operated stores in the Hong Kong Special Administrative Region, two company-operated stores in the Macao Special Administration Region, and two company-operated store in Taiwan, PRC. As of February 2, 2020, there were six company-operated stores in the Hong Kong Special Administrative Region, two company-operated stores in the Macao Special Administration Region, and one company-operated store in Taiwan, PRC.

Our retail locations have experienced temporary closures during the first three quarters of fiscal 2020 as a result of COVID-19. Almost all locations were open during the third quarter of fiscal 2020. Subsequent to November 1, 2020, while almost all of our retail locations have remained open, we have experienced some temporary closures and are currently operating with tighter capacity restrictions in certain markets.

Retail locations operated by third parties under license and supply arrangements are not included in the above table. As of November 1, 2020, 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 November 1, 2020, 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 and Chinese subsidiaries on U.S. dollar denominated monetary assets and liabilities. Please refer to Note 9 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 three quarters of fiscal 2020, the change in the relative value of the U.S. dollar against the Canadian dollar resulted in a \$6.7 million increase in accumulated other comprehensive loss within stockholders' equity. During the first three quarters of fiscal 2019, the change in the relative value of the U.S. dollar against the Canadian dollar resulted in a \$0.9 million reduction 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 three quarters of fiscal 2020 would have resulted in lower income from operations of approximately \$10.6 million in the first three quarters of fiscal 2020. This assumes a consistent 10% appreciation in the U.S. dollar against the Canadian dollar over the first three quarters of fiscal 2020. 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 committed revolving credit facilities provide us with available borrowings in an amount up to \$700.0 million in the aggregate. Because our revolving credit facilities bear 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 November 1, 2020, aside from letters of credit of \$2.7 million, there were no borrowings outstanding under these credit facilities. 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, 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 November 1, 2020. Based on that evaluation, our principal executive officer and principal financial and accounting officer concluded that, at November 1, 2020, our disclosure controls and procedures were effective.

There were no changes in our internal control over financial reporting during the quarter ended November 1, 2020 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.