

## **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, 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.

### ***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 recommend precautions to mitigate the spread of the virus, especially when congregating in heavily populated areas, such as malls and lifestyle centers. Government authorities in certain markets in which we operate have also issued orders that require the closure of non-essential businesses and people to remain at home.

We have taken actions to close retail locations and to reduce operating hours, and 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. All of these locations have since reopened. In March 2020, we temporarily closed all of our retail locations in North America, Europe, and certain countries in Asia Pacific. Subsequent to May 3, 2020, we began reopening our retail locations in these markets in line with the guidance from local authorities. As of June 10, 2020, 295 of our company-operated stores were open. Our distribution centers in Columbus, Ohio and Sumner, Washington were temporarily closed for one and two weeks, respectively, during the first quarter of fiscal 2020 due to COVID-19. As of June 10, 2020, all of our distribution centers were open.

Our retail locations and distribution centers are operating with precautionary measures in place such as reduced operating hours, physical distancing, enhanced cleaning and sanitation, and maximum 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 progresses, 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 store 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 quarter of fiscal 2020, and we expect it to continue to impact our results of operations, financial position, and liquidity. 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 May 3, 2020, we had cash and cash equivalents of \$823.0 million and the capacity under our committed revolving credit facility was \$398.2 million.

### ***Financial Highlights***

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

- Net revenue decreased 17% to \$652.0 million. On a constant dollar basis, net revenue decreased 16%.
- Direct to consumer net revenue increased 68%, or increased 70% on a constant dollar basis.
- Gross profit decreased 21% to \$334.4 million.
- Gross margin decreased 260 basis points to 51.3%.
- Income from operations decreased 75% to \$32.8 million.
- Operating margin decreased 1,150 basis points to 5.0%.
- Income tax expense decreased 85% to \$5.3 million. Our effective tax rate for the first quarter of fiscal 2020 was 15.6% compared to 26.4% for the first quarter of fiscal 2019.
- Diluted earnings per share were \$0.22 compared to \$0.74 in the first quarter of fiscal 2019.

As the temporary store closures from COVID-19 have resulted in a significant number of stores being removed from our comparable store base, total comparable sales and comparable store sales are not currently representative of the underlying trends of our business. We do not believe these 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.

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 and direct to consumer net revenue.

## Results of Operations

### First Quarter Results

The following table summarizes key components of our results of operations for the quarters ended May 3, 2020 and May 5, 2019. The percentages are presented as a percentage of net revenue.

	Quarter Ended			
	May 3, 2020	May 5, 2019	May 3, 2020	May 5, 2019
	<i>(In thousands)</i>		<i>(Percentages)</i>	
Net revenue	\$ 651,962	\$ 782,315	100.0%	100.0%
Cost of goods sold	317,560	360,595	48.7	46.1
Gross profit	334,402	421,720	51.3	53.9
Selling, general and administrative expenses	301,651	292,908	46.3	37.4
Income from operations	32,751	128,812	5.0	16.5
Other income (expense), net	1,174	2,379	0.2	0.3
Income before income tax expense	33,925	131,191	5.2	16.8
Income tax expense	5,293	34,588	0.8	4.4
Net income	\$ 28,632	\$ 96,603	4.4%	12.3%

### Net Revenue

Net revenue decreased \$130.4 million, or 17%, to \$652.0 million for the first quarter of fiscal 2020 from \$782.3 million for the first quarter of fiscal 2019. On a constant dollar basis, assuming the average exchange rates for the first quarter of fiscal 2020 remained constant with the average exchange rates for the first quarter of fiscal 2019, net revenue decreased \$122.7 million, or 16%.

The decrease in net revenue was primarily due to the impact of COVID-19, including temporary closures of company-operated stores. Decreased company-operated store net revenue as well as a decrease in net revenue from our other locations contributed to the decrease in net revenue. This was partially offset by an increase in direct to consumer net revenue.

Net revenue on a segment basis for the quarters ended May 3, 2020 and May 5, 2019 is summarized below. The percentages are presented as a percentage of total net revenue.

	Quarter Ended			
	May 3, 2020	May 5, 2019	May 3, 2020	May 5, 2019
	<i>(In thousands)</i>		<i>(Percentages)</i>	
Company-operated stores	\$ 259,970	\$ 506,422	39.9%	64.7%
Direct to consumer	352,039	209,844	54.0	26.8
Other	39,953	66,049	6.1	8.4
Net revenue	\$ 651,962	\$ 782,315	100.0%	100.0%

*Company-Operated Stores.* Net revenue from our company-operated stores segment decreased \$246.5 million, or 49%, to \$260.0 million in the first quarter of fiscal 2020 from \$506.4 million in the first quarter 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 closed for a significant portion of the quarter.

*Direct to Consumer.* Net revenue from our direct to consumer segment increased \$142.2 million, or 68%, to \$352.0 million in the first quarter of fiscal 2020 from \$209.8 million in the first quarter of fiscal 2019. Direct to consumer net revenue increased 70% 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. This was partially offset by a decrease in dollar value per transaction. There was a shift in the way guests shopped in the first quarter of fiscal 2020 as a result of COVID-19, with more guests shopping online instead of in-store, primarily due to temporary store closures.

*Other.* Net revenue from our other segment decreased \$26.1 million, or 40%, to \$40.0 million in the first quarter of fiscal 2020 from \$66.0 million in the first quarter of fiscal 2019. This decrease was primarily the result of the temporary closures of our other retail locations as a result of COVID-19.

## Gross Profit

Gross profit decreased \$87.3 million, or 21%, to \$334.4 million for the first quarter of fiscal 2020 from \$421.7 million for the first quarter of fiscal 2019.

Gross profit as a percentage of net revenue, or gross margin, decreased 260 basis points to 51.3% in the first quarter of fiscal 2020 from 53.9% in the first quarter of fiscal 2019. The decrease in gross margin was primarily the result of:

- an increase in occupancy and depreciation costs as a percentage of revenue of 330 basis points, primarily due to lower net revenue;
- an increase in costs as a percentage of revenue related to our distribution centers of 100 basis points primarily due to lower net revenue; and
- an unfavorable impact of foreign exchange rates of 20 basis points.

This was partially offset by an increase in product margin of 180 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 \$8.7 million, or 3%, to \$301.7 million in the first quarter of fiscal 2020 from \$292.9 million in the first quarter of fiscal 2019. The increase in selling, general and administrative expenses was primarily due to:

- an increase in head office costs of \$7.6 million, comprised of:
  - an increase in other costs of \$18.2 million primarily due to increases in depreciation, information technology costs, brand and community costs, and other head office costs; and
  - a decrease in employee costs of \$10.6 million primarily due to decreased incentive and stock-based compensation expense; and
- an increase in costs related to our operating channels of \$16.6 million, comprised of:
  - an increase in variable costs of \$10.4 million primarily due to an increase in distribution costs as a result of increased direct to consumer net revenue;
  - an increase in other costs of \$11.6 million primarily due to increased digital marketing expenses;
  - a decrease in employee costs of \$5.4 million primarily due to lower incentive compensation expenses due to temporary store closures as a result of COVID-19; and

The increase in selling, general and administrative expenses was partially offset by \$14.3 million of government payroll subsidies which were recognized during the first quarter of fiscal 2020, and by an increase in net foreign exchange and derivative revaluation gains of \$1.2 million.

As a percentage of net revenue, selling, general and administrative expenses increased 890 basis points, to 46.3% in the first quarter of fiscal 2020 from 37.4% in the first quarter of fiscal 2019.

## Income from Operations

Income from operations decreased \$96.1 million, or 75%, to \$32.8 million in the first quarter of fiscal 2020 from \$128.8 million in the first quarter of fiscal 2019. Operating margin decreased 1,150 basis points to 5.0% compared to 16.5% in the first 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 (loss) from operations for the quarters ended May 3, 2020 and May 5, 2019 is summarized below. The percentages are presented as a percentage of net revenue of the respective operating segments.

	Quarter Ended			
	May 3, 2020	May 5, 2019	May 3, 2020	May 5, 2019
	<i>(In thousands)</i>		<i>(Percentage of segment revenue)</i>	
Segmented income (loss) from operations:				
Company-operated stores . . . . .	\$ (30,154)	\$ 120,911	(11.6)%	23.9%
Direct to consumer . . . . .	156,947	79,337	44.6	37.8
Other . . . . .	(269)	12,623	(0.7)	19.1
	<u>126,524</u>	<u>212,871</u>		
General corporate expense . . . . .	<u>93,773</u>	<u>84,059</u>		
Income from operations . . . . .	<u>\$ 32,751</u>	<u>\$ 128,812</u>		

*Company-Operated Stores.* Income from operations from our company-operated stores segment decreased \$151.1 million, or 125%, to a loss of \$30.2 million for the first quarter of fiscal 2020 from income of \$120.9 million for the first quarter of fiscal 2019. The decrease was primarily the result of decreased gross profit of \$177.5 million which was primarily due to temporary store closures resulting from COVID-19, and lower gross margin, which was primarily due to deleverage on occupancy and depreciation costs as a result of lower net revenue. This was partially offset by a decrease in selling, general and administrative expenses, primarily due to decreased store operating expenses including the recognition of government payroll subsidies, and lower credit card fees, distribution costs, and packaging costs primarily as a result of lower net revenue. Additionally, there was a decrease in employee costs, primarily due to lower incentive compensation expenses due to temporary store closures. 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 \$77.6 million, or 98%, to \$156.9 million for the first quarter of fiscal 2020 from \$79.3 million for the first quarter of fiscal 2019. The increase was primarily the result of increased gross profit of \$103.2 million which was primarily due to increased net revenue as more guests shopped online in the first quarter of fiscal 2020 as a result of COVID-19, and due to higher gross margin. This was partially offset by an increase in selling, general and administrative expenses primarily due to higher variable costs including distribution costs and credit card fees as a result of higher net revenue, as well as higher digital marketing expenses. Income from operations as a percentage of direct to consumer net revenue increased 680 basis points primarily due to higher gross margin and leverage on selling, general and administrative expenses.

*Other.* Income from operations from our other channels decreased \$12.9 million, or 102%, to a loss of \$0.3 million for the first quarter of fiscal 2020 from income of \$12.6 million for the first quarter of fiscal 2019. The decrease was primarily the result of decreased gross profit of \$13.0 million which was primarily due to decreased net revenue, primarily due to temporary store closures resulting from COVID-19. Income from operations as a percentage of other net revenue decreased primarily due to deleverage on selling, general and administrative expenses and lower gross margin.

*General Corporate Expense.* General corporate expense increased \$9.7 million, or 12%, to \$93.8 million for the first quarter of fiscal 2020 from \$84.1 million for the first quarter of fiscal 2019. This increase was primarily due to increases in depreciation, information technology costs, and as a result of donations made through our Ambassador Relief Fund that provided grants to fitness studio owners impacted by COVID-19. The increase in general corporate expense was partially offset by a decrease in head office employee costs, and an increase in net foreign exchange and derivative revaluation gains of \$1.2 million.

### Other Income (Expense), Net

Other income, net decreased \$1.2 million, or 51%, to \$1.2 million for the first quarter of fiscal 2020 from income of \$2.4 million for the first quarter of fiscal 2019. The decrease was primarily due to a decrease in net interest income.

### Income Tax Expense

Income tax expense decreased \$29.3 million, or 85%, to \$5.3 million for the first quarter of fiscal 2020 from \$34.6 million for the first quarter of fiscal 2019. The effective tax rate for the first quarter of fiscal 2020 was 15.6% compared to 26.4% for the first quarter of fiscal 2019. The decrease in the effective tax rate was primarily due to an increase in tax deductions related to stock-based compensation which, as a result of the lower pre-tax income for the quarter, represented a higher proportion of income before income tax expense and so reduced the overall effective tax rate.

## **Net Income**

Net income decreased \$68.0 million, or 70%, to \$28.6 million for the first quarter of fiscal 2020 from \$96.6 million for the first quarter of fiscal 2019. This was primarily due to a decrease in gross profit of \$87.3 million, an increase in selling, general and administrative expenses of \$8.7 million, and a decrease in other income (expense), net of \$1.2 million, partially offset by a decrease in income tax expense of \$29.3 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, 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 omni-channel approach to support the shopping behavior of our guests. This involves country and region specific websites, mobile apps, including mobile apps on in-store devices that allow demand to be fulfilled via our distribution centers, social media, product notification emails, and online order fulfillment through stores.

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 typically 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 typically use total comparable sales to evaluate the performance of our business from an omni-channel perspective. We therefore typically believe that investors would similarly find these metrics useful in assessing the performance of our business. However, as the temporary store closures from COVID-19 have resulted in a significant number of stores being removed from our comparable store base, we believe total comparable sales and comparable store sales are not currently representative of the underlying trends of our business. We do not believe these 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.

## ***Non-GAAP Financial Measures***

Constant dollar changes in net revenue 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 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 and direct to consumer net revenue**

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

	<b>Quarter Ended May 3, 2020</b>		
	<b>Net Revenue</b>		<b>Direct to Consumer Net Revenue</b>
	<i>(In thousands)</i>	<i>(Percentages)</i>	<i>(Percentages)</i>
Change .....	\$ (130,353)	(17)%	68%
Adjustments due to foreign exchange rate changes .....	7,674	1	2
Change in constant dollars .....	<u>\$ (122,679)</u>	<u>(16)%</u>	<u>70%</u>

**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 May 3, 2020, our working capital, excluding cash and cash equivalents, was \$240.0 million, our cash and cash equivalents were \$823.0 million, and our capacity under our committed 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>Quarter Ended</b>	
	<b>May 3, 2020</b>	<b>May 5, 2019</b>
	<i>(In thousands)</i>	
Total cash (used in) provided by:		
Operating activities .....	\$ (121,243)	\$ (62,803)
Investing activities .....	(45,626)	(63,908)
Financing activities .....	(90,587)	(170,292)
Effect of exchange rate changes on cash .....	(13,043)	(8,076)
Decrease in cash and cash equivalents .....	<u>\$ (270,499)</u>	<u>\$ (305,079)</u>

**Operating Activities**

Cash flows 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 used in operating activities increased \$58.4 million, to \$121.2 million for the first quarter of fiscal 2020 compared to \$62.8 million for the first quarter of fiscal 2019, primarily as a result of a decrease of \$68.0 million in net income primarily due to the impact of COVID-19, including temporary closures of company-operated stores. This was partially offset by the following:

- an increase of \$6.0 million in non-cash expenses primarily related to an increase in depreciation, partially offset by a decrease in stock-based compensation expense; and

- an increase of \$3.5 million in changes in operating assets and liabilities, primarily due to the following:
  - an increase of \$92.9 million related to income taxes, primarily due to the deferral of Canadian income tax payments to the third quarter of fiscal 2020 as well as payments for withholding taxes on repatriated foreign earnings in the first quarter of fiscal 2019;
  - an increase of \$61.9 million related to other current and non-current liabilities primarily due to an increase in forward currency contract liabilities as a result of foreign exchange fluctuations, and an increase in the sales return allowance as a result of COVID-19 reducing in-period returns; and
  - an increase of \$7.6 million related to accounts payable.

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

- a decrease of \$69.0 million related to inventories, primarily due to lower than expected net revenue as a result of the temporary store closures from COVID-19;
- a decrease of \$37.2 million related to other prepaid expenses and other current and non-current assets, primarily due to an increase in forward currency contract assets as a result of foreign exchange fluctuations;
- a decrease of \$27.6 million related to accrued compensation related expenses; and
- a decrease of \$25.1 million related to right-of-use lease assets and current and non-current lease liabilities.

### **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 decreased \$18.3 million to \$45.6 million for the first quarter of fiscal 2020 from \$63.9 million for the first quarter of fiscal 2019. The decrease was primarily the result of adjusting our investments in light of COVID-19. This included decreasing our corporate capital expenditures on information technology and business systems as well as decreasing our capital expenditures for renovations and relocations of 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 \$79.7 million to \$90.6 million for the first quarter of fiscal 2020 compared to \$170.3 million for the first quarter of fiscal 2019. The decrease was primarily the result of a decrease in our stock repurchases.

Our cash used in financing activities for the first quarter of fiscal 2020 included \$63.7 million to repurchase 0.4 million shares of our common stock compared to \$163.5 million to repurchase 1.0 million shares for the first quarter of fiscal 2019. During the first quarter of fiscal 2019, we repurchased 1.0 million shares in a private transaction. We did not purchase any shares in a private transaction during the first quarter 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. As of March 31, 2020, we temporarily paused our share repurchase program.

We believe that our cash and cash equivalent balances, cash flows from operations, and borrowings available to us under our revolving credit facilities 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, 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, we may make discretionary capital improvements with respect to our stores, distribution facilities, headquarters, or systems, or we may make strategic investments or 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 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 May 3, 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 May 3, 2020, aside from letters of credit of \$1.8 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 \$18.4 million, the revolving loan is equivalent of up to \$14.2 million, and the financial bank guarantee facility is equivalent of up to \$4.2 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 May 3, 2020, we were in compliance with the covenants. As of May 3, 2020, there were immaterial 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 May 3, 2020, 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 2019 Annual Report on Form 10-K filed with the SEC on March 26, 2020, and in Notes 1, 2, 5, and 6, included in Item 1 of Part I of this Quarterly Report on Form 10-Q.

### **Operating Locations**

Our company-operated stores by country as of May 3, 2020 and February 2, 2020 are summarized in the table below.

	<u>May 3, 2020</u>	<u>February 2, 2020</u>
United States . . . . .	301	305
Canada . . . . .	61	63
People's Republic of China <sup>(1)</sup> . . . . .	41	38
Australia . . . . .	31	31
United Kingdom . . . . .	14	14
Japan . . . . .	7	7
New Zealand . . . . .	7	7
Germany . . . . .	6	6
South Korea . . . . .	6	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 . . . . .	<u>489</u>	<u>491</u>

<sup>(1)</sup> Included within PRC as of May 3, 2020, were seven 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. 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.

As of May 3, 2020, all of our retail locations in North America, Europe, and certain countries in Asia Pacific were temporarily closed as a result of COVID-19.

Retail locations operated by third parties under license and supply arrangements are not included in the above table. As of May 3, 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 May 3, 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 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 quarter of fiscal 2020, the change in the relative value of the U.S. dollar against the Canadian dollar resulted in a \$74.4 million increase in accumulated other comprehensive loss within stockholders' equity. During the first quarter of fiscal 2019, the change in the relative value of the U.S. dollar against the Canadian dollar resulted in a \$16.8 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 quarter of fiscal 2020 would have resulted in additional income from operations of approximately \$1.6 million in the first quarter of fiscal 2020. This assumes a consistent 10% appreciation in the U.S. dollar against the Canadian dollar over the first quarter 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 facility provides us with available borrowings in an amount up to \$400.0 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 May 3, 2020, aside from letters of credit of \$1.8 million, there were immaterial 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, 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 May 3, 2020. Based on that evaluation, our principal executive officer and principal financial and accounting officer concluded that, at May 3, 2020, our disclosure controls and procedures were effective.

There were no changes in our internal control over financial reporting during the quarter ended May 3, 2020 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.