

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549**

FORM 10-K

(Mark One)

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended February 1, 2020

or

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _____ to _____
Commission file number: 001-35720

RH

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of
incorporation or organization)

45-3052669
(I.R.S. Employer
Identification Number)

15 Koch Road
Corte Madera, CA
(Address of principal executive offices)

94925
(Zip Code)

Registrant's telephone number, including area code: (415) 924-1005
Securities registered pursuant to Section 12(b) of the Act:

Common Stock, \$0.0001 par value
(Title of class)

RH
(Trading Symbol)

New York Stock Exchange, Inc.
(Name of each exchange on which registered)

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes No

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer
Non-accelerated filer Smaller reporting company
Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

As of August 2, 2019, the last business day of the registrant's most recently completed second quarter, the approximate market value of the registrant's common stock held by non-affiliates was \$2,188,285,246. Solely for purposes of this disclosure, shares of common stock held by executive officers and directors of the registrant as of such date have been excluded because such persons may be deemed to be affiliates.

As of March 27, 2020, 19,238,681 shares of registrant's common stock were outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's Proxy Statement for its 2020 Annual Meeting of Stockholders are incorporated by reference in Part III of this Annual Report on Form 10-K where indicated. Such proxy statement will be filed with the Securities and Exchange Commission within 120 days of the registrant's fiscal year ended February 1, 2020.

RH
INDEX TO FORM 10-K

	<u>Page</u>
PART I.	
Item 1. Business	1
Item 1A. Risk Factors	10
Item 1B. Unresolved Staff Comments	44
Item 2. Properties	44
Item 3. Legal Proceedings	44
Item 4. Mine Safety Disclosures	45
PART II.	
Item 5. Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities	46
Item 6. Selected Consolidated Financial Data	47
Item 7. Management’s Discussion And Analysis of Financial Condition and Results of Operations	54
Item 7A. Quantitative and Qualitative Disclosures About Market Risk	98
Item 8. Financial Statements and Supplementary Data	101
Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure	165
Item 9A. Controls and Procedures	165
Item 9B. Other Information	165
PART III.	
Item 10. Directors, Executive Officers and Corporate Governance	166
Item 11. Executive Compensation	166
Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters	166
Item 13. Certain Relationships and Related Transactions and Director Independence	166
Item 14. Principal Accountant Fees and Services	166
PART IV.	
Item 15. Exhibits and Financial Statement Schedules	167
Item 16. Form 10-K Summary	167

SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS AND MARKET DATA

This annual report contains forward-looking statements that are subject to risks and uncertainties. Forward-looking statements give our current expectations and projections relating to our financial condition, results of operations, plans, objectives, future performance and business. You can identify forward-looking statements by the fact that they do not relate strictly to historical or current facts. These statements may include words such as “anticipate,” “estimate,” “expect,” “project,” “plan,” “intend,” “believe,” “may,” “will,” “short-term,” “non-recurring,” “one-time,” “unusual,” “should,” “likely” and other words and terms of similar meaning in connection with any discussion of the timing or nature of future operating or financial performance or other events.

Forward-looking statements are subject to risk and uncertainties that may cause actual results to differ materially from those that we expected. We derive many of our forward-looking statements from our operating budgets and forecasts, which are based upon many detailed assumptions. While we believe that our assumptions are reasonable, we caution that it is very difficult to predict the impact of known factors and it is impossible for us to anticipate all factors that could affect our actual results and matters that we identify as “short term,” “non-recurring,” “unusual,” “one-time,” or other words and terms of similar meaning may in fact recur in one or more future financial reporting periods. Important factors that could cause actual results to differ materially from our expectations, or cautionary statements, are disclosed in *Item 1A—Risk Factors*, *Item 7—Management’s Discussion and Analysis of Financial Condition and Results of Operations*, and elsewhere in this annual report. All forward-looking statements attributable to us, or persons acting on our behalf, are expressly qualified in their entirety by these cautionary statements, as well as other cautionary statements. You should evaluate all forward-looking statements made in this annual report in the context of these risks and uncertainties.

We cannot assure you that we will realize the results or developments we expect or anticipate or, even if substantially realized, that they will result in the consequences or affect us or our operations in the way we expect. The forward-looking statements included in this annual report are made only as of the date hereof. We undertake no obligation to publicly update or revise any forward-looking statement, whether as a result of new information, future events or otherwise, except as required by law.

PART I

Item 1. Business

Overview

RH (“we,” “us,” or the “Company”) is a leading luxury retailer in the home furnishings marketplace. Our curated and fully-integrated assortments are presented consistently across our sales channels in sophisticated and unique lifestyle settings that we believe are on par with world-class interior designers. We offer dominant merchandise assortments across a growing number of categories, including furniture, lighting, textiles, bathware, décor, outdoor and garden, and child and teen furnishings. We position our Galleries as showrooms for our brand, while our Source Books and websites act as virtual extensions of our stores. Our retail business is fully integrated across our multiple channels of distribution, consisting of our stores, Source Books, and websites. We have an integrated RH Hospitality experience in eight of our new Design Gallery locations, which include restaurants, wine vaults and barista bars.

As of February 1, 2020, we operated a total of 68 RH Galleries consisting of 22 Design Galleries, 40 legacy Galleries, 2 RH Modern Galleries and 4 RH Baby & Child Galleries throughout the United States and Canada, and 15 Waterworks showrooms throughout the United States and in the U.K. As of February 1, 2020, we operated 38 outlet stores throughout the United States and Canada.

In response to the public health crisis posed by COVID-19, effective from March 17, 2020, the Company temporarily closed its retail locations for an indeterminate period of time. Although we continue to serve our customers virtually through our Gallery representatives and designers, as well as our online websites, our business operations are being substantially affected by applicable regulatory restrictions including stay-at-home requirements applicable in California where our corporate headquarters is located. Our decision to reopen retail locations will be affected by a number of factors including applicable regulatory restrictions and there is substantial uncertainty regarding the manner and timing in which we can return some or all of our business to more normal business operations. We may face longer term closure requirements and other operational restrictions with respect to some or all of our physical locations for prolonged periods of time due to, among other factors, evolving and increasingly stringent federal, state and local restrictions including shelter-in-place orders. Even once we are able to reopen closed physical locations, changes in consumer behavior and health concerns may continue to impact consumer demand for our products and customer traffic at our Galleries, restaurants and outlets and may make it more difficult to staff our business operations. For more information, refer to *Item 1A—Risk Factors—The global outbreak of the COVID-19 virus is likely to have an adverse impact on our business* and *Item 7—Management’s Discussion and Analysis of Financial Condition and Results of Operations—Overview*.

Products and Product Development

We have positioned RH as a lifestyle brand and design authority by offering dominant merchandise assortments. We are merchants of luxury home furnishings and our luxury products embody our design aesthetic and reflect inspiration from across the centuries and around the globe.

We have developed a proprietary product development platform that is fully integrated from ideation to presentation. Key aspects of our product development platform are:

- *Organization*—We have established a collaborative, cross-functional organization centered on product leadership and coordinated across our product development, sourcing, merchandising, inventory and creative teams. Our product teams are focused on maximizing the sales potential of each product category across all channels, which eliminates channel conflicts and functional redundancies.
- *Process*—For many of our products, we work closely with our network of artisan partners who possess specialized product development and manufacturing capabilities and who we consider an extension of

our product development team. We collaborate with our global network of specialty vendors and manufacturers to produce artisanal pieces of high quality and value on a large scale, including both distinctive original designs and reinterpretations of antiques.

- *Facility*—We have built the *RH Center of Innovation & Product Leadership*, a facility which supports the entire product development process from product ideation to presentation for all channels.

As a result of our proprietary organization, process and facility, our typical product lead times are 3 – 9 months, which enhances our ability to introduce more new products with each collection. In addition, our product development platform, sourcing capabilities and significant scale enable us to reduce our product costs.

Sales Channels

We distribute our products through a fully integrated sales platform comprised of our Stores, E-Commerce, Source Books and Trade and Contract. We believe the level of integration among all of our channels and our approach to the market distinguishes us from other retailers. We believe our channels complement each other and our customers’ buying decisions are influenced by their experiences across more than one of our sales channels. We encourage our customers to shop across our channels and have aligned our business and internal organization to be channel agnostic. Our integrated distribution and product delivery network serves all of our channels. We believe the key advantage of our multiple sales channels is our ability to leverage the unique attributes of each channel in our approach to the market.

Stores

Retail Locations

As of February 1, 2020, our retail locations are comprised of RH Galleries and Waterworks Showrooms:

	February 1, 2020	
	Count	Average Leased Selling Square Footage⁽¹⁾
RH		
Design Galleries	22	33,100
Legacy Galleries	40	7,300
Modern Galleries	2	8,300
Baby & Child and Teen Galleries	4	3,900
Total Galleries	<u>68</u>	
Waterworks Showrooms	15	4,000
Total retail locations	<u>83</u>	

(1) Average leased selling square footage is calculated based on total leased selling square footage divided by total locations. Leased selling square footage is retail space at our retail locations used to sell our products. Leased selling square footage excludes backrooms at retail locations used for storage, office space, food preparation, kitchen space or similar purpose, as well as exterior sales space located outside a retail location, such as courtyards, gardens and rooftops.

Our Galleries are located in upscale malls and street locations, as well as in iconic locations. We believe situating our Galleries in desirable locations is critical to the success of our business. New sites are identified based on a variety of factors, such as (i) the availability of suitable new site locations based on several store specific factors including geographic location, demographics, and proximity to affluent consumers, (ii) the ability to negotiate favorable economic terms, as well as (iii) the satisfactory and timely completion of real estate development including procurement of permits and completion of construction. We pursue a market-based sales

strategy, whereby we assess each market's overall sales potential and how best to approach the market across all of our channels. We customize square footage, as well as catalog circulation, to maximize each market's sales potential and increase our return on invested capital.

Our Galleries reinforce our luxury brand aesthetic and are highly differentiated from other home furnishings retailers. We have revolutionized the customer experience by showcasing products in a sophisticated lifestyle setting that we believe is on par with world-class interior designers, consistent with the imagery and product presentation featured on our websites and in our catalogs. Products in our Galleries are presented in fully appointed rooms, emphasizing collections over individual pieces. This presentation encourages a higher average order value as our customers are inspired to consider purchasing a full collection of products to replicate the design aesthetic experienced in our Galleries. In addition, our associates use iPads and other devices to allow customers to shop our entire merchandise assortment while in a retail location.

In 2015 we began to introduce an integrated hospitality experience, including cafés, wine vaults and barista bars, into a number of our new Gallery locations. We believe this has created a unique new retail experience that cannot be replicated online, and that the addition of hospitality is helping to drive incremental sales of home furnishings in these Galleries. As of February 1, 2020, eight of our RH Design Galleries included an integrated RH Hospitality experience and we plan to incorporate hospitality into the new Galleries that we open in the future.

We have identified key learnings from our real estate transformation that have supported the development of a multi-tier market approach that we believe will optimize both market share and return on invested capital over time.

First, we have developed a RH prototype Design Gallery that is an innovative and flexible blueprint which we believe will enable us to more quickly place our disruptive product assortment and immersive retail experience into the market. The new model is a standard we will utilize in the future that is based on key learnings from more recent Design Gallery openings and will have approximately 38,000 leased selling square feet inclusive of our integrated hospitality experience. This prototype will present our assortments across our businesses and contain interior design offices and presentation rooms where design professionals can work with clients on their projects. This new model will be more capital efficient with less time and cost risk, but yield similar productivity. We anticipate the new prototype Design Galleries will represent the format of most of our upcoming Design Galleries in North America. Our most recently opened Design Galleries in Minneapolis and Columbus are prototype Design Galleries, and upcoming prototype locations include Corte Madera, CA, Charlotte, NC, Jacksonville, FL, Dallas, TX and Oakbrook, IL.

Second, we will continue to develop and open larger Bespoke Design Galleries in the top metropolitan markets, similar to those we opened in New York and Chicago. These iconic locations are highly profitable statements for our brand, and we believe they create a long-term competitive advantage that will be difficult to duplicate.

Third, we will continue to open indigenous Bespoke Galleries in the best second home markets where the wealthy and affluent visit and vacation. These Galleries are tailored to reflect the local culture and are sized to the potential of each market. Examples of current indigenous Bespoke Galleries include Yountville, CA and Aspen, CO.

Fourth, we are developing a new Gallery model tailored to secondary markets. Targeted to be 10,000 to 18,000 square feet, we believe these smaller expressions of our brand will enable us to gain share in markets currently only served by smaller competitors. Examples of target secondary markets include Oklahoma City, OK and Milwaukee, WI, among others. We expect these Galleries to require a substantially smaller net investment than our larger Design Galleries and to pay back our capital investment in most instances within two years or less. Our plan is to test a few of these Galleries over the next several years, and if proven successful, this format could lead to an increase in our long-term Gallery potential in the United States.

We believe our multi-tier market approach to transforming our real estate will enable us to ramp our opening cadence from 3 to 5 new Galleries per year, to a pace of 5 to 7 new Galleries per year.

We plan to expand our product sales to international markets and are currently exploring opportunities for Design Galleries in several locations outside of North America, including the United Kingdom and Europe.

The following tables present our retail location metrics:

	Year Ended			
	February 1, 2020		February 2, 2019	
	Count	Total Leased Selling Square Footage ⁽¹⁾ <i>(in thousands)</i>	Count	Total Leased Selling Square Footage ⁽¹⁾ <i>(in thousands)</i>
Beginning of period	86	1,089	83	981
Design Galleries:				
Minneapolis Design Gallery	1	32.9	—	—
Columbus Design Gallery	1	33.0	—	—
Portland Design Gallery	—	—	1	26.0
Nashville Design Gallery	—	—	1	45.6
New York Design Gallery	—	—	1	50.5
Yountville Design Gallery	—	—	1	6.7
Modern Galleries:				
Dallas RH Modern Gallery (relocation)	—	(4.5)	—	—
Dallas RH Modern Gallery	—	—	1	8.2
Baby & Child Galleries:				
Dallas RH Baby & Child Gallery	(1)	(3.7)	1	3.7
Portland RH Baby & Child Gallery	(1)	(4.7)	1	4.7
Legacy Galleries:				
San Diego legacy Gallery (relocation)	—	0.5	—	—
Minneapolis legacy Gallery	(1)	(13.3)	—	—
Columbus legacy Gallery	(1)	(6.2)	—	—
Durham legacy Gallery	(1)	(5.7)	—	—
Dallas legacy Gallery (relocation)	—	(2.6)	—	—
San Antonio legacy Gallery (relocation)	—	(3.8)	—	—
Portland legacy Gallery	—	—	(1)	(4.7)
Nashville legacy Gallery	—	—	(1)	(7.1)
Washington DC legacy Gallery	—	—	(1)	(5.6)
New York legacy Gallery	—	—	(1)	(21.4)
Waterworks Showrooms:				
Waterworks Scottsdale Showroom (relocation)	—	—	—	1.1
End of period	83	1,111	86	1,089
Total leased square footage at end of period ⁽²⁾		1,497		1,467
Weighted-average leased square footage ⁽³⁾		1,468		1,409
Weighted-average leased selling square footage ⁽³⁾		1,088		1,047

(1) Leased selling square footage is retail space at our retail locations used to sell our products. Leased selling square footage excludes backrooms at retail locations used for storage, office space, food preparation, kitchen space or similar purpose, as well as exterior sales space located outside a retail location, such as courtyards, gardens and rooftops. Leased selling square footage includes approximately 37,700 and 11,600 square feet as of fiscal 2019 and fiscal 2018, respectively, related to two owned retail locations.

- (2) Total leased square footage includes approximately 48,700 and 16,100 square feet as of fiscal 2019 and fiscal 2018, respectively, related to two owned retail locations.
- (3) Weighted-average leased square footage and leased selling square footage are calculated based on the number of days a Gallery location was opened during the period divided by the total number of days in the period.

The following list shows the number of retail locations in each U.S. state, each Canadian province and in the U.K. where we operate as of February 1, 2020:

<u>Location</u>	<u>Count</u>	<u>Location</u>	<u>Count</u>	<u>Location</u>	<u>Count</u>
Alabama	1	Massachusetts	2	Tennessee	1
Arizona	2	Michigan	1	Texas	8
California	20	Minnesota	1	Utah	1
Colorado	2	Missouri	1	Virginia	2
Connecticut	4	Nevada	1	Washington	1
Florida	5	New Jersey	2	District of Columbia	1
Georgia	2	New York	5	Alberta	2
Illinois	3	North Carolina	1	British Columbia	1
Indiana	1	Ohio	3	Ontario	1
Kansas	1	Oklahoma	1	London ⁽¹⁾	1
Louisiana	1	Oregon	1		—
Maryland	1	Pennsylvania	2	Total	<u>83</u>

(1) The London retail location is a Waterworks showroom.

We continually analyze opportunities to selectively consolidate retail locations in connection with openings of our Design Galleries or close retail locations that have been under-performing or are no longer consistent with our brand positioning. In many cases, we continue to operate a retail location until its lease has expired in order to effect the closure in a cost-efficient manner.

Outlet Stores

Our outlet stores are branded as RH Outlet or Restoration Hardware Outlet and are typically located in outlet malls. Our outlet stores serve as a key part of our reverse logistics platform and provide an efficient means to sell primarily returned merchandise and, to a lesser extent, discontinued and overstock merchandise outside of our core sales channels. As of February 1, 2020, we operated 38 outlet stores.

E-Commerce

Our primary RH websites, www.rh.com, www.restorationhardware.com, www.rhmodern.com, www.rhbabyandchild.com and www.rhteen.com, provide our customers with the ability to purchase our merchandise online. We sell Waterworks products online through www.waterworks.com.

Our e-commerce platform allows our customers to experience the unique lifestyle settings reflected in our catalogs and throughout our stores, and to shop all of our current product assortment. We update our websites regularly to reflect new products, product availability and occasionally special offers.

The RH websites also offer room-based navigation, which allows the customer to envision and shop items by room or by product, expanding on the richness of the online experience. Customers can search our websites for products by size or color, browse through our extensive product categories and see detailed information about each item and collection, such as dimensions, materials and care instructions. Additionally, customers can select color swatches and view merchandise displayed with different color and fabric options.

Source Books

We produce a series of catalogs, which we refer to as Source Books, to showcase our merchandise assortment. In fiscal 2019, our mailed Source Books included RH Interiors, RH Modern, RH Outdoor, RH Baby & Child, RH Teen, RH Beach House, RH Ski House and RH Rugs. Our Source Books are one of our primary branding and advertising vehicles. We have found that merchandise assortments displayed in our Source Books contribute to increased sales of those products across all of our channels. As in our Galleries, our Source Books present our merchandise in lifestyle settings that reflect our unique design aesthetic. Our Source Books also feature profiles of select artisan vendors and other compelling editorial content regarding home décor. All creative work on our Source Books is coordinated in-house in our *RH Center of Innovation & Product Leadership*, providing us greater control over the brand image presented to our customers, while also reducing our Source Book production costs.

Our Source Book mailings serve as a key driver of sales through both our stores and websites. Our customers respond to the Source Books across all of our channels, with sales trends closely correlating to the assortments that we emphasize and feature prominently in our Source Books, websites and Galleries. We continue to evaluate and optimize our Source Book strategy based on our experience.

We maintain a database of customer information, including customer information from our RH Members Program, which includes sales patterns, detailed purchasing information and certain demographic information, as well as mailing and email addresses. We mail our Source Books to addresses within this database and to addresses provided to us by third parties. The database supports our ability to analyze our customers' buying behaviors across sales channels and facilitates the development of targeted marketing strategies, and is maintained in accordance with our privacy policy disclosed on our website. We segment our customer files based on multiple variables, and we tailor our Source Book mailings and emails in response to the purchasing patterns and product needs of our customers. We focus on continually improving the segmentation of customer files and the expansion of our customer database.

Our Source Books, in concert with our e-commerce channel, are a cost-effective means to test new products, and allow us to launch categories in a disciplined, expeditious and cost-effective manner.

Trade and Contract

In addition to our core channels, we continue to expand into B2B channels, including Trade and Contract. In the Trade channel, we work directly with independent interior designers and decorators purchasing products for their clients' residential projects. We also sell directly to customers who make purchases with the assistance of their interior designers or decorators, which we refer to as "designer-assisted sales." Our Contract business supplies products to large-scale hospitality, commercial and residential development projects, by working with architecture and design firms, developers and their ecosystem of business partners. These channels offer additional avenues for reaching new customers, including both businesses and individuals.

Marketing and Advertising

Our Galleries and our Source Books are the primary branding and advertising vehicles for the RH brands. In addition, we employ a variety of marketing and advertising vehicles to drive customer traffic across all our channels, strengthen and reinforce our brand image and acquire new customers. These include targeted Source Book circulation, promotional mailings, email communications, online and print advertisements, and public relations activities and events. We use our customer database to tailor our programs and increase productivity of our marketing and promotion initiatives. We leverage our marketing and advertising expenses across all our channels as we seek to optimize the efficiency of our investment.

The highly-differentiated design aesthetic and shopping environment of our stores drive customer traffic not only to our stores but also to our direct channel. Our Source Books and targeted emails further reinforce the RH brand image and drive sales across all of our sales channels. We also engage in a wide range of other marketing, promotional and public relations activities to promote our brands. These campaigns include media coverage in design, lifestyle, culture/society and specialty publications, as well as in-store events related to new Design Gallery openings and product launches. We also engage in print advertising in brand-relevant publications such as *Architectural Digest*, *Elle Décor*, *Veranda*, *Town and Country*, *T: The New York Times Style Magazine*, *WSJ Magazine* and others, and deliver marketing messages to customers via online advertising. We believe that these efforts will drive increased brand awareness, leading to higher sales over time.

RH Members Program

The RH Members Program is an exclusive program that reimagines and simplifies the shopping experience. For an annual fee, the RH Members Program provides a set discount every day across all RH brands, excluding RH Hospitality and Waterworks, in addition to other benefits including complimentary interior design services through the RH Interior Design program and eligibility for preferred financing plans on the RH Credit Card, among other benefits. The RH Members Program allows our customers to shop for what they want, when they want, and receive the greatest value, which has resulted in orders and sales being more evenly distributed throughout the year as opposed to the peaks and valleys of orders and sales we experienced under the prior promotional model. We believe the shift to a membership model has enhanced the customer experience, rendered our brand more valuable, improved operational execution and reduced costs.

Sourcing

We primarily contract with third-party vendors to manufacture our merchandise. Our sourcing strategy focuses on identifying and using vendors that can provide quality materials and fine craftsmanship that our customers expect of our brand. To ensure that our high standards of quality and timely delivery of merchandise are met, we work closely with vendors and manufacturers. Our products are generally made from readily available raw materials. We seek to ensure the consistent quality of our manufacturers' products by selectively inspecting pre-production samples, conducting periodic site visits to certain of our vendors' production facilities and selectively inspecting inbound shipments at our distribution facilities. In fiscal 2019, we sourced approximately 75% of our purchase dollar volume from approximately 31 vendors. In fiscal 2019, one vendor accounted for approximately 10% of our purchase dollar volume. Based on total dollar volume of purchases for fiscal 2019, approximately 70% of our products were sourced in from Asia, 16% from the United States and the remainder from other countries and regions. For fiscal 2019, approximately 38% of our products were sourced from China.

RH is committed to offering safe, legal, high quality products, made consistently with our values. RH has a Compliance and Social Responsibility team dedicated to ensuring we keep these commitments through product testing, audits and other verification methods. Product testing is a core process for our organization. For example, RH Baby & Child offers an extensive selection of GREENGUARD Gold Certified children's furniture. GREENGUARD Gold Certified products aid in the creation of healthier indoor environments by emitting fewer airborne chemical compounds that can contribute to health issues, including asthma, allergies and other respiratory conditions. We are in the process of expanding our offering of GREENGUARD certified collections to include products in our core brands beyond RH Baby & Child.

While we currently do not have any long-term merchandise supply contracts, we believe that we generally have strong relationships with our product vendors. Although we transact business primarily on an order-by-order basis, we typically work with many of our vendors over extended periods of time, and many vendors are making long-term capacity investments to serve our increasing demands.

Distribution and Delivery

We manage the distribution and delivery of our products through our distribution centers. We currently operate two furniture fulfillment centers and one small parcel fulfillment center servicing RH products, which are located strategically in three markets throughout the United States. We have one fulfillment center in the United States servicing Waterworks products.

We operate portions of our home delivery services in 13 key markets to leverage operating costs and improve our customers' delivery experience, while reducing returns and damage to our products. We offer a white glove home delivery service for our larger merchandise and furniture categories, where third-party personnel deliver fully assembled items to the location of our customers' choice. We believe there is an opportunity to improve the customer experience by taking greater control of the home delivery experience over time. We believe that many third-party furniture delivery providers are designed to support mass and mid-market companies and that significant opportunity exists for developing improved solutions for the luxury market. We believe we have dramatically enhanced the customer experience while reducing return rates, damages and deliveries per order by enhancing the quality of our delivery providers through metric-based accountability standards.

Through our distribution center network redesign, reverse logistics and outlet redesign, and the reconceptualization of home delivery, we have improved our supply chain and fulfillment capabilities, and have built a scalable infrastructure to support our future growth. We believe our enhanced supply chain and fulfillment operations allow us to manage customer orders and distribute merchandise to our customers in an efficient and cost-effective manner. We also believe that these upgrades have improved customer satisfaction by reducing delivery times, reducing damage to merchandise, and improving our customer's overall buying experience.

Competition

The home furnishings industry is highly competitive. We primarily compete against a large number of independent retailers that provide unique items and custom-designed product offerings at high price points, including antique dealers and home furnishings retailers who market to the interior design community. We also compete with national and regional home furnishings retailers and department stores, as well as with mail order catalogs and online retailers focused on home furnishings.

We believe that we compete primarily on the basis of design, quality and value, and that our distinct combination of these elements, along with the strength of our brand and our fully integrated multi-channel business model, allows us to compete effectively and differentiate ourselves from competitors. We compete with the interior design trade and specialty merchants by providing a high quality, broad product assortment at an exceptional value. We compete against certain other home furnishings retailers primarily by offering what we believe are superior quality, highly distinctive design styles and a sophisticated lifestyle presentation in our product offering.

We also believe that our success depends in substantial part on our ability to originate and define product trends, as well as to timely anticipate, gauge and react to changing consumer demands. Certain competitors are larger and have greater financial, marketing and other resources than us. However, many smaller specialty retailers may lack the financial resources, infrastructure, scale and national brand identity necessary to compete effectively with us. We believe we are effectively positioned to gain market share from both of these segments and drive growth.

Employees

As of February 1, 2020, we had approximately 5,100 employees, of which approximately 700 were part-time employees. As of that date, approximately 3,000 of our employees were based in our stores. None of our employees are represented by a union, and we have had no labor-related work stoppages. We believe our relations with our employees are good.

Intellectual Property

The “RH,” “Restoration Hardware,” “RH Interiors,” “RH Modern,” “RH Outdoor,” “RH Baby & Child,” “RH Teen,” “RH Beach House,” “RH Ski House,” “RH Rugs” and “Waterworks,” and “Waterworks Studio” trademarks, among others, are registered or are the subject of pending trademark applications with the United States Patent and Trademark Office and with the trademark registries of several foreign countries. Each of our trademark registrations is perpetually renewable provided that we use or continue to use the trademarks in commerce in the particular geographic market and for the goods or services covered by the registration. In addition, we own many domain names, including “rh.com,” “restorationhardware.com,” “rhmodern.com,” “rhhbabyandchild.com,” “rhteen.com,” “rhbeachhouse.com,” “rhskihouse.com,” “waterworks.com” and others that include our trademarks. These domain names are perpetually renewable. We own design patents or pending design patent applications to protect the ornamental appearance of several of our products. These design patents are valid for 15 years from their date of issuance. We own copyrights, including copyright registrations or pending applications, for our website and for several of our Source Books. We believe that our trademarks, design patents, and copyrights have significant value and we vigorously protect them against infringement.

Fluctuation in Quarterly Results

Our quarterly results vary depending upon a variety of factors, including our product offerings, store openings, shifts in the timing of holidays and the timing of Source Book releases, promotional events and the timing and extent of our realization of the costs and benefits of our numerous strategic initiatives, among other things. As a result of these factors, our working capital requirements and demands on our product distribution and delivery network may fluctuate during the year. Unique factors in any given quarter may affect period-to-period comparisons between the quarters being compared, and the results for any quarter are not necessarily indicative of the results that we may achieve for a full fiscal year.

Corporate Information

The Company was formed as a Delaware corporation on August 18, 2011. On November 7, 2012, the Company completed an initial public offering. On December 15, 2016, Restoration Hardware Holdings, Inc. filed a Certificate of Amendment to its Amended and Restated Certificate of Incorporation with the Secretary of State of the State of Delaware to change its name to “RH,” effective January 1, 2017.

Regulation and Legislation

We are subject to numerous regulations, including labor and employment laws, customs, laws governing truth-in-advertising, consumer protection, privacy, safety, real estate, environmental and zoning and occupancy laws, and other laws and regulations that regulate retailers and govern the promotion and sale of merchandise and the operation of our retail locations, outlets and warehouse facilities, in the United States, Canada and the U.K., as well as in jurisdictions from which we source our products. We believe we are in material compliance with laws applicable to our business.

Where You Can Find More Information

We are required to file annual, quarterly and current reports, proxy statements and other information required by the Securities Exchange Act of 1934, as amended (the “Exchange Act”), with the SEC. The SEC maintains a website that contains reports, proxy statements and other information about issuers, like us, who file electronically with the SEC. The address of that website is <http://www.sec.gov>.

We maintain public internet sites at www.restorationhardware.com and www.rh.com and make available, free of charge, through these sites our Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, Proxy Statements and Forms 3, 4 and 5 filed on behalf of directors and executive officers,

as well as any amendments to those reports filed or furnished pursuant to the Exchange Act as soon as reasonably practicable after we electronically file such material with, or furnish it to, the SEC. We also put on our websites the charters for our Board of Directors' Audit Committee, Compensation Committee, and Nominating and Corporate Governance Committee, as well as our Code of Business Conduct, our Corporate Governance Guidelines and Code of Ethics governing our chief executive and senior financial officers and other related materials. The information on our websites is not part of this annual report.

Our Investor Relations Department can be contacted at RH, 15 Koch Road, Corte Madera, CA 94925, Attention: Investor Relations; telephone: 415-945-3500; e-mail: investorrelations@rh.com.

Item 1A. Risk Factors

Certain factors may have a material adverse effect on our business, financial condition, and results of operations. You should consider carefully the risks and uncertainties described below, in addition to other information contained in this Annual Report on Form 10-K, including our consolidated financial statements and related notes. If any of the following risks actually occurs, our business, financial condition, results of operations, and future prospects could be materially and adversely affected. In that event, the trading price of our common stock could decline, and you could lose part or all of your investment. The risks and uncertainties described below are not the only ones we face. Additional risks and uncertainties that we are unaware of, or that we currently believe are not material, may also become important factors that adversely affect our business.

Risks Related to Our Business

The global outbreak of the COVID-19 virus is likely to have an adverse impact on our business.

The global outbreak of the coronavirus (COVID-19) poses significant and widespread risks to our business as well as to the business environment and the markets in which we operate our business. We have already experienced significant disruption to our business as a result of the rapid development of the COVID-19 pandemic. The immediate impact from this global health crisis has been both in terms of disruption in numerous aspects of our business operations, as well as indirect in terms of the adverse effect on overall economic conditions. For example, the Company has temporarily closed its retail locations for an indeterminate period of time, and we believe changes in consumer behavior and health concerns have impacted customer demand. The magnitude and duration of the negative impact to our business from the COVID-19 pandemic cannot be predicted with certainty. Accordingly, we withdrew all prior guidance and outlook statements that relate to the performance of our business with respect to fiscal 2020.

Public health officials and other governmental authorities have adopted numerous mitigation measures to address the spread of the virus, and in particular to discourage people from congregating in public, commercial or private spaces. Federal, state and local authorities in the U.S. and Canada have implemented a number of different directives that encourage or require changes in our business practices including requirements to close our retail stores and to curtail various aspects of our business operations. The scope and duration of these directives is evolving and not entirely clear. A large number of states and municipalities in the U.S. where we operate have implemented temporary closure requirements with respect to non-essential business operations and the duration of these requirements are unknown. Governmental restrictions applicable to our restaurants have different terms and conditions than those that apply to our Galleries. Many of our Galleries are located in malls or otherwise located in proximity to a number of other retail stores. A number of mall operators as well as other retailers have elected to temporarily cease operations and our decision to close Galleries has been influenced by these closures of other retail locations.

In response to the public health crisis posed by COVID-19, effective from March 17, 2020, the Company temporarily closed its retail locations for an indeterminate period of time. Although we continue to serve our customers virtually through our Gallery representatives and designers, as well as our online websites, our business operations are being substantially affected by applicable regulatory restrictions including stay-at-home

requirements applicable in California where our corporate headquarters is located. Our decision to reopen retail locations will be affected by a number of factors including applicable regulatory restrictions and there is substantial uncertainty regarding the manner and timing in which we can return some or all of our business to more normal business operations. We may face longer term closure requirements and other operational restrictions with respect to some or all of our physical locations for prolonged periods of time due to, among other factors, evolving and increasingly stringent federal, state and local restrictions including shelter-in-place orders. Even once we are able to reopen closed physical locations, changes in consumer behavior and health concerns may continue to impact consumer demand for our products and customer traffic at our Galleries, restaurants and outlets and may make it more difficult to staff our business operations. The COVID-19 outbreak may have a material adverse impact on our supply chain including the manufacture, supply, distribution, transportation and delivery of our products. There have been substantial disruptions that have already occurred with respect to the global supply chain as a result of the COVID-19 health crisis. Our business depends on the successful operation of a global supply chain. Based on total dollar volume of purchases for fiscal 2019, approximately 70% of our products were sourced in from Asia (including a substantial portion from China), 16% from the United States and the remainder from other countries and regions. Although China was at the center of the initial outbreak of the COVID-19, the health crisis has spread to numerous other countries throughout the world. The presence of the virus and the response to the health crisis in various countries is likely to have a continuing impact on our supply chain and the extent that the health crisis may abate in particular countries such as China is uncertain.

If we are not able to access capital at the time and on terms that our business requires, we may encounter difficulty funding our business requirements including debt repayments when due. We may not be able to access liquidity or the terms and conditions of available credit may be substantially more expensive than previously expected due to changes in financial conditions and credit markets. We may require waivers or amendments to our existing credit facilities and these requirements may trigger pricing increases from lenders for available credit. If we are not able to access credit to fund our business requirements for liquidity, or the cost of available credit increases, we may need to curtail our business operations including various business initiatives that require capital investment. We have recently commenced an effort to expand our business internationally by establishing a new retail presence in global markets including Europe and the United Kingdom. In addition, we are in the process of developing a number of new Gallery locations in the U.S. In addition, our RH Guesthouse initiative may be negatively impacted by the disease outbreak as federal, state and local governments have restricted travel, conferences, events and gatherings. Reductions in our liquidity position and the need to use capital for other day to day requirements of our business may affect a number of our business initiatives and long-term investments and as a result we may be required to curtail and/or postpone business investments including those related to international expansion, the pace of opening new Galleries in the U.S. as well as other initiatives that require capital investment.

Our business also depends on a number of third parties including vendors, landlords, lenders and other suppliers. One or more of these third parties may experience financial distress, staffing shortages or liquidity challenges, file for bankruptcy protection, go out of business, or suffer disruptions in their business due to the COVID-19 outbreak. The health crisis, resulting deterioration in financial markets and overall economic conditions could have a material adverse effect on the financial condition of third parties that are essential to our business operations and we may incur losses and other negative impact for difficulties experienced by our vendors and other third parties.

As a result of the COVID-19 outbreak, and the corresponding reduction in our sales, we have had to institute a number of measures to mitigate expenses and reduce costs. These efforts may not be enough to offset anticipated declines in revenue including the loss of sales related to store closures, and may negatively affect our ability to quickly resume operations when we are able to re-open our Galleries, restaurants and outlets. In addition, new regulation or requirements with respect to the compensation of our employees that governmental authorities may impose could also have an adverse effect on our business. Substantially all of our management personnel, including those in our corporate office in Corte Madera, CA, are subject to shelter-in-place

requirements which have resulted in most of our management team being required to work remotely. These working arrangements as well as other related restrictions including severe limitations on travel may have an impact on our operations and management effectiveness. Although we have technology and other resources to support these new work requirements, there can be no assurance that we will not suffer material risks to our business, operations, productivity and results of operations as a result of these restrictions. If a significant percentage of our workforce is unable to work, including because of illness or travel or government restrictions in connection with COVID-19, our operations may be negatively impacted, potentially materially adversely affecting our business, liquidity, financial condition or results of operations.

The COVID-19 pandemic and mitigation measures have also had an adverse impact on global economic conditions as well as the business climate in our primary consumer markets in the U.S. and Canada, which could have an adverse effect on our business and financial condition and our ability to regain previous sales levels as we reopen our retail locations. Our business also depends to some extent on conditions in financial markets. We have determined that our customer purchasing patterns are influenced by economic factors including the health of the stock market. We have seen that previous downturns in the stock market have been correlated with a reduction in consumer demands for our products. The precise impact on our business from the disruption of financial markets and the weakening of overall economic conditions cannot be predicted with certainty. Uncertainties regarding the economic impact of COVID-19 have resulted in, and are likely to continue to result in, sustained impact on the economy. The Company's business is particularly sensitive to reductions in discretionary consumer spending, which may be adversely impacted by a recession or fears of a recession, volatility and declines in the stock market and increasingly pessimistic consumer sentiment due to perceived or actual economic and/or health risks.

The global scale and scope of COVID-19 is unknown and the duration of the business disruption and related financial impact cannot be reasonably estimated at this time. The extent to which the COVID-19 pandemic impacts our results will depend on future developments that are highly uncertain and cannot be predicted, including the duration of our RH Galleries, restaurant and outlet closures, emerging information concerning the severity of COVID-19 and the actions taken by governments and private businesses to attempt to contain COVID-19. However, the Company believes COVID-19 is likely to result in an adverse impact on our business, results of operations and financial condition, particularly if ongoing mitigation actions occur for a significant amount of time.

We have experienced significant fluctuations in the growth rate of our business during the last several years, and high levels of growth may not be achieved in future periods and may not generate a corresponding improvement in our results of operations.

We have experienced significant fluctuations in the growth rate of our business during the last several years. We may continue to experience wide fluctuations in quarter-to-quarter performance, not only because the rate of sales growth in some quarters may be slower than in prior periods but also because we may experience some quarters that have growth rates that are higher than prior periods. We are currently engaged in a number of initiatives to support the growth and transformation of our business, including investments to elevate the customer experience, which includes architecting a new fully integrated back-end operating platform, inclusive of the supply chain network, the home delivery experience as well as a new metric-driven quality system and company-wide decision data, the transition from a promotional to a membership model, and a more aggressive approach to rationalizing our SKU count and optimizing inventory including through selling slower moving, discontinued and other inventory through markdowns and our outlet channel. While we anticipate that these initiatives will support the growth of our business, costs and timing issues associated with pursuing these initiatives can negatively affect our gross margins in the short term and may amplify fluctuations in our growth rate from quarter to quarter depending on the timing and extent of our realization of the costs and benefits of such initiatives.

There can be no assurance that these efforts will be successful or that we will not encounter other operational difficulties that may have a material negative impact on growth and profitability. In addition, these

initiatives may have near-term material negative impacts on growth and profitability as we incur costs or pursue strategies that may not contribute to our profits and margins until future periods, if at all. For example, in fiscal 2017, net revenues increased 14%, of which 2.9 points of growth was related to higher outlet and warehouse sales stemming from our accelerated inventory optimization efforts. While our higher outlet revenues and inventory optimization efforts had a positive impact on revenues and working capital, they had a negative impact on margins and earnings.

Some factors affecting our business, including macroeconomic conditions and policies and changes in legislation, are not within our control. In prior periods, our results of operations have been adversely affected by weakness in the overall economic environment such as periods of economic recession as well as slowdowns in the housing market. Our business depends on consumer demand for our products and, consequently, is sensitive to a number of factors that influence consumer spending, including, among other things, the general state of the economy, capital and credit markets, consumer confidence, general business conditions, the availability and cost of consumer credit, the level of consumer debt, interest rates, level of taxes affecting consumers, housing prices, new construction and other activity in the housing sector and the state of the mortgage industry and other aspects of consumer credit tied to housing, including the availability and pricing of mortgage refinancing and home equity lines of credit.

In particular, our business performance is linked to the overall strength of luxury consumer spending in markets in which we operate. Economic conditions affecting selected markets in which we operate are expected to have an impact on the strength of our business in those local markets. As an example, during periods in which the price for oil declined rapidly, we experienced a slowing in our business in some regions where the economy is linked to energy exploration and production, including Texas and Canada. The global economic environment is currently in a period of heightened uncertainty, and in the event that equity and credit markets continue to experience volatility and disruption, our results of operations may be adversely affected.

In addition, our rates of revenue growth have sharply fluctuated from quarter to quarter over the last three years and we expect volatility in the rates of our growth to continue in future quarterly periods. Unique factors in any given quarter may affect period-to-period comparisons in our revenue growth, including;

- the overall economic and general retail sales environment, including the effects of uncertainty or stock market volatility on consumer spending;
- consumer preferences and demand;
- the number, size and location of stores we open, close, remodel or expand in any period;
- changes in Source Book circulation, and the number of pages in our Source Books and timing of mailing;
- our ability to efficiently source and distribute products;
- changes in our product offerings and the introduction, and timing thereof, of introduction of new products and new product categories;
- promotional events;
- our competitors introducing similar products or merchandise formats;
- the timing of various holidays, including holidays with potentially heavy retail impact; and
- the success of our marketing programs.

Due to these factors, our results for any quarter are not necessarily indicative of the results that we may achieve for a full fiscal year. Our results of operations may also vary relative to corresponding periods in prior years. We may take certain pricing, merchandising or marketing actions that could have a disproportionate effect on our business, financial condition and results of operations in a particular quarter or selling season, and as a result we believe that period-to-period comparisons of our results of operations are not necessarily meaningful and cannot be relied upon as indicators of future performance.

Other future developments in our business could also result in material changes in our operating costs, including increased merchandise inventory costs and costs for paper and postage associated with the mailing and shipping of Source Books and products. We cannot assure you that we will succeed in offsetting any such expenses with increased efficiency or that cost increases associated with our business will not have an adverse effect on our financial results.

We are undertaking a large number of business initiatives at the same time, including exploring opportunities to expand into new categories and complementary businesses. If these initiatives are not successful, they may have a negative impact on our results of operations.

We are undertaking a large number of new business initiatives at the same time in order to support our future growth. For example, we have developed and continue to refine and enhance our Gallery format, which involves larger store square footage. We also continue to add new product categories and to expand product assortments. For example, in fiscal 2015 we launched our new RH Modern and RH Teen categories and in fiscal 2019 we launched RH Beach House and RH Ski House. We are currently contemplating other new product lines and extensions. We introduced RH Hospitality in fiscal 2015 at RH Chicago, The Gallery at the Three Arts Club. As of February 1, 2020, eight of our RH Design Galleries included an integrated RH Hospitality experience and, based on the success of our hospitality offering to date, we plan to incorporate an integrated RH Hospitality offering, including cafés, wine vaults, and barista bars, in many of the new Galleries that we open in the future. We continue to refine and develop the RH Hospitality model as we seek to optimize this part of our business and its integration with the operation of our Gallery locations. RH Hospitality is different from our traditional home furnishings business and involves evolving strategies that are untested and unproven and may expose us to a number of risks including risks related to the management and execution of food and hospitality operations in various locations where we operate retail locations. Although we have experienced a number of positive business outcomes from the RH Hospitality operations including the incremental revenue that we believe is driven in Gallery with a hospitality offering, there can be no assurance that these benefits will be sustained or that we will avoid operational or other complications from the hospitality business. There can be no assurance that we will successfully scale RH Hospitality, that we will optimally balance the resources and square footage allocated to our hospitality offerings versus our product offerings at our Galleries, or that our hospitality offerings will be attractive to consumers in our market over a sustained period of time.

We have also embarked on an initiative to expand our product sales to international markets and are currently exploring opportunities for Design Galleries in several locations outside the United States, including the U.K. and Europe. International expansion will expose us to new risks, including, but not limited to, risks related to currency fluctuation, supply chain and product sourcing, new regulatory regimes applicable to our products, Galleries and employees, global health emergencies such as that related to the outbreak of COVID-19, and international economic or political events including but not limited to the U.K.'s withdrawal from the European Union, commonly referred to as "Brexit," from which there is expected to be considerable change in the regulatory framework governing business in the U.K. and which may negatively impact the luxury market. We may be unsuccessful in adapting our operations to address such risks. We also may be unsuccessful in accurately selecting which international markets would support demand for our products or sizing our Gallery openings to such markets. If we are not successful in managing the large number of new initiatives that are underway, we might experience an adverse impact on our financial condition and results of operations. We may determine to curtail and/or slow our international expansion initiative as part of our efforts to manage liquidity in response to overall market conditions and to address priorities in the different capital requirements of our business.

Furthermore, we can provide no assurances that customers will respond favorably to our new product offerings, Galleries or complementary businesses or that we will successfully execute on such business initiatives. Such new business opportunities may not achieve market acceptance or may only achieve market acceptance in limited geographic areas or at certain Design Galleries. In addition, developing and testing new and multiple business opportunities and strategies often requires knowledge in areas of expertise that may be new to

our organization and may require significant time of our management and resources. For example, RH Hospitality extended our business into an area where we have had limited historical operating and management experience and where low margins and high customer expectations can put pressure on results and performance. Expanding our business internationally will also require that we develop management expertise in new markets and regulatory regimes, and an inability to adapt our business quickly and efficiently to support our international expansion could materially adversely affect our financial condition and results of operations. We can provide no assurances that we will be successful in expanding our operations into any new businesses and product lines.

Any new businesses we enter may also expose us to additional laws, regulations and risks, including the risk that we may incur ongoing operating expenses in such businesses in excess of revenues, which could harm our financial condition and results of operations. The financial profile of any such new businesses may be different than our current financial profile, which could affect our financial performance and the market price for our common stock. For example, RH Hospitality may expose us to new risks related to consumer litigation and longer lease terms.

We often have in the past, and may in the future, incur significant costs for any new initiative before we realize any corresponding revenue with respect to such initiative. In addition, we may incur costs as we revise, restructure or discontinue existing product categories or business offerings in favor of pursuing new initiatives or retail concepts. For example, as we continue to open larger format Design Galleries in select major metropolitan markets, we expect to close a number of legacy Galleries and replace them with our Design Gallery format. The introduction of an integrated hospitality experience, including roll out of an integrated food and beverage experience at a new Gallery location often requires significant investments by us before the location is open to customers and able to generate revenues, and we anticipate that a number of Galleries to be opened during the next several years will continue to require this form of upfront investment before they generate revenue from the food and beverage offerings. To the extent that these new business opportunities do not generate sufficient revenue to recoup the cost of developing and operating such new concepts, our results of operations could be materially adversely affected.

In addition, we are continuing a number of new initiatives to improve the operations of our business, including ongoing refinements to our management structure and organizational design. Some of the improvements we are pursuing include changing the ways we source and deliver our products to our customers, as well as streamlining and realigning the management structure in our home office operations. We have also focused on elevating the customer experience, which includes improving our distribution and delivery of products to our customers and architecting a new fully integrated back-end operating platform, inclusive of the supply chain network, the home delivery experience as well as a new metric-driven quality system and company-wide decision data. We have focused on rationalizing our SKU count and optimizing inventory, which includes selling slower moving, discontinued and other inventory through markdowns and our outlet channel, as well as enhancing and optimizing our product sourcing capabilities and adding new management information systems.

Given the large number of organizational initiatives we are pursuing, as well as the complexity and untested nature of many of these efforts, there can be no certainty that we will be successful in executing on these initiatives including changes to our organizational design and management structure. We may not experience the operational or financial benefits we expect these improvements to generate and we may face unanticipated costs related to pursuing these initiatives such as personnel turnover, management distraction, or compliance and quality control risks, any of which could have a material adverse effect on our financial condition or results of operations.

All of the foregoing risks may be compounded due to various factors including any economic downturn. If we fail to achieve the intended results of our current business initiatives, or if the implementation of these initiatives is delayed or abandoned, diverts management's attention or resources from other aspects of our business or costs more than anticipated (including, as a result of personnel turnover or compliance and control risks), we may experience inadequate return on investment for some or all such business initiatives, which could have a material adverse effect on our financial condition or results of operations.

Changes in consumer spending and factors that influence spending of the specific categories of consumers that purchase from us, including the health of the high-end housing market, may significantly impact our revenue and results of operations.

We target consumers of high-end home furnishings as customers for our products. As a result, we believe that our sales are sensitive to a number of factors that influence consumer spending generally, but are particularly affected by the financial health of the higher end customer and demand levels from that customer demographic. In addition, not all macroeconomic factors are highly correlated in their impact on lower end housing versus the higher end customer. Demand for lower priced homes and first time home buying may be influenced by factors such as employment levels, interest rates, demographics of new household formation and the affordability of homes for the first time home buyer. The higher end of the housing market may be disproportionately influenced by other factors including the number of foreign buyers in higher end real estate markets in the U.S., the number of second and third homes being sold, stock market volatility and illiquid market conditions, global economic uncertainty, decreased availability of income tax deductions for mortgage interest and state income and property taxes, and the perceived prospect for capital appreciation in higher end real estate. In recent periods the stock market has experienced significant volatility as well as periods of significant decline, and rising house prices have dampened and increases in interest rates may dampen growth in the U.S. housing market and may depress consumer optimism about the U.S. housing market and home buying in the higher end of the housing market. There can be no assurance that some of the other macroeconomic factors described above will not adversely affect the higher end consumer that we believe makes up the bulk of our customer demand.

We believe that a number of these factors have in the past had, and may in the future have, an adverse impact on the high-end retail home furnishings sector and affect our business and results. These factors may make it difficult for us to accurately predict our operating and financial results for future periods and some of these factors could contribute to a material adverse effect on our business and results of operations.

If we are unable to maintain and enhance our brand or market our product offerings, we may be unable to attract a sufficient number of customers or sell sufficient quantities of our products.

Our business depends in part on a strong brand image, and we continue to invest in the development of our brand and the marketing of our business. We believe that the brand image we have developed, and the lifestyle image associated with our brand, have contributed significantly to the success of our business to date. We also believe that maintaining and enhancing our brand is integral to the future of our business and to the implementation of our strategies for expanding our business. This will require us to continue to make investments in areas such as marketing and advertising, as well as the day-to-day investments required for store operations, Source Book mailings, website operations and employee training. Our brand image may be diminished if new products, services or other businesses fail to maintain or enhance our distinctive brand image.

Additionally, our reputation could be jeopardized if we fail to maintain high standards for merchandise and service quality. With the growth in importance and the impact of social media, any negative publicity from product defects, recalls or failures in service may be magnified and reach a large portion of our customer base in a very short period of time, which could harm the value of our brand and, consequently, our financial performance could suffer. We may also suffer reputational harm if we fail to maintain high ethical, social and environmental standards for all of our operations and activities, if we fail to comply with local laws and regulations or if we experience other negative events that affect our image or reputation. Any failure to maintain a strong brand image could have an adverse effect on our sales and results of operations.

Our failure to successfully manage the strategy and costs of our Source Book mailings or other promotional programs and costs could have a negative impact on our business.

Source Book mailings are an important component of our business. We continue to adjust and refine our Source Book mailing strategy based on a variety of factors, including the success of the various changes that we

adopt. We can provide no assurances as to the success of any Source Book strategy we pursue. Increased expenditures on our catalog strategy may result in the production of too many Source Books, which could negatively affect our operating margins. Reducing expenditures on our catalog strategy, however, could overly restrict catalog circulation and have a negative effect on our revenues. Our efforts to optimize our Source Books and strategies for use of the Source Books to market our business may encounter difficulties. There can be no assurance that we will be successful as we make changes to our Source Book strategy including with respect to the cadence and timing of mailings, the format of the Source Books, the team we staff for optimizing our Source Book format and mailings, and the use of the Source Books as a marketing and promotional tool including with respect to prospecting for new customers. Additionally, due to the size of our Source Books we have in the past received negative publicity from environmental groups. If we fail to adequately adjust our catalog strategy to meet our goals, or if our catalog strategy is unsuccessful, our results of operations could be negatively impacted.

We also rely on customary discounts from the basic shipping rate structure that are available for our catalog mailings, which could be changed or discontinued at any time, and we are subject to fluctuations in the market price for paper, which has historically fluctuated significantly and may continue to fluctuate in the future. Future increases in shipping rates, paper costs or printing costs would have a negative impact on our results of operations to the extent that we are unable to offset such increases through increased sales or by raising prices, by implementing more efficient printing, mailing, delivery and order fulfillment systems, or by using alternative direct-mail formats.

We have historically experienced fluctuations in customer response to our Source Books. Customer response depends substantially on product assortment, product availability and creative presentation, the selection of customers to whom the catalogs are mailed, changes in mailing strategies, page size, page count, frequency and timing of delivery of catalogs, as well as the general retail sales environment and current domestic and global economic conditions. The failure to effectively produce or distribute our catalogs could affect the timing of catalog delivery. The timing of catalog delivery has in the past been, and in the future can be, affected by shipping service delays. Any delays in the timing of catalog delivery could cause customers to forgo or defer purchases. If the performance of our catalogs declines, if we misjudge the correlation between our catalog circulation and net revenues, or if our catalog circulation optimization strategy is not successful, our results of operations could be negatively impacted.

Competition in the home furnishings sector of the retail market may adversely affect our future financial performance.

The home furnishings sector within the retail market is highly competitive. We compete with the interior design trade and specialty stores, as well as antique dealers and other merchants that provide unique items and custom-designed product offerings at higher price points. We also compete with national and regional home furnishing retailers and department stores. In addition, we compete with mail order catalogs and online retailers focused on home furnishings.

We compete generally with these other retailers for customers, suitable retail locations, vendors, qualified employees and management personnel. As we have traditionally been a leader in the home furnishings sector, some of our competitors have also attempted to imitate our product offerings and business initiatives from time to time in the past. In addition, many of our competitors have significantly greater financial, marketing and other resources than we do and therefore may be able to devote greater resources to the marketing and sale of their products, generate greater national brand recognition or adopt more aggressive pricing policies than we can. Such competitors may also be able to adapt to changes in customer preferences more quickly than we can due to their greater financial or marketing resources, through new product launches or by adapting their business models and operations to new customer trends, which may in turn change how our customers acquire products or view our business and brand. Further, increased catalog mailings by our competitors may adversely affect response rates to our own Source Book mailings. There can be no assurance that such competitors will not be more successful than us, based on imitation or otherwise, or that we will be able to continue to maintain a leadership position in style and innovation in the future.

Increased competition also has resulted, and may in the future result, in potential or actual litigation between us and our competitors related to a variety of activities, including hiring practices. If we are not successful in such litigation, our business could be harmed.

If we fail to successfully anticipate consumer preferences and demand our results of operations may be adversely affected.

We are vulnerable to customer preferences and demand. Our success depends in large part on our ability to originate and define home product trends, as well as to anticipate, gauge and react to changing consumer demands in a timely manner. Our products must appeal to a range of consumers whose preferences cannot always be predicted with certainty. We cannot assure you that we will be able to continue to develop products that customers positively respond to or that we will successfully meet consumer demands in the future. Any failure on our part to anticipate, identify or respond effectively to consumer preferences and demand could adversely affect sales of our products, which could have a material adverse effect on our financial condition and results of operations.

If we fail to successfully and timely deliver merchandise to our customers and manage our supply chain commensurate with demand, our results of operations may be adversely affected.

We must successfully manage our supply chain and vendors in order to produce sufficient quantities of products that our customers wish to purchase in a timely manner. We must manage our supply chain and inventory levels, including predicting the appropriate levels and type of inventory to stock within each of our distribution centers, such that our “in stock” position in merchandise correlate well to consumer demand and expected delivery times. Because much of our merchandise requires that we provide vendors with significant ordering lead times, frequently before market factors are known, we may not be able to source sufficient inventory to meet demand if our products prove more popular than anticipated. In addition, our current initiatives to streamline and optimize our inventory levels may not be successful and implementing such initiatives may complicate our efforts to manage our supply chain. To the extent our business initiatives result in new product lines, new product or service offerings or expansion into new markets in the U.S. or abroad, we may need to establish new vendor relationships or new supply chain operations, which may expose us to new counterparty, regulatory, market or other risks and which may not be successful. From time to time, we have experienced periods in which some of our vendors were not able to meet customer demand levels for certain products resulting in significant back orders for goods, higher rates of cancellation on orders in process and, in some instances, the loss of customer sales when orders could not be completed in a timely manner. In addition, vulnerabilities in the information systems of our vendors could make our vendors the targets of cybersecurity breaches or cyber fraud, which could result in disruptions in our supply chain and product sourcing. Further, the seasonal nature of some of our products requires us to carry a significant amount of inventory prior to certain selling seasons. If we are unable to accurately predict and track demand, we may be required to mark down the price of certain products in order to sell excess inventory or we may be required to sell such inventory through our outlet stores or warehouse sales. For these reasons, our results of operations in any given quarterly period may be adversely affected. We expect these factors to continue from time to time as we add new product assortments and new merchandise categories into our business.

We are subject to risks associated with our dependence on foreign manufacturing and imports for our merchandise.

Based on total dollar volume of purchases for fiscal 2019, approximately 70% of our products were sourced from Asia, 16% from the United States and the remainder from other countries and regions. For fiscal 2019, approximately 38% of our products were sourced from China. We expect the amount of products that we source from China will be lower in fiscal 2020 compared to fiscal 2019, but the exact product mix in terms of vendor factory locations is subject to a range of different factors and is inherently difficult to predict with accuracy. In addition, some of the merchandise we purchase from vendors in the United States also depends, in whole or in

part, on vendors located outside the United States. As a result, our business highly depends on global trade, as well as any trade and or other factors that impact the specific countries where our vendors' production facilities are located. Our future success will depend in large part upon our ability to maintain our existing foreign vendor relationships and to develop new ones based on the requirements of our business and any changes in trade dynamics that might dictate changes in the locations for sourcing of products. In addition, we face risks related to the ability of our vendors to scale their operations whether in connection with new products we introduce or new production manufacturing locations that may be added to our supply chain, which in some cases would require substantial ongoing investments to support additional capacity. In addition, we have previously encountered difficulties in the ability of our vendors to scale production commensurate with demand from our customers. While we rely on long-term relationships with many of our vendors, we do not rely on long-term contracts with our vendors and generally transact business with them on an order-by-order basis.

Many of our imported products are subject to existing duties, tariffs, anti-dumping duties and other similar trade restrictions that may limit the quantity or affect the price of some types of goods that we import into the United States. In addition, substantial regulatory uncertainty exists regarding international trade relations and trade policy, both in the United States and abroad. An introduction of new duties, tariffs, quotas or other similar trade restrictions, or increases in existing duties or tariff rates, on products imported into the United States, whether actual, pending or threatened, may have a negative impact on our results of operations. Significant uncertainty exists as to whether and when tariffs may be imposed, and what countries may be implicated. For example, proposed tariffs on goods imported from Mexico have been introduced and subsequently withdrawn by the U.S. government. Additionally, such uncertainties, even if not directly applicable to our imported products, may have a negative influence on the domestic and international economy generally and indirectly reduce market demand for our products.

A significant subset of our products sourced from China has been affected by increased levels of tariffs that were imposed in 2018 and 2019. The initial round of these increased tariffs became effective on certain products that we source from China including furniture and lighting initially as a 10 percent ad valorem duty on September 24, 2018, which amount increased to 25 percent on May 10, 2019, and is expected to increase further to 30 percent on October 1, 2019. On August 1, 2019, President Trump announced a new 10 percent ad valorem duty on additional categories of goods imported from China, which amount was then increased to 15 percent on August 23, 2019. The new tariff at the rate of 15 percent became effective September 1, 2019 with respect to certain categories of goods and was expected to become effective for additional categories of goods on December 15, 2019. In January 2020, the U.S. and China signed a "Phase One" trade agreement pursuant to which, among other things, the U.S. will modify its Section 301 tariff actions and which suspended the tariff on this additional set of goods. Further, as of February 14, 2020, the 15 percent tariff which was implemented on September 1, 2019 was reduced to 7.5 percent.

While we have been working with our vendor partners on mitigation strategies to seek to address the impact of the tariffs on goods imported from China, such efforts may not be fully sufficient to remediate the impact of the existing ad valorem duty on certain products imported from China or the future ad valorem duties to be imposed on products from China. In addition, such mitigation efforts may not be successful with respect to other pending or future increases in tariffs. There is substantial uncertainty regarding the possible application of additional tariffs with respect to China, or the possible imposition of tariffs on trade with additional countries other than China. We may not be able to anticipate the exact contours of tariffs and other burdens on global trade that may become applicable and our efforts to respond to these circumstances may be inadequate. In particular, we may not be able to receive or sustain adequate pricing concessions from our vendors with respect to applicable tariffs and any applicable pricing increases that we seek to pass through to our customers may not be successful in achieving our objectives. Our sales may fall in response to any price increases and our vendors may not be able to support the level of pricing concessions that we seek.

In addition, we are undertaking ongoing efforts to examine our sourcing strategy in a comprehensive way in order to achieve the best possible outcomes for our business. Such efforts include addressing among other factors

the country of origin and the current and potential future imposition of tariffs with respect to particular countries of origin. These efforts to optimize our supply chain may not be successful and we may encounter various obstacles to these and other related initiatives. Although we have moved some of our merchandise sourcing away from China to other countries, these efforts may not achieve the desired outcomes. For example, we may not be able to move sufficient quantities of our product manufacturing to new locations outside of China and the quality of products manufactured in new factories may not meet the requirements of our business. In addition, we may encounter logistics and other challenges in moving manufacturing to new jurisdictions including the potential imposition of new tariffs on products sourced from such other jurisdictions.

In addition, there can be no assurance that tariffs that are imposed or proposed will not become effective on a longer term basis. In the event that any tariffs applicable to our business become applicable on a longer term basis, there can be no assurance that our efforts to mitigate the impact of such longer term tariffs will be successful.

There can be no assurance that we will not experience disruption in our business related to tariffs or other changes in trade practices and applicable rules or as a result of our efforts to respond to these matters. Tariffs and other similar trade actions are inherently unpredictable and can change quickly based on political or economic pressures or policy changes. Any changes to tariffs or other rules and practices related to cross border trade, including the possible implementation of additional tariffs, could materially increase our cost of goods sold with respect to merchandise that we purchase from vendors who manufacture products in China or other countries outside the United States, which could in turn require us to increase our prices and, in the event consumer demand declines as a result, negatively impact our financial performance. While we may seek to adopt mitigation measures and changes to our business practices to seek to counteract the effect of such tariffs on our business and results of operations, due to multiple factors that can occur in the context of trade disputes and the inherent unpredictability of how customers and market participants may respond, any mitigation measures we adopt may be not achieve their intended purpose. Certain of our competitors may be better positioned than us to withstand or react to these kinds of changes including border taxes, tariffs or other restrictions on global trade and as a result we may lose market share to such competitors. In addition, to the extent that our competitors, our vendors or companies in other industries that manufacture products in China respond to the tariffs imposed to date or the possibility of future tariffs by shifting production to other countries in Asia or to other regions, the costs of production in such countries may increase, which may increase our costs or otherwise have an adverse impact on our product supply chain. Similarly, to the extent that we or our vendors respond to the tariffs imposed to date or the possibility of future tariffs by shifting merchandise purchases or production to other countries in Asia or to other regions, we may face delays or costs associated with developing new vendor relationships and our vendors may face delays or costs associated with bringing online new manufacturing facilities, which may increase the cost of our products or cause delays in the shipment of our merchandise that result in the cancellation of orders by our customers. An interruption or delay in supply from our foreign sources, or the imposition of additional duties, taxes or other charges on these imports, could have a material adverse effect on our business, financial condition and results of operations unless and until alternative supply arrangements are secured. Due to broad uncertainty regarding the timing, content and extent of any regulatory changes in the U.S. or abroad, we cannot predict the impact, if any, that these changes could have to our business, financial condition and results of operations.

Our dependence on foreign imports also makes us vulnerable to risks associated with products manufactured abroad, including, among other things, risks of damage, destruction or confiscation of products while in transit to our distribution centers located in the United States, product quality control charges on or assessment of additional import duties, tariffs, anti-dumping duties and quotas, loss of “most favored nation” trading status by our foreign trading partners with the United States, work stoppages, including without limitation as a result of events such as longshoremen strikes, transportation and other delays in shipments, including without limitation as a result of heightened security screening and inspection processes or other port-of-entry limitations or restrictions in the United States, freight cost increases, political unrest, economic uncertainties, including inflation, foreign government regulations, trade restrictions, increased labor costs and other similar factors that might affect the operations of our vendors in specific countries such as China.

In addition, there is a risk of compliance violations by our vendors, which could lead to adverse consequences related to the failure of our vendors to adhere to applicable manufacturing requirements or other applicable rules or regulations. Any such noncompliance could have an adverse impact on our business and may result in product recalls, regulatory action, product liabilities, investigation by governmental agencies and other similar adverse consequences. Any failure by our vendors outside the United States to adhere to applicable legal requirements or our global compliance standards such as fair labor standards, prohibitions on child labor and other product safety or manufacturing safety standards could give rise to a range of adverse consequences including the disruption of our supply chain as well as potential liability to us and harm our reputation and brand and could subject us to other adverse consequences including boycotts by our consumer or special interest groups including activists, any of which actions could negatively affect our business and results of operations.

Our growth strategy and performance depend on our ability to purchase quality merchandise in sufficient quantities at competitive prices, including products that are produced by artisans and specialty vendors. Any disruptions we experience in our ability to obtain quality products in a timely fashion or in the quantities required could have a material adverse effect on our business.

We purchase substantially all of our merchandise from a number of third party vendors. Many such vendors are the sole sources for particular products, and we generally transact business with such vendors on an order-by-order basis without any long-term or other contractual assurances of continued supply, pricing or access to new products with our vendors. Therefore, we may be dependent on particular vendors that produce popular items, and any vendor could discontinue selling to us at any time. In addition, the expansion of our business into new U.S. or international markets or new product categories could put pressure on our ability to source sufficient quantities of our products from such vendors. In the event that one or more of our vendors is unable or unwilling to meet the quantity or quality of our product requirements, we may not be able to develop relationships with new vendors in a manner that is sufficient to supply the shortfall. We also may be required to develop such new vendor relationships in response to changes in our supply chain, for example in response to new tariffs or competitive pressures. Even if we do identify such new vendors, we may experience product shortages and customer backorders as we transition our product requirements to incorporate alternative suppliers. Our relationship with any new vendor would be subject to the same or similar risks as those of our existing suppliers.

Furthermore, our growth strategy includes expanding our product assortment, and our performance depends on our ability to purchase our merchandise in sufficient quantities at competitive prices. However, many of our key products are produced by artisans, specialty vendors and other vendors that are small, undercapitalized or that may have limited production capacity, and we have from time to time in prior periods experienced supply constraints that have affected our ability to supply high demand items or new products due to such capacity and other limits in our vendor base.

A number of our vendors, particularly our artisan vendors, may have limited financial or other resources and operating histories and may receive various forms of credit from us, including with respect to payment terms or other arrangements. In some cases, we have advanced payments to vendors in order to assist a vendor in funding additional merchandise production to meet our orders. We may advance a portion of the payments to be made to some vendors under our purchase orders prior to the delivery of the ordered products. These advance payments are normally unsecured. Vendors may become insolvent and their failure to repay our advances, and any failure to deliver products to us, could have a material adverse impact on our results of operations. There can be no assurance that the capacity of any particular vendor will continue to be able to meet our supply requirements in the future, as our vendors may be susceptible to production difficulties or other factors that negatively affect the quantity or quality of their production during future periods. A disruption in the ability of our significant vendors to access liquidity could also cause serious disruptions or an overall deterioration of their businesses, which could lead to a significant reduction in their ability to manufacture or ship products to us. Any difficulties that we experience in our ability to obtain products in sufficient quality and quantity from our vendors could have a material adverse effect on our business.

Our vendors may sell similar or identical products to our competitors or on their own, which could harm our business.

Because the arrangements with our vendors are generally not exclusive, many of our vendors might be able to sell similar or identical products to our competitors. Our competitors may enter into arrangements with suppliers that could impair our ability to sell those suppliers' products, including by requiring suppliers to enter into exclusive arrangements, which could limit our ability to enter into arrangements with such suppliers or otherwise access their products. Such competitors may also purchase products in significantly greater volume than we do, which may enable them to sell the products at reduced cost or flood the market with similar products.

Our vendors could also initiate or expand sales of their products through vendor-owned stores or through the Internet to the retail market and therefore directly compete with us or sell their products through outlet centers or discount stores, increasing the competitive pricing pressure we face.

Any of the above factors could negatively affect our business and results of operations.

Defective merchandise purchased from our vendors could damage our reputation and brand image and harm our business, and we may not have adequate remedies against our vendors for defective merchandise.

We have in recent periods, and may in the future, recall products from the market due to quality or other issues. Despite our ongoing efforts to improve customers' satisfaction with their experience at RH, we may fail to maintain the necessary level of quality for some of our products in order to satisfy our customers. For example, our vendors may not be able to continuously adhere to our quality control standards, and we might not identify a quality deficiency before merchandise ships to our stores or customers. Our failure to supply high quality merchandise in a timely and effective manner to our customers, our announcement of additional product recalls, or any perception that we are not adequately maintaining our sourcing and quality control processes in order to anticipate product quality issues could damage our reputation and brand image, and could lead to an increase in product returns or exchanges or customer litigation against us and a corresponding increase in our routine and non-routine litigation costs. Further, any merchandise that does not meet our quality standards or applicable government requirements could trigger high rates of customer complaints or returns, become subject to a product recall and/or attract negative publicity, which could in turn damage our reputation and brand image, result in consumer litigation (including class-action lawsuits), and harm our business. With the growth in importance and the impact of social media, the magnitude of such harm to our business, reputation and brand image may be significantly amplified. The number of business initiatives we are undertaking to enhance the quality of our customers' experience and to improve our organizational design, which are expected to include increasingly significant operational and other changes in the near term, may complicate our supply chain and quality control management process, and any inability to invest sufficient resources in quality control and compliance processes or significant turnover in the personnel dedicated to such function may result in quality control issues or product recalls.

Even if we detect that merchandise is defective before such merchandise is shipped to our customers, we may not be able to return such products to the vendor, obtain a refund of our purchase price from the vendor or obtain other indemnification from the vendor. The limited capacities of certain of our vendors may constrain the ability of such vendors to replace any defective merchandise in a timely manner. Similarly, the limited capitalization and liquidity of certain of our vendors and their lack of insurance coverage for product recall claims may result in such vendors being unable to refund our purchase price or pay applicable penalties or damages associated with any such defects or resulting product recalls.

Our results may be adversely affected by fluctuations in raw materials, energy costs and currency exchange rates.

Increases in the prices of the components and raw materials used in our products could negatively affect the sales of our merchandise and our product margins. Alternatively, the strength of the U.S. dollar may negatively impact the ability of some of our customers to purchase our goods. We believe some portion of our business depends on non-U.S. consumers, including sales in our stores in Canada and Waterworks showrooms in the U.K., as well as sales in some of our U.S.-based stores which have a high number of visitors from other countries who purchase goods from us while visiting the United States. Declines in the purchasing power of the British pound sterling and volatility in the British pound sterling exchange rate as a result of Brexit, for example, may dampen demand for our products in the U.K. and may delay or negatively affect the success of our business initiative to expand internationally.

Changes in prices for raw materials and fluctuations in exchange rates are dependent on a number of factors beyond our control, including macroeconomic factors that may affect commodity prices (including prices for oil, lumber and cotton); changes in supply and demand; general economic conditions; significant political events; labor costs; competition; import duties, tariffs, anti-dumping duties and other similar costs; currency exchange rates and government regulation; and events such as natural disasters and widespread outbreaks of infectious diseases (such as the recent outbreak of COVID-19). In addition, energy costs have fluctuated dramatically in the past and, in recent periods, energy prices have been declining and could experience significant volatility in the near term. Depending on the nature of changes in these different factors that affect our business, we may experience an adverse impact on our business for different reasons including increased costs of operation or lower demand for our products. We may experience slower demand from customers in markets that depend upon energy prices for a portion of their economic activity.

Changes in the value of the U.S. dollar relative to foreign currencies, including the Chinese Yuan, may increase our vendors' cost of business and ultimately our cost of goods sold and our selling, general and administrative costs. If we are unable to pass such cost increases on to our customers or the higher cost of the products results in decreased demand for our products, our results of operations could be harmed.

We are subject to risks associated with occupying substantial amounts of space, including future increases in occupancy costs. We are pursuing various alternatives to traditional leasing of our Gallery locations that may subject us to a range of risks related to real estate development including risks related to construction and development of locations, risks related to the financing of commercial real estate and the market for commercial real estate.

We lease nearly all of our retail store locations and we also lease our outlet stores, our corporate headquarters and other storage and office space, and our distribution and home delivery facilities. The initial lease term of our retail locations generally ranges from ten to fifteen years, and certain leases contain renewal options for anywhere from ten to twenty-five years. The initial lease term for one of our future Design Galleries is forty-one years, and contains a renewal option for five years. Most leases for our retail locations provide for a minimum rent, typically including escalating rent amounts, plus a percentage rent based upon sales after certain minimum thresholds are achieved, as well as common area maintenance charges, real property insurance and real estate taxes.

We are currently pursuing several other models for the transformation of our real estate beyond a traditional leasing approach including a real estate development model, a joint venture model and a capital light model. While these alternative models are designed to achieve superior financial returns to traditional real estate lease structures for a retail business, some of these new ways of operation will expose us to a range of different risks. Various aspects of our recently developed multi-tier real estate strategy may expose us to new forms of risk versus our traditional leasing model. Our new strategies include (1) our "capital light" leasing deals, where as much as 65% to 100% of the capital requirement would be funded by the landlord, versus 35% to 50%

previously; (2) our real estate development model where we expect either to do a sale-leaseback transaction or to pre-sell the property and structure the transaction such that the capital to build the project is advanced by the buyer during construction; and (3) our hybrid or joint venture structure where we are working on joint venture projects in which we share the upside of development with the developer/landlord.

These new approaches might cause us to pursue complicated real estate transactions and may require additional capital investment and could present different risks related to the ownership and developments of real estate compared to those risks associated with a traditional store lease with a landlord, including greater financial exposure if our plans for the relevant real estate are not as successful as we originally anticipate or if the value of the real estate we acquire subsequently decreases. Pursuing multiple different paths for addressing our real estate needs may create various risks including increased complexity and risks related to the time and costs of real estate development as well as the need for additional capital and risks related to resale of real estate projects. These risks could distract management focus, strain our operational resources and personnel, or expose us to new regulatory or tax regimes in which we must develop expertise.

Several of our new real estate development strategies expose us to additional risks related to operating in commercial real estate from a development perspective. Such risks include the cost and financing of the acquisition of real estate interests, market risks related to real estate prices, the time and costs related to developing real estate projects including construction and development risks and other factors that affect the commercial real estate industry more generally. We have not historically operated directly in all phases of real estate development including managing all aspects of construction of large scale real estate projects. Although our strategy in assuming greater risk and responsibility for real estate development in certain projects is to achieve greater financial returns and a higher overall return on investment if our efforts are successful, we could face increased downside risks if we encounter difficulties in implementing these strategies such as cost overruns or delays in construction.

If we decide to close an existing or future store, we may nonetheless have continuing obligations with respect to that property pursuant to the applicable lease or ownership arrangements, including, among other things, paying the base rent for the balance of the lease term. Our ability to re-negotiate favorable terms on an expiring lease, to arrange for the sale of an owned property or to negotiate favorable terms for a suitable alternate location could depend on conditions in the real estate market, competition for desirable properties, our relationships with current and prospective landlords and other factors that are not within our control. Our inability to enter into new leases or renew existing leases on terms acceptable to us or be released from our obligations under leases or other obligations for stores that we close could materially adversely affect our business and results of operations.

A number of factors that affect our ability to successfully open new stores within the time frames we initially target or optimize our store footprint are beyond our control, and these factors may harm our ability to execute our strategy to transform our real estate, which may negatively affect our results of operations.

We are focused on sizing our assortments and our stores to the potential of the market by adjusting the square footage and number of stores on a geographic market-by-market basis. We plan to optimize our real estate by continuing to open larger square footage Galleries in key markets and relocating or closing selected stores in these or adjacent markets. In addition, we have developed a new RH prototype Design Gallery, we intend to continue to open indigenous Bespoke Galleries in the second home markets and we are developing a new Gallery model tailored to secondary markets. When we address the introduction of new stores in a particular market or changes to, or closure of, existing stores, we must make a series of decisions regarding the size and location of new stores (or the existing stores slated to undergo changes or closure) and the impact on our other existing stores in the area or being without presence or “out of the market.”

Our ability to maximize the productivity of our retail store base, depends on many factors, including, among others, our ability to:

- identify suitable locations, the availability of which is largely outside of our control;

- size the store locations to the market opportunity;
- retain customers in a certain geographic market when we close stores in such market or an adjacent market;
- negotiate acceptable new lease terms or lease renewals, modifications or terminations;
- efficiently build and equip new stores or remodel existing locations;
- source sufficient levels of inventory to meet the needs of changes in our store footprint in a timely manner;
- successfully integrate changes in our store base into our existing operations and information technology systems;
- obtain or maintain adequate capital resources on acceptable terms;
- avoid construction or local permit delays, construction accidents and injuries and cost overruns in connection with the opening of new stores or the expansion or remodeling of existing stores;
- maintain adequate distribution facilities, information systems and other operational systems to serve our new stores and remodeled stores; and
- address competitive, merchandising, marketing, distribution and other challenges encountered in connection with expansion into new geographic areas and markets.

We have experienced delays in opening some new stores within the time frames we initially targeted, and may experience such delays again in the future. We have also incurred higher levels of capital and other expenditures associated with the opening of some of our new Gallery locations. While we are investing in strategies to address these challenges in the future, we may not be successful in deploying such strategies or they may not have the effect that we anticipate. Any of the above challenges or other similar challenges could delay or prevent us from completing store openings or the additional remodeling of existing stores or hinder the operations of stores we open or remodel. If any of these challenges delays the opening of a store, our results of operations will be negatively affected as we will incur various costs during the delay without associated store revenue at such location and our overall return on investment and profit goals for some locations could be adversely affected. Unfavorable economic and business conditions and other events could also interfere with our plans to expand or modify store footprints. Changes in regulation or increases in building or construction costs including with respect to the cost of building materials could result in unanticipated increases in real estate development costs or delays in the completion of our real estate projects. Our failure to effectively address challenges such as those listed above could adversely affect our ability to successfully open new stores or change our store footprint in a timely and cost-effective manner and could have a material adverse effect on our business, results of operations and financial condition.

Reductions in the volume of mall and other in-store traffic or the closing of shopping malls as a result of changing demographic patterns could significantly reduce our sales.

Although many of the new Design Galleries that we have opened are being developed outside of the shopping mall setting, a significant portion of our existing footprint of legacy Galleries is currently located in shopping malls. Sales at stores located in malls are derived, in part, from the volume of traffic in those malls. These stores benefit from the ability of the malls to generate consumer traffic in the vicinity of our stores and the continuing popularity of the malls as shopping destinations and positive experiences.

However, in recent years there has been a shift in consumer preferences to purchasing certain products online rather than in stores. This shift, particularly when coupled with past unfavorable economic conditions in certain regions, has adversely affected mall traffic in some regions and has threatened the viability of certain commercial real estate firms that operate major shopping malls. A continuation of such trend could adversely impact the sales generated by our stores currently located in shopping malls.

If we are unable to successfully optimize and operate our distribution centers, furniture home delivery centers and other aspects of our supply chain and customer delivery network, or if we are not able to fulfill orders and deliver our merchandise to our customers in an effective manner, our business and results of operations will be harmed.

Our business depends upon the successful operation of our distribution centers, furniture home delivery centers and other aspects of our supply chain and customer delivery network, as well as upon our order management and fulfillment services and the re-stocking of certain inventories within our stores. The efficient flow of our merchandise requires that our facilities have adequate capacity to support our current level of operations and any anticipated increased levels that may follow from any growth of our business.

We are currently engaged in efforts to improve the quality of our customer experience, which includes making changes to the way in which we operate our distributions centers, furniture home delivery centers and other aspects of our supply chain and customer delivery network. Additionally, we plan to invest significant time architecting a new fully integrated back-end operating platform, inclusive of the supply chain network, the home delivery experience as well as a new metric driven quality system and company-wide decision data. Some of these efforts may require us to make significant expenditures in periods in the near term, which may also have a negative effect on our results of operations if there is no associated increase in revenues or decrease in returns or if any such effect is less than anticipated. There can be no assurance however that any of these efforts will be successful or that we will not encounter additional difficulties in achieving higher levels of customer satisfaction.

We are also engaged in initiatives to rationalize our SKU count, and in order to realize the anticipated benefits of such initiatives, including through lower inventories and reduced working capital, we have focused on optimizing the use of our distribution centers, furniture home delivery centers and outlets. For example, we have consolidated our distribution center network and we are in the process of opening new outlet and home delivery center locations and reconfiguring our furniture home delivery centers and outlets in order to streamline our operations. While we believe that optimizing and consolidating our distribution centers and other aspects of our supply chain and customer delivery network will allow us to more efficiently manage our inventory and optimize our uses of capital, in the short term such strategy may result in additional costs, including increased freight costs and lease early termination fees. Furthermore, in the past, during periods of significant customer growth and demand, we have found that our distribution centers often run at capacity. If we fail to accurately anticipate the future capacity requirements of our distribution centers, we may experience delays and difficulties in fulfilling orders and delivering merchandise to customers in a timely manner. Furthermore, we may be unable to remedy such issues quickly as opening additional distribution and home delivery facilities can face operational difficulties, such as disruptions in transitioning fulfillment orders to the new distribution facilities, competition for distribution facility space and problems associated with operating new facilities or reducing the size and changing functions of existing facilities. These difficulties can result in a negative experience for our customers. Any delays in fulfilling orders and delivering merchandise to customers, or related negative experience of our customers, could harm our results of operations.

We currently rely upon independent third-party transportation providers for the majority of our product shipments, which subjects us to certain risks.

We currently rely upon independent third-party transportation providers for product shipments from our vendors to our stores and to our customers outside of certain areas. Our utilization of third-party delivery services for shipments is subject to risks, including increases in fuel prices, which would increase our shipping costs, as well as strikes, work stoppages and inclement weather, which may impact shipping companies' abilities to provide delivery services that adequately meet our shipping needs. For example, strikes or even threat of strikes involving longshoreman and clerical workers at ports in the past have completely shut down such ports for periods of time, impacting retail and other industries. If we change shipping companies, we could face logistical difficulties that could adversely affect deliveries and we would incur costs and expend resources in connection with such change. Moreover, we may not be able to obtain terms as favorable as those received from the third-party transportation providers we currently use, which in turn would increase our costs.

Our operations have significant liquidity and capital requirements and depend on the availability of adequate financing and sources of capital on reasonable terms. If we fail to use our financial resources effectively, or if we are unable to obtain sufficient capital when needed, it could have a significant negative effect on our ability to grow our business.

We have historically relied on the availability of some amount of debt financing to fund our operations, including borrowings under our revolving line of credit. We have also incurred indebtedness to finance other strategic initiatives, including our share repurchase programs, such as (i) the aggregate \$1 billion in share repurchase programs authorized by our Board of Directors, which program was fully completed during fiscal 2017, and (ii) the share repurchase program authorized by our Board of Directors in October 2018 in an aggregate amount of \$700 million of which (x) \$250.0 million in share repurchases were completed in fiscal 2018, (y) the \$700 million authorization amount was replenished by the Board of Directors in March 2019 and (z) of which \$250.0 million in share repurchases were completed in fiscal 2019. We completed debt financing in fiscal 2014, fiscal 2015, fiscal 2018 and fiscal 2019 through the issuance of four series of convertible senior notes, the aggregate principal amount of which was \$985 million as of February 1, 2020. As of February 1, 2020, we had no outstanding borrowings and \$321.7 million of availability under our revolving line of credit facility, net of \$13.2 million in outstanding letters of credit. Our revolving line of credit contains various restrictive covenants, including, among others, limitations on the ability to incur liens, make loans or other investments, incur additional debt, issue additional equity, merge or consolidate with or into another person, sell assets, pay dividends or make other distributions, or enter into transactions with affiliates. These restrictive covenants may limit the amount of borrowings available to us under our line of credit and our operational and financial flexibility. We may face financial and contractual consequences to the extent we are not able to maintain our compliance with such covenants, which could have a materially adverse effect on our business, financial condition and results of operations.

We will have significant capital requirements for the operation of our business in the near term if we are to continue to pursue all of our current business initiatives. In addition, the \$300 million principal amount of convertible senior notes that we issued in fiscal 2015 matures on July 15, 2020, at which time we expect to repay the remaining principal balance of such notes in cash. We have substantial capital requirements related to investments in our business, our real estate strategy, our international expansion, the development of new businesses and our significant number of concurrent initiatives. We have invested significant capital expenditures in remodeling and opening new Galleries, and these capital expenditures have increased in the past and may continue to increase in future periods as we open additional Design Galleries, which may require us to undertake upgrades to historical buildings or construction of new buildings. During fiscal 2019, our adjusted net capital expenditures were \$157.9 million, inclusive of cash received related to landlord tenant allowances of \$28.3 million.

We are implementing a number of changes to our business operations as a result of the COVID-19 health crisis and the related impact to our business resulting from the closure of stores and other operational restrictions on our business that have resulted from the health crisis. One focal point of these operational changes is to preserve cash and maintain liquidity in response to the reduction in our sales. As a result of these efforts to manage our liquidity, we anticipate substantial reductions to the level of our fiscal 2020 capital expenditures. The exact scope of our capital plans for 2020 will depend on a variety of factors including the availability of other sources of capital and the way that our business performs during the duration of the health crisis.

Our current real estate strategy involves opening Design Galleries in select major metropolitan markets, developing new RH model Design Galleries and Galleries tailored to secondary markets, and opening indigenous Bespoke Galleries in the second home markets, as well as pursuing category extensions of our brand and exploring new business areas. We have principally relied upon leases with landlords for most of our Gallery locations to date. We have begun to pursue a real estate development model strategy for some of our new Gallery developments in which we invest in ownership of real estate such as we did in the case of our current Gallery location in San Francisco where we own both the building and the land. The real estate development model may

require us to pursue additional capital expenditures than a traditional leasing model, but we may be able to recoup substantial amounts of capital and may also achieve gains on our capital investments if we are successful with this model and are able to sell the real estate interests to a real estate investor in a sale-leaseback transaction. As we develop new Galleries, as well as potentially other strategic initiatives in the future like our integrated hospitality experience, we may explore other models for our real estate, which could include longer lease terms or further purchases of, or joint ventures or other forms of equity ownership in, real estate interests associated with new sites and buildings. These approaches might require greater capital investment than a traditional store lease with a landlord. In the event that such capital and other expenditures require us to pursue additional funding sources, we can provide no assurances that we will be successful in securing additional funding on attractive terms or at all. In addition, the effects of COVID-19 on our business, including due to actions taken by federal, state and local government authorities in response to the outbreak, may require changes to our real estate strategy and related capital expenditure and financing plans. For example, we expect that there will be a need to delay planned construction projects and Gallery openings and defer expansions into new markets including our anticipated international expansion. In addition, we may continue to be required to make lease payments for our Galleries, restaurants and outlets that have been closed. Our efforts to mitigate the costs of construction delays and deferrals, store closures and other operational difficulties resulting from COVID-19, including negotiating with landlords and other third parties regarding the timing and amount of payments under existing contractual arrangements, may not be successful, and as a result, our real estate strategy may have ongoing significant liquidity needs even as we scale back our operations and expansion cadence.

While our general approach has been to target capital toward investments that we believe will achieve favorable returns for our shareholders, these decisions involve a significant amount of judgment regarding the availability of capital and the anticipated growth of the business in both revenue and earnings in future periods. In addition, our near term decisions regarding the sources and uses of capital in our business will reflect and adapt to changes in market conditions and disruption in our business related to COVID-19.

During the time period from fiscal 2017 through fiscal 2019, we have invested substantial amounts of capital to repurchase shares which has materially reduced the number of our outstanding shares which could in turn yield financial benefits to our investors including the potential for increased earnings per share. At the same time, such share repurchases have increased our aggregate levels of indebtedness, increased our costs for cash and/or non-cash interest expense and diverted capital from other purposes including other investments that we might have undertaken with respect to the business. We can provide no assurances of the exact financial and operational impact of previous or future share repurchases on our business and results of operation and the resulting incurrence of debt may have an impact on our future liquidity position and capital available for other aspects of our business. Although our share repurchase programs are intended to enhance long-term shareholder value, depending on the exact financial and operational impact of these programs on our business, there can be no assurance that share repurchases will have the benefits that we expect.

When we purchase shares in the market as part of one of our share repurchase programs, we generally undertake such transactions out of a belief that the shares represent a good investment and that the market price for the shares may be undervalued. There can be no assurance that these decisions will prove to be correct as valuation of common stock is subject to a range of factors and is subject to inherent degrees of uncertainty. Over time it may turn out that the value of our common stock will be substantially higher or lower than some of the prices that we pay to undertake repurchase transactions. For example, the market price of our common stock may subsequently decline below the levels at which repurchases were made or it may appreciate to prices substantially above the amounts we pay for the buyback. If we access capital through sales of our common stock or other securities linked to the price of our common stock, our investors may experience dilution from such capital transactions and there can be no assurance that such financing will be incurred at prices that are higher for shares of our common stock than the prices at which we engaged in share repurchases.

Pursuit of share repurchases may expose us to other risks in connection with our business including legal and financial constraints, risks related to capital allocation, the level of indebtedness that we carry, increases

costs for borrowing, risks related to legal claims and litigation and increased dependency on capital markets and sources of financing to fund the requirements of our business including the costs of any share repurchases. To the extent that we incur indebtedness in connection with our business in connection with or as a result of our share repurchases, the requirements of such debt may include terms and conditions that could have an adverse effect upon our business including as a result of restrictive financial or operational covenants, burdensome rates of interest, cross defaults and other terms that may reduce our operational or financial flexibility or cause us to incur substantial costs including restructuring or refinancing such indebtedness.

In addition, while we anticipate that we should be able to repay our debt maturities as they come due, there can be no assurance that we will have sufficient financial resources at the maturity of any specific indebtedness, whether upon its state maturity or otherwise. In particular, we may need to incur additional debt or refinance existing debt in order to achieve repayment of existing debt. Given the fast moving nature of the COVID-19 health crisis, and the corresponding impact on financial markets and the economy as a whole, there is an enhanced degree of uncertainty regarding the Company's capital position and availability of capital to fund the Company's liquidity requirements.

In recognition of the significant threat to the liquidity of financial markets posed by COVID-19, the Federal Reserve and Congress have taken dramatic actions to provide liquidity to businesses and the banking system in the U.S. For example, on March 27, 2020, the President signed into law the Coronavirus Aid, Relief, and Economic Security Act (the "CARES Act"), a sweeping stimulus bill intended to bolster the U.S. economy, among other things, and provide emergency assistance to qualifying businesses and individuals. There can be no assurance that these interventions by the government will be successful, and the financial markets may experience significant contractions in available liquidity. While the Company may receive financial, tax or other relief and other benefits under and as a result of the CARES Act, it is not possible to estimate at this time the availability, extent or impact of any such relief. In addition, store closures and other operational difficulties faced by the Company may negatively affect the Company's financial condition and restrict the availability of liquidity for its operational needs, including due to, among other reasons, increased and unforeseeable liquidity needs and limited flexibility to control expenses in line with potential decreases in revenue. If the Company is not able to arrange financing to repay its debt obligations, or to extend the maturities of existing debt or otherwise refinance the Company's obligations as needed, we may experience a material adverse effect on our business and operations. For example, in certain circumstances, we may be required to repay the three series of convertible senior notes that we issued in fiscal 2015, fiscal 2018 and fiscal 2019 with cash payments. See *Item 2—Management's Discussion and Analysis of Financial Condition and Results of Operations—Liquidity and Capital Resources—Convertible Senior Notes*. The \$300 million principal amount of convertible senior notes that we issued in fiscal 2015 matures on July 15, 2020 and is convertible as of February 1, 2020 through the close of business on the second schedule trading day immediately preceding July 15, 2020. At the time the notes become due, and prior to maturity to the extent holders exercise their conversion right, the trading price of our common stock may be such that we may find it necessary to settle the notes in cash. There can be no assurance that we will be able to pay the amount of cash due if holders surrender their notes for conversion. In addition, agreements governing any debt may restrict our ability to make each of the required cash payments even if we have sufficient funds to make them. Furthermore, our ability to purchase the notes or to pay cash upon the conversion of the notes may be limited by law or regulatory authority. In addition, if we fail to purchase the notes, to pay special interest, if any, due on the notes, or to pay the amount of cash due upon conversion, we will be in default under the respective indentures governing the notes, which in turn may result in the acceleration of other indebtedness we may then have. If the repayment of the other indebtedness were to be accelerated, we may not have sufficient funds to repay that indebtedness and to purchase the notes or to pay the amount of cash due upon conversion.

The need to repay our convertible senior notes or other debt obligations could cause us to incur additional borrowings or issue additional debt to investors and lenders. We may also experience cash flow shortfalls in the future, and we may otherwise require additional external funding, or we may need to raise funds to take advantage of unanticipated opportunities, to make acquisitions of other businesses or companies or to respond to changing business conditions or unanticipated competitive pressures. Disruptions in the global financial markets

and banking systems have made credit and capital markets more difficult for companies to access, even for some companies with established revolving or other credit facilities. The continued volatility of, or other adverse developments in, U.S. or global market conditions, including as a result of fluctuations in the stock market, the global outbreak of COVID-19, risks related to Brexit, declines in energy prices or the housing market or other U.S. or global political or economic trends, could affect our ability to access future debt and to manage our debt obligations. We cannot assure you that we will be able to raise necessary funds on favorable terms, if at all, or that future financing requirements would not be dilutive to holders of our capital stock. If we fail to raise sufficient additional funds, we may be required to delay or abandon some of our planned future expenditures or aspects of our current operations.

Our business is dependent on certain key personnel; if we lose key personnel or are unable to hire additional qualified personnel, our business may be harmed.

The success of our business depends upon our ability to retain continued service of certain key personnel, particularly our Chairman and Chief Executive Officer, Gary Friedman, and to attract and retain additional qualified key personnel in the future. We face risks related to loss of any key personnel and we also face risks related to any changes that may occur in key senior leadership executive positions. Any disruption in the services of our key personnel could make it more difficult to successfully operate our business and achieve our business goals and could adversely affect our results of operation and financial condition. These changes could also increase the volatility of our stock price.

Many of our key personnel periodically travel together while on company business. We do not have a policy that prohibits key officers and directors from flying together, whether flying commercially or in our corporate aircraft. We face risks related to any loss of key personnel that might arise as a result of such travel arrangements. In addition, we do not maintain key man life insurance policies on any of our key personnel. As a result, we may not be able to cover the financial loss we may incur in losing the services of any of our key personnel.

In March 2019, we appointed a new Chief Financial Officer as a result of the prior President, Chief Financial and Administrative Officer's decision to step down due to health considerations. We may face risks related to this and other transitions in our leadership team.

Competition for qualified employees and personnel in the retail industry is intense, particularly in the San Francisco Bay Area where our headquarters are located, and we may be unable to retain personnel that are important to our business or hire additional qualified personnel. The process of identifying personnel with the combination of skills and attributes required to carry out our goals is often lengthy. Our success depends to a significant degree upon our ability to attract, retain and motivate qualified management, marketing and sales personnel, and store managers, and upon the continued contributions of these people. In addition, our complex operations require the services of qualified and experience management personnel, with expertise in the areas including information technology and supply chain management. We cannot assure you that we will be successful in attracting and retaining qualified executives and personnel. In addition, we are pursuing a dynamic business model which is subject to a number of new business initiatives as we seek to optimize our business and financial performance. As a result of the ongoing evolution of our business, we frequently implement changes to our organizational design in order to more closely align our management structure with the needs of the business. In connection with such changes to our management structure, we also implement changes in personnel and reductions in force as a result of which we may incur severance costs and other reorganization charges and expenses. Changes in our organizational structure may also have an impact on retention of personnel.

Inasmuch as our success depends in part upon our ability to attract, motivate and retain a sufficient number of store and other employees who understand and appreciate our corporate culture and customers. Turnover in the retail industry and food and beverage industry is generally high. Excessive employee turnover will result in higher employee costs associated with finding, hiring and training new store employees. If we are unable to hire

and retain store and other personnel capable of consistently providing a high level of customer service, our ability to open new stores, service the needs of our customers and expand our food and beverage business may be impaired, the performance of our existing and new stores and operations could be materially adversely affected and our brand image may be negatively impacted.

Material damage to, or interruptions in, our information systems as a result of external factors, staffing shortages, cybersecurity breaches or cyber fraud, or difficulties in updating our existing software or developing or implementing new software could have a material adverse effect on our business or results of operations, and we may be exposed to risks and costs associated with protecting the integrity and security of our customers' information.

We depend largely upon our information technology systems in the conduct of all aspects of our operations, many of which we have only adopted and implemented within the past several years or are in the midst of implementing in connection with rebuilding our supply chain and infrastructure. These systems can be complex to develop, maintain, upgrade and protect against emerging threats, and we may fail to adequately hire or retain adequate personnel to manage our information systems, we may fail to accurately gauge the level of financial and managerial resources to invest in our information systems, or we may fail to realize the anticipated benefits of resources invested in our information systems particularly as our business changes as a result of the many initiatives that we are pursuing. Such systems are subject to damage or interruption from power outages, computer and telecommunications failures, computer viruses, security breaches and natural disasters. In addition, damage or interruption can also occur as a result of non-technical issues, including vandalism, catastrophic events, and human error. Damage or interruption to our information systems may require a significant investment to fix or replace the affected system, and we may suffer interruptions in our operations in the interim. Any material interruptions or failures in our systems or the systems of our third party vendors may have a material adverse effect on our business or results of operations.

We routinely experience cybersecurity attacks and expect to continue to be the target of cyber fraud, hacking or theft. While to date none of these incidents have been material, despite our efforts to ensure the integrity of our information technology systems, we may not be able to anticipate, detect or implement adequate preventive measures against all cyber threats because techniques used to obtain unauthorized access or to sabotage systems change frequently and often are not recognized until launched against a target. Our operations are also dependent on the information technology systems and cybersecurity measures of our third party vendors. Attempted cyber intrusions into our information systems through compromised vendor networks, if successful, could compromise our information systems. In addition, our information systems can face risks to the extent we acquire new businesses but are not able to quickly or comprehensively integrate such acquired businesses into our policies and procedures for addressing cybersecurity risks or identify and address weaknesses in such acquired entity's information systems, which risks may be compounded to the extent the information systems of an acquired entity are integrated with ours, thus providing access to a broader set of sensitive customer information through a compromised network at the acquired entity level. If a computer hacker or other third party is able to circumvent our security measures, he or she could destroy or steal valuable information or disrupt our operations. Any successful breaches or attempted intrusions could result in increased information systems costs and potential reputational damage, which could materially adversely affect our business and results of operations.

Additionally, in order for our business to function successfully, we and other market participants must be able to handle and transmit confidential and personal information securely, including in customer orders placed through our website. That information includes data about our customers, including personally identifiable information and credit card information, as well as sensitive information about our vendors and workforce, including social security numbers and bank account information. If our systems are damaged, interrupted or subject to unauthorized access, information about our customers, vendors or workforce could be stolen or misused. Any security breach could expose us to risks of data loss, fines, litigation and liability and could seriously disrupt our operations and harm our reputation, any of which could adversely affect our business. We may be subject to one or more claims or lawsuits related to the intentional or unintentional release of confidential

or personal information, including personally identifiable information about our customers, vendors or workforce. In addition to the possibility of fines, lawsuits and other claims, we could be required to expend significant resources to change our business practices or modify our service offerings in connection with the protection of personally identifiable information, which could have a material adverse effect on our business. Any breach could also cause consumers to lose confidence in the security of our website and choose not to purchase from us.

We are also subject to payment card association rules and network operating rules, including data security rules, certification requirements and rules governing electronic funds transfers, which could change over time. For example, we are subject to Payment Card Industry Data Security Standards (“PCI DSS”), which contain compliance guidelines and standards with regard to our security surrounding the physical and electronic storage, processing and transmission of individual cardholder data. As of October 1, 2015, the payment card industry shifted the liability of certain credit card transactions to retailers who are not able to process Europay, MasterCard, Visa (“EMV”) chip enabled card transactions. As a result, before our implementation of the EVM technology is complete, we may be liable for costs incurred by payment card issuing banks or other third parties for fraudulent transactions initiated through EMV chip enabled cards before our implementation of EMV chip technology. In addition, if our internal systems are breached or compromised, we may be liable for card re-issuance costs, subject to fines and higher transaction fees and lose our ability to accept credit and/or debit card payments from our members, and our business and operating results could be adversely affected.

States and the federal government have enacted additional laws and regulations to protect consumers against identity theft, including laws governing treatment of personally identifiable information. For example, the EU General Data Protection Regulation (“GDPR”), which took effect in May 2018, and the California Consumer Privacy Act, which took effect in January 2020, impose stringent requirements on how we and third parties with whom we contract collect and process personal information, and provide for significant penalties for noncompliance. These laws have increased the costs of doing business and, if we fail to implement appropriate safeguards or we fail to detect and provide prompt notice of unauthorized access as required by some of these laws, we could be subject to potential claims for damages and other remedies. If we were required to pay any significant amount in satisfaction of claims under these laws, or if we were forced to cease our business operations for any length of time as a result of our inability to comply fully with any such law, our business, results of operations and financial condition could be adversely affected. We may also incur legal costs if we are required to defend our methods of collection, processing and storage of personal data. Investigations, lawsuits, or adverse publicity relating to our methods of handling personal data could result in increased costs and negative market reaction.

Furthermore, data security breaches suffered by well-known companies and institutions have attracted a substantial amount of media attention, prompting additional state and federal proposals addressing data privacy and security. As the data privacy and security laws and regulations evolve, we may be subject to more extensive requirements to protect the customer information that we process in connection with the purchases of our products. Our failure to successfully respond to these risks and uncertainties could reduce website sales and have a material adverse effect on our business or results of operations.

We currently maintain insurance to protect against cybersecurity risks and incidents. However, there can be no assurance that such insurance coverage will be available in the future on commercially reasonable terms or at commercially reasonable rates. In addition, insurance coverage may be insufficient or may not cover certain cybersecurity losses and liability.

We face product liability risks and certain of our products may be subject to recalls or other actions by regulatory authorities, and any such recalls or similar actions could have a material adverse effect on our business.

We face product liability, product safety and product compliance risks relating to the design, manufacturing, raw material sourcing, testing, contents, importation, sale, use and performance of some of our products. The

products we sell must be designed and manufactured to be safe for their intended purposes. Some of our products must comply with certain federal and state laws and regulations. For example, some of our products are subject to the Consumer Product Safety Act, the Federal Hazardous Substances Act and the Consumer Product Safety Improvement Act (the “CPSIA”), which empower the Consumer Product Safety Commission (the “CPSC”) to establish product bans, substance bans, substance limits, performance requirements, test methods and other compliance verification processes. The CPSC is empowered to take action against hazards presented by consumer products, up to and including product recalls. We are required to report certain incidents related to the safety and compliance of our products to the CPSC, and failure to do so could result in a civil penalty. The CPSC is particularly active in regulation and enforcement activities related to the kinds of children’s products sold in our RH Baby & Child division. Certain of the products we sell are subject to the Lacey Act, prohibiting the importation and sale of products containing illegally harvested wood, among other things. Likewise, many of our products are subject to the regulations of the California Air Resources Board (the “CARB”) and the Environmental Protection Agency regarding formaldehyde emissions from composite wood products (e.g., plywood and medium density fiberboard).

If we experience negative publicity, regardless of any factual basis, customer complaints or litigation alleging illness or injury, related to our products, or if there are allegations of failure to comply with applicable regulations, our brand reputation would be harmed.

We maintain a product safety and compliance program to help ensure our products are safe, legal and made consistently in compliance with our values. Nevertheless, our products have in the past (including during fiscal 2019) been, and may in the future be, subject to recall for product safety and compliance reasons. Our efforts to address the sources of these product recalls, including those due to products sourced from our vendors, may not be successful and we may continue to face additional product recalls. Concerns of product safety and compliance could result in future voluntary or involuntary removal of products, product recalls, other actions by applicable government authorities or product liability, personal injury or property damage claims. To the extent future product recalls create a negative public perception of our business, we could face reputational harm or could be subject to elevated levels of legal claims. There can be no assurance that we will have the benefit of adequate insurance or payments from third parties including our product vendors in order to address losses and expenses that we may incur in connection with product recalls. Not all of the costs and expenses that we have previously incurred in connection with product recalls have been covered by insurance or reimbursement from third parties including our product vendors. We and our product vendors may be unable to obtain such insurance or the insurance may be prohibitively expensive and any coverage that is available may be inadequate to cover costs we incur in connection with product recalls.

Federal, state, provincial and local legislators and regulators in the United States, Canada and the U.K., where our products are sold, continue to adopt new product laws and regulations. These new laws and regulations have increased or likely will significantly increase the regulatory requirements governing the manufacture and sale of certain of our products as well as the potential penalties for noncompliance with applicable regulations. In addition, product recalls, removal of products, product compliance enforcement actions and defending product liability claims can result in, among other things, lost sales, diverted resources, potential harm to our reputation and increased customer service costs, any of which could have a material adverse effect on our business and results of operations.

We are involved in legal and regulatory proceedings from time to time that may affect our Company and/or our management including litigation, claims, investigations and regulatory and other proceedings, which could distract management from our business activities and result in significant liability.

From time to time, we and/or our management are involved in legal and regulatory proceedings including litigation, claims, investigations and regulatory and other proceedings related to a range of matters in connection with the conduct of our business, including (i) privacy and data security, (ii) our labor and employment practices including laws related to discrimination, wages and benefits, ERISA and disability claims, (iii) intellectual

property issues with respect to copyright, trademarks, patents and trade dress, (iv) trade and business practices including unfair competition and unfair business practices, (v) consumer class action claims relating to our consumer practices including the collection of zip code or other information from customers, (vi) product safety and compliance including products liability, product recalls personal injury, (vii) advertising and promotion of products and services, (viii) compliance with securities laws including class actions related to allegations of securities fraud, (ix) taxation, (x) contractual disputes, and (xi) health and safety regulations.

Claims and legal proceedings may involve arbitration, mediation, private litigation, class action matters, derivative claims, investigations and enforcement matters. We are subject to regulatory oversight and legal enforcement by a range of government and self-regulatory organizations including federal, state and local governmental bodies both within the U.S. and in other jurisdictions where we operate such as, among others, the United States Equal Employment Opportunity Commission, the Consumer Product Safety Commission, the Federal Trade Commission, the Department of Labor, the SEC, FINRA, the New York Stock Exchange (the “NYSE”), the Department of Justice and numerous state and local governmental authorities including state attorney generals and state agencies. Litigation against us, depending on the outcome of such claims, could lead to further claims and proceedings including on new and otherwise unrelated matters, for example by attracting the attention of plaintiff’s firms or of regulators.

We have recently faced certain securities litigations, including securities class action cases that were consolidated by the court (the “Class Action Case”) and certain related legal proceedings (collectively, the “Derivative Case”). We are also currently responding to several governmental investigations regarding trading in our securities. We have settled the Class Action Case, and the court granted final approval of the Class Action Case settlement on October 25, 2019 and such settlement has been funded entirely by our insurance carriers. On March 19, 2020, we reached an agreement in principle to settle the Derivative Case, and we expect that the Derivative Case settlement will be funded by our insurance carriers. We maintain insurance for legal proceedings but there can be no assurance that such insurance will be available for the payment of all or any portion of the costs associated with any particular investigation, legal proceedings or other claims against us, or that coverage under any such insurance will be adequate to fund the full cost of any such legal proceedings including the costs of investigation, defense and resolution of any such legal proceedings.

Legal proceedings often involve complex factual and legal issues, which are subject to risks and uncertainties and which could require significant management time that could otherwise be focused on our operations. Furthermore, legal proceedings where the related claims involve members of our management team could distract management from the operation of our business, damage the reputation of our management team and otherwise materially adversely affect our operations and management morale. Litigation and other claims and regulatory proceedings against our management or us could result in unexpected expenses and liability and could also materially adversely affect our operations and our reputation.

Intellectual property claims by third parties or our failure or inability to protect our intellectual property rights could diminish the value of our brand and weaken our competitive position.

Third parties have in the past asserted, and may in the future assert, intellectual property claims against us, particularly as we expand our business to include new products and product categories and move into other geographic markets. Our defense of any claim, regardless of its merit, could be expensive and time consuming and could divert management resources. Successful infringement claims against us could result in significant monetary liability and prevent us from selling some of our products. In addition, resolution of claims may require us to redesign our products, license rights from third parties or cease using those rights altogether, which could have a material adverse impact on our business, financial condition or results of operations.

We currently rely on a combination of copyright, trademark, patent, trade dress and unfair competition laws, as well as confidentiality procedures and licensing arrangements, to establish and protect our intellectual property rights. We believe that our photographs, trademarks and other proprietary rights have significant value and are

important to identifying and differentiating certain of our products and brand from those of our competitors and creating and sustaining demand for certain of our products. We have from time to time encountered other retailers selling products substantially similar to our products or misrepresenting that the products such retailers were selling were our products. We cannot assure you that the steps taken by us to protect our intellectual property rights will be adequate to prevent infringement of our rights by others (especially with respect to infringement by non-U.S. entities with no physical U.S. presence), including imitation of our products and misappropriation of our images and brand. The costs of defending and enforcing our intellectual property assets may incur significant time and legal expense, and we may not be entirely successful in protecting our assets, enforcing our rights or collecting on judgments as a prevailing party. If we are unable to protect and maintain our intellectual property rights, the value of our brand could be diminished and our competitive position could suffer.

Compliance with laws, including laws relating to our business activities outside of the United States, may be costly, and changes in laws could make conducting our business more expensive or otherwise change the way we do business.

We are subject to numerous regulations, including labor and employment, customs, truth-in-advertising, consumer protection, e-commerce, privacy, health and safety, real estate, environmental and zoning and occupancy laws, and other laws and regulations that regulate retailers, food and beverage providers or otherwise govern our business. In addition, to the extent we expand our operations as a result of engaging in new business initiatives or product lines, pursuing our multi-tier real estate strategy or expanding into new international markets, we may become subject to new regulations and regulatory regimes. We may need to continually reassess our compliance procedures, personnel levels and regulatory framework in order to keep pace with the numerous business initiatives that we are pursuing, and there can be no assurance that we will be successful in doing so. If the regulations applicable to our business operations were to change or were violated by us or our vendors or buying agents, the costs of certain goods could increase, or we could experience delays in shipments of our goods, be subject to fines or penalties, or suffer reputational harm, which could reduce demand for our products and harm our business and results of operations.

In addition to increased regulatory compliance requirements, changes in laws could make ordinary conduct of our business more expensive or require us to change the way we do business. For example, public health officials and other governmental authorities have adopted numerous mitigation measures to address the spread of COVID-19, and in particular to discourage people from congregating in public, commercial or private spaces. Federal, state and local authorities, and in some instances mall and shopping center owners, in the U.S. and Canada have implemented a number of different directives that encourage or require changes in our business practices including requirements to close our retail stores and to curtail various aspects of our business operations. The scope and duration of these directives is evolving and not entirely clear. A large number of states and municipalities in the U.S. where we operate have implemented temporary closure requirements with respect to non-essential business operations and the duration of these requirements are unknown. In response to the public health crisis posed by COVID-19, effective from March 17, 2020, the Company temporarily closed its retail locations for an indeterminate period of time. Although we continue to serve our customers virtually through our Gallery representatives and designers, as well as our online websites, our business operations are being substantially affected by applicable regulatory restrictions including stay-at-home requirements applicable in California where our corporate headquarters is located. Our decision to reopen retail locations will be affected by a number of factors including applicable regulatory restrictions and there is substantial uncertainty regarding the manner and timing in which we can return some or all of our business to more normal business operations. We may face longer term closure requirements and other operational restrictions with respect to some or all of our physical locations for prolonged periods of time due to, among other factors, evolving and increasingly stringent federal, state and local restrictions including shelter-in-place orders. Even once we are able to reopen closed physical locations, changes in consumer behavior and health concerns may continue to impact consumer demand for our products and customer traffic at our Galleries, restaurants and outlets and may make it more difficult to staff our business operations. In addition, as a retail business, changes in laws related to employee benefits and treatment of employees, including laws related to limitations on employee hours, supervisory status,

leaves of absence, mandated health benefits or overtime pay, could negatively impact us by increasing compensation and benefits costs for overtime and medical expenses. Changes to United States health care laws, or potential global and domestic greenhouse gas emission requirements and other environmental legislation and regulations, could result in increased direct compliance costs for us (or may cause our vendors to raise the prices they charge us in order to maintain profitable operations because of increased compliance costs), increased transportation costs or reduced availability of raw materials.

In fiscal 2019, we sourced 84% of our products from outside the United States, and we are increasing the level of our international sourcing activities in an effort to obtain more of our products directly from vendors located outside the United States. Additionally, we have expanded our business-to-business sales. The foreign and U.S. laws and regulations that are applicable to our operations are complex and may increase the costs of regulatory compliance, or limit or restrict the products or services we sell or subject our business to the possibility of regulatory actions or proceedings. The United States Foreign Corrupt Practices Act, and other similar laws and regulations, generally prohibit companies and their intermediaries from making improper payments to foreign governmental officials for the purpose of obtaining or retaining business. While our policies mandate compliance with applicable laws and regulations, including anti-bribery laws and other anti-corruption laws, we cannot assure you that we will be successful in preventing our employees or other agents from taking actions in violation of these laws or regulations. Such violations, or allegations of such violations, could disrupt our business and result in a material adverse effect on our financial condition, results of operations and cash flows.

Labor organizing and other activities could negatively impact us.

Currently, none of our employees are represented by a union. However, our employees have the right at any time to form or affiliate with a union, and union organizational activities have occurred from time to time. We cannot predict the negative effects that any future organizing activities will have on our business and operations. If we were to become subject to work stoppages, we could experience disruption in our operations and increases in our labor costs, either of which could materially adversely affect our business, financial condition or results of operations.

In addition, one of our key value driving strategies involves the development and introduction of new Gallery locations. We pursue a range of different real estate development models for these projects. In a number of these projects, we perform a significant role in various aspects of the design and construction of the Gallery location. Both we and third party contractors that we use in these construction projects may be subject to efforts and activities by organized labor to drive the hiring of union labor on these projects. To the extent that union workers are not involved in these projects, we and our third party contractors may be subject to picketing and other labor actions that could affect our business including protests in front of our Gallery locations in order to discourage our customers from entering our stores, which could adversely affect our business at those locations and our results of operations, including our same-store sales metrics. In addition, to the extent that we become more directly involved in additional aspects of the construction work at our Gallery locations, we could be subject to additional pressure from organized labor including union organizing efforts.

Fluctuations in our tax obligations and effective tax rate and realization of our deferred tax assets, including net operating loss carryforwards, may result in volatility of our results of operations.

We are subject to income taxes in the United States and certain foreign jurisdictions. We record income tax expense based on our estimates of future payments, which include reserves for uncertain tax positions in multiple tax jurisdictions, and valuation allowances related to certain net deferred tax assets, including net operating loss carryforwards. At any one time, many tax years are subject to audit by various taxing jurisdictions. The results of these audits and negotiations with taxing authorities may affect the ultimate settlement of these issues. We expect that throughout the year there could be ongoing variability in our quarterly tax rates as events occur and exposures are evaluated.

In addition, our effective tax rate in a given financial statement period may be materially impacted by changes in the mix and level of earnings, timing of the utilization of net operating loss carryforwards, changes in the valuation allowance for deferred taxes or by changes to existing accounting rules or regulations.

Changes to accounting rules or regulations may adversely affect our results of operations.

New accounting rules or regulations and varying interpretations of existing accounting rules or regulations have occurred and may occur in the future. It is difficult to predict the impact of future changes to accounting principles or current accounting practice and the exact impact of such changes may not be what we anticipate. A change in accounting rules or regulations may even affect our reporting of transactions completed before the change is effective and future changes to accounting rules or regulations or the questioning of current accounting practices may adversely affect our results of operations. For example, we adopted Accounting Standards Update 2014-09—*Revenue from Contracts with Customers (Topic 606)* in the first quarter of fiscal 2018, the adoption of which materially impacted the timing of recognizing advertising expense related to direct response advertising, including costs associated with our Source Books. In addition, we adopted Accounting Standards Update 2016-02—*Leases (Topic 842)* in the first quarter of fiscal 2019, the adoption of which materially impacted our financial statements including (i) our consolidated balance sheets due to the initial recognition of right of use assets and lease liabilities for our operating and finance lease arrangements, (ii) our consolidated statements of operations, specifically cost of goods sold and interest expense—net, primarily due to the change from the build-to-suit lease transactions under the previous accounting guidance to the new finance lease classification treatment, and (iii) our cash flows due to amortization and interest expense for our operating and finance lease arrangements and classification of landlord assets under construction. For information regarding recently issued accounting pronouncements, refer to Note 3—*Significant Accounting Policies* in our consolidated financial statements within Part II of this Annual Report on Form 10-K.

We may be unsuccessful in identifying attractive acquisition opportunities or, to the extent that we pursue attractive acquisition opportunities, we may be unsuccessful in completing or realizing the expected benefits of such acquisitions.

As part of exploring growth opportunities, we may from time to time seek to acquire value-creating, add-on businesses that we believe will broaden our existing position and market reach. For example, in fiscal 2016, we acquired a controlling interest in Waterworks. In the fourth quarters of fiscal 2018 and fiscal 2017, we recorded goodwill impairment charges of \$17.4 million and \$33.7 million, respectively, with respect to Waterworks due to indicators identified in the fourth quarters of fiscal 2018 and fiscal 2017 that there could be an impairment of the Waterworks reporting unit. In addition, in the fourth quarter of fiscal 2018, we recorded a tradename impairment charge of \$14.6 million with respect to Waterworks due to indicators identified in the fourth quarter of fiscal 2018 that there could be an impairment of the Waterworks reporting unit. Refer to Note 3—*Significant Accounting Policies* in our consolidated financial statements within Part II of this Annual Report on Form 10-K. There can be no assurance that the Waterworks business will meet its future operating or financial objectives and if its results do not improve we may recognize additional charges related to this business and our financial results of operation may be adversely affected.

Furthermore, there can be no assurance that in the future we will be able to find suitable businesses to purchase if we choose to acquire additional businesses, that we will be able to acquire such businesses on acceptable terms, or that we will be successful in realizing the benefits of any acquisition we pursue. If we are unsuccessful in any such acquisition efforts, then our ability to continue to grow at rates we anticipate could be adversely affected.

In addition, we face the risk that an acquired business may not be successful on the RH platform and may underperform relative to expectations. We may be unable to achieve synergies originally anticipated, we may be exposed to unexpected liabilities or we may be unable to sufficiently integrate completed acquisitions into our current business model and platform. The success of any completed acquisition will depend on our ability to

effectively manage the business after the acquisition. The process of maintaining the right incentives for management of acquired businesses and integrating the acquired businesses may involve unforeseen difficulties and may require a disproportionate amount of our managerial and financial resources. Our failure to incorporate acquired businesses into our existing operations successfully or to minimize any unforeseen operational difficulties could have a material adverse effect on our financial condition and results of operations. Further, if we fail to allocate our capital appropriately, in respect of either our acquisitions or organic growth in our operations, we could be overexposed in certain markets and geographies and unable to expand into adjacent products or markets.

Any efforts that we undertake to improve the operations of an acquired business or to improve the integration of such business with our larger business operations may not be successful and may create additional operational challenges, in particular at a time when we are also engaged in numerous initiatives to re-conceptualize our own organizational design and elevate the customer experience. To the extent we are unsuccessful in such efforts, and our acquired business does not perform in line with our expectations or does not contribute to the overall performance of our business, our gross margins, results of operations and business could be materially adversely affected.

Our total assets include intangible assets with an indefinite life, goodwill, tradename and trademarks, and substantial amounts of long-lived assets, principally property and equipment and lease right-of-use assets. Changes to estimates or projections used to assess the fair value of these assets, or results of operations that are lower than our current estimates at certain store locations, may cause us to incur impairment charges that could adversely affect our results of operations.

Our total assets include intangible assets with an indefinite life, goodwill, tradename, trademarks and domain names, and substantial amounts of property and equipment and lease right-of-use assets. We evaluate these long-lived assets for possible impairment annually or earlier if impairment indicators exist and make certain estimates and projections in connection with the impairment analyses for these long-lived assets. We also review the carrying value of these assets for impairment whenever events or changes in circumstances indicate that the carrying value of the asset may not be recoverable. We will record an impairment loss when the carrying value of the underlying asset, asset group or reporting unit exceeds its fair value. These calculations require us to make a number of estimates and projections of future results. If these estimates or projections change, we may be required to record additional impairment charges on certain of these assets. If these impairment charges were significant, our results of operations would be adversely affected. Refer to “Impairment” within Note 3—*Significant Accounting Policies* in our consolidated financial statements within Part II of this Annual Report on Form 10 K.

If we are unable to implement and maintain effective internal control over financial reporting in the future, the accuracy and timeliness of our financial reporting may be adversely affected.

We are subject to Section 404 of the Sarbanes-Oxley Act of 2002, as amended (the “Sarbanes-Oxley Act”), which requires us to maintain internal control over financial reporting and to report any material weaknesses in such internal control. We have in the past periodically experienced deficiencies in our internal controls that have been identified during the audit process or at other times. If we identify in the future one or more material weaknesses in our internal control over financial reporting, we will be unable to assert that our internal control over financial reporting is effective. In addition, our independent registered public accounting firm is required to attest to the effectiveness of our internal control over financial reporting. Therefore, even if our management concludes that our internal control over financial reporting is effective, our independent registered public accounting firm may issue a report that is qualified if they are not satisfied with our controls or the level at which our controls are documented, designed, operated, or reviewed. Material weaknesses and significant deficiencies may be identified during the audit process or at other times.

Our reporting obligations as a public company place a significant strain on our management and our operational and financial resources and systems and will continue to do so for the foreseeable future. In addition,

we have experienced changes in personnel who are involved in our financial reporting. Although we believe that we have invested adequate resources in developing and maintaining the procedures, personnel and systems necessary to support our reporting obligations, there can be no assurance that these efforts have been or will be successful. Changes in personnel, systems or procedures, as well as other events might have an adverse impact on our internal controls. Deficiencies in our internal controls or other challenges in the financial reporting aspects of our business may have an adverse impact on our ability to provide financial statements in accordance with generally accepted accounting procedures and may give rise to errors in our financial statement. There can be no assurance that our internal controls and financial reporting infrastructure and personnel have in the past complied, or will continue in the future to comply, with our financial reporting obligations. If we fail to timely achieve and maintain the adequacy of our internal control over financial reporting, we may not be able to produce reliable financial reports. Our failure to achieve and maintain effective internal control over financial reporting could prevent us from filing our periodic reports on a timely basis, which could result in the loss of investor confidence in the reliability of our financial statements, harm our business, and negatively impact the trading price of our common stock.

Our operations are subject to risks of natural or man-made disasters, acts of war, terrorism or widespread illness, any one of which could result in a business stoppage and negatively affect our results of operations.

Our business operations depend on our ability to maintain and protect our facilities, computer systems and personnel. Our operations and consumer spending may be affected by natural or man-made disasters or other similar events, including floods, hurricanes, earthquakes, widespread illness, fires, loss of power, interruption of other utilities, industrial accidents, social unrest and riots. In particular, our corporate headquarters is located in Northern California and other parts of our operations are located in Northern and Southern California, each of which is vulnerable to the effects of disasters, including fires and earthquakes that could disrupt our operations and affect our results of operations, and there is evidence that extreme weather, extended drought and shifting climate patterns have intensified the frequency and severity of wildfires in California. Many of our vendors are also located in areas that may be affected by such events. Moreover, geopolitical or public safety conditions which affect consumer behavior and spending may impact our business. Terrorist attacks or other hostilities, or threats thereof, in the United States or in other countries around the world, as well as future events occurring in response to or in connection with them, could again result in reduced levels of consumer spending. Any of these occurrences could have a significant impact on our results of operations, revenue and costs.

If we encounter difficulties associated with any of our facilities or if any of our facilities were to shut down for any reason, including as a result of a natural disaster, we could face shortages of inventory resulting in backorders, significantly higher costs and longer lead times associated with distributing our products to both our stores and online customers and the inability to process orders in a timely manner or ship goods to our customers. Further, any significant interruption in the operation of our customer service centers could also reduce our ability to receive and process orders and provide products and services to our stores and customers, which could result in lost sales, cancelled sales and a loss of loyalty to our brand and have a material adverse effect on our business, financial condition and results of operations.

Risks Related to Ownership of Our Common Stock

Our common stock price may be volatile or may decline regardless of our operating performance.

The market price for our common stock has recently experienced extreme volatility. As a retailer, our results are significantly affected by factors outside our control, particularly consumer spending and consumer confidence, which can significantly affect our stock price. In addition, the market price of our common stock may fluctuate significantly in response to a number of other factors, including those described elsewhere in this “Risk Factors” section, as well as the following:

- quarterly variations in our results of operations compared to market expectations;
- changes in preferences of our customers;

- announcements of new products or significant price reductions by us or our competitors;
- size of our public float;
- stock price performance of our competitors;
- fluctuations in stock market prices and volumes;
- default on our indebtedness;
- actions by competitors or other shopping center tenants;
- changes in senior management or key personnel;
- changes in financial estimates by securities analysts or failure to meet their expectations;
- actual or anticipated negative earnings or other announcements by us or other retail companies;
- downgrades in our credit ratings or the credit ratings of our competitors;
- natural or man-made disasters or other similar events;
- issuances or expected issuances of capital stock;
- impacts of the COVID-19 global outbreak; and
- global economic, legal and regulatory changes unrelated to our performance.

In addition, stock markets have experienced extreme price and volume fluctuations that have affected and continue to affect the market prices of equity securities of many retail companies. Stockholders can institute securities class action litigation following periods of market volatility. We have been subject to such class action securities litigation and may experience further claims of this kind. Any such securities litigation can result in substantial costs and expenses and the attention of management could be diverted from our business.

Substantial future sales of our common stock, or the perception in the public markets that these sales may occur, may depress our stock price.

In the future, we may issue our securities in connection with a capital raise or acquisitions. The amount of shares of our common stock issued in connection with a capital raise or acquisition could constitute a material portion of our then-outstanding shares of our common stock, which would result in dilution.

In addition, sales of substantial amounts of our common stock in the public market, or the perception that these sales could occur, could adversely affect the price of our common stock and could impair our ability to raise capital through the sale of additional shares.

Anti-takeover provisions in our charter documents and Delaware law might discourage or delay acquisition attempts for us that you might consider favorable.

Our certificate of incorporation and bylaws contain provisions that may make the acquisition of our Company more difficult without the approval of our board of directors. These provisions:

- establish a classified board of directors so that not all members of our board of directors are elected at one time;
- authorize the issuance of undesignated preferred stock, the terms of which may be established and the shares of which may be issued without stockholder approval, and which may include super voting, special approval, dividend or other rights or preferences superior to the rights of the holders of common stock;
- prohibit stockholder action by written consent, which requires all stockholder actions to be taken at a meeting of our stockholders;

- provide that our board of directors is expressly authorized to make, alter or repeal our bylaws; and
- establish advance notice requirements for nominations for elections to our board of directors or for proposing matters that can be acted upon by stockholders at stockholder meetings.

Our certificate of incorporation also contains a provision that provides us with protections similar to Section 203 of the Delaware General Corporation Law (“DGCL”), and prevents us from engaging in a business combination with a person who acquires at least 15% of our common stock for a period of three years from the date such person acquired such common stock unless board or stockholder approval is obtained prior to the acquisition, subject to certain exceptions. These anti-takeover provisions and other provisions under Delaware law could discourage, delay or prevent a transaction involving a change in control of our Company, even if doing so would benefit our stockholders. These provisions could also discourage proxy contests and make it more difficult for you and other stockholders to elect directors of your choosing and to cause us to take other corporate actions you desire.

We do not expect to pay any cash dividends for the foreseeable future.

We do not anticipate that we will pay any cash dividends on shares of our common stock for the foreseeable future. Any determination to pay dividends in the future will be at the discretion of our board of directors and will depend upon results of operations, financial condition, contractual restrictions, restrictions imposed by applicable law and other factors our board of directors deems relevant. Accordingly, realization of a gain on your investment will depend on the appreciation of the price of our common stock, which may never occur. Investors seeking cash dividends in the foreseeable future should not purchase our common stock.

Expectations of our company relating to environmental, social and governance factors may impose additional costs and expose us to new risks.

There is an increasing focus from certain investors, customers and other key stakeholders concerning corporate responsibility, specifically related to environmental, social and governance (“ESG”) factors. Some investors may use ESG criteria to guide their investment strategies and, in some cases, may choose not to invest in us if they believe our policies relating to corporate responsibility are inadequate. Third-party providers of corporate responsibility ratings and reports on companies have increased to meet growing investor demand for measurement of corporate responsibility performance. In addition, the ESG factors by which companies’ corporate responsibility practices are assessed may change, which could result in greater expectations of us and cause us to undertake costly initiatives to satisfy such new criteria. Alternatively, if we are unable to satisfy such new criteria, investors may conclude that our policies with respect to corporate responsibility are inadequate. We risk damage to our brand and reputation in the event that our corporate responsibility procedures or standards do not meet the standards set by various constituencies. Furthermore, if our competitors’ corporate responsibility performance is perceived to be greater than ours, potential or current investors may elect to invest with our competitors instead. In addition, in the event that we communicate certain initiatives and goals regarding ESG matters, we could fail, or be perceived to fail, in our achievement of such initiatives or goals, or we could be criticized for the scope of such initiatives or goals. If we fail to satisfy the expectations of investors and other key stakeholders or our initiatives are not executed as planned, our reputation and financial results could be materially and adversely affected.

We expect that our common stock may experience increased trading volatility in connection with our Convertible Notes Financing.

In September 2019, we issued \$350 million of 0.00% convertible senior notes due 2024 (the “2024 Notes”). In June 2018, we issued \$300 million of 0.00% convertible senior notes due 2023 and, on June 26, 2018, we issued an additional \$35 million pursuant to the exercise of an overallotment option granted to the initial purchasers as part of the June 2018 offering (the “2023 Notes”). In June 2015, we issued \$250 million of 0.00%

convertible senior notes due 2020 and, on July 2, 2015, we issued an additional \$50 million pursuant to the exercise of the overallotment option granted to the initial purchasers as part of the June 2015 offering (collectively, the “2020 Notes”). In June 2014, we issued \$300 million of 0.00% convertible senior notes due 2019 and, on June 24, 2014, we issued an additional \$50 million pursuant to the exercise of an overallotment option granted to the initial purchasers as part of the June 2014 offering (the “2019 Notes” and, together with the 2024 Notes, 2023 Notes and the 2020 Notes, the “Notes”). In connection with each offering of the Notes, we entered into convertible note hedge transactions with certain counterparties (the “Bond Hedge”) and warrant transactions (the “Warrants” and together with the Notes and the Bond Hedge, the “Convertible Notes Financing”) with the same counterparties (the “hedge counterparties”).

We have been advised that, in connection with establishing their initial hedge positions with respect to the Bond Hedge and Warrants, the hedge counterparties and/or their affiliates would likely purchase shares of our common stock or enter into various derivative transactions with respect to our common stock concurrently with, or shortly after, the pricing of the Notes, including with certain investors in the Notes. These hedging activities could increase (or reduce the size of any decrease in) the market price of our common stock or the Notes.

In addition, we expect that many investors in, including future purchasers of, the Notes may employ, or seek to employ, a convertible arbitrage strategy with respect to the Notes. Investors would typically implement such a strategy by selling short the common stock underlying the Notes and dynamically adjusting their short position while continuing to hold the Notes. Investors may also implement this type of strategy by entering into swaps on our common stock in lieu of or in addition to short selling the common stock.

Further, investors in the Notes may periodically modify their arbitrage strategies with respect to the Notes or modify their hedge positions with respect to the Notes from time to time. The hedge counterparties and/or their respective affiliates also may periodically modify their hedge positions from time to time (and are likely to do so during the conversion period relating to any conversion of the Notes or following any repurchase of Notes by us on any fundamental repurchase date or otherwise). Such modifications may be implemented by entering into or unwinding various derivatives with respect to our common stock, and/or by purchasing or selling shares of our common stock or other securities of the Company in secondary market transactions and/or open market transactions. The effect, if any, of these transactions and activities on the market price of our common stock or the trading prices of the Notes (which could affect a noteholder’s ability to convert the Notes or the amount and value of the consideration received upon conversion of the Notes) will depend in part on market conditions and cannot be ascertained at this time. Any of these activities, however, could adversely affect the market price of our common stock.

It is not possible to predict the effect that these hedging or arbitrage strategies adopted by holders of the Notes or counterparties to the Bond Hedge and Warrants will have on the market price of our common stock. For example, the SEC and other regulatory and self-regulatory authorities have implemented various rules and taken certain actions, and may in the future adopt additional rules and take other actions, that may impact those engaging in short selling activity involving equity securities (including our common stock). Such rules and actions include Rule 201 of SEC Regulation SHO, the adoption by the Financial Industry Regulatory Authority, Inc. of a “Limit Up-Limit Down” program, the imposition of market-wide circuit breakers that halt trading of securities for certain periods following specific market declines, and the implementation of certain regulatory reforms required by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. Any changes in government regulations or other factors that affect the manner in which third parties can engage in hedging strategies, including entering into short sales or swaps on our common stock, could adversely affect the trading prices and the liquidity of the Notes and/or our common stock.

Taken together, the Bond Hedge and Warrants are intended, but not guaranteed, to offset any actual earnings dilution that could occur upon delivery of shares of common stock to satisfy to our conversion obligation under the Notes. For the 2024 Notes, the corresponding Bond Hedge and Warrants are intended to limit the earnings dilution that our stockholders would experience until the Company’s common stock is above approximately

\$338.24 per share, the strike price of the 2024 Notes warrant transactions, which represented a 100% premium over the closing price of our common stock at the time we entered into the Bond Hedge and Warrants related to the 2024 Notes. For the 2023 Notes, the corresponding Bond Hedge and Warrants are intended to limit the earnings dilution that our stockholders would experience until the Company's common stock is above approximately \$309.84 per share, the strike price of the 2023 Notes warrant transactions, which represented a 100% premium over the closing price of our common stock at the time we entered into the Bond Hedge and Warrants related to the 2023 Notes. For the 2020 Notes, the corresponding Bond Hedge and Warrants are intended to limit the earnings dilution that our stockholders would experience until the Company's common stock is above approximately \$189.00 per share, the strike price of the 2020 Notes warrant transactions, which represented a 100% premium over the closing price of our common stock at the time we entered into the Bond Hedge and Warrants related to the 2020 Notes. However, these transactions are complex, and there can be no assurance that they will operate as planned.

We do not make any representation or prediction as to the direction or magnitude of any potential effect that the transactions described above may have on the price of our common stock. In addition, we do not make any representation that the counterparties to those transactions will engage in these transactions or activities or that these transactions and activities, once commenced, will not be discontinued without notice; the counterparties or their affiliates may choose to engage in, or discontinue engaging in, any of these transactions or activities with or without notice at any time, and their decisions will be in their sole discretion and not within our control.

We may issue additional shares of our common stock or instruments convertible into shares of our common stock, including in connection with the conversion of the Notes, and thereby materially and adversely affect the market price of our common stock and the trading prices of the Notes.

We are not restricted from issuing additional shares of our common stock or other instruments convertible into, or exchangeable or exercisable for, shares of our common stock during the life of each of the Notes. If we issue additional shares of our common stock or instruments convertible into shares of our common stock, it may materially and adversely affect the market price of our common stock and, in turn, the trading prices of the Notes. In addition, the conversion of some or all of the Notes may dilute the ownership interests of existing holders of our common stock, and any sales in the public market of any shares of our common stock issuable upon such conversion of the Notes could adversely affect prevailing market prices of our common stock. In addition, the anticipated conversion of the Notes could depress the market price of our common stock.

The fundamental change provisions of the Notes and the terms of the Bond Hedge and Warrants may delay or hinder an otherwise beneficial takeover attempt of us.

The fundamental change purchase rights allow holders of Notes to require us to purchase all or a portion of their Notes upon the occurrence of a fundamental change. The provisions of the indenture governing the Notes requiring an increase to the conversion rate for conversions in connection with a make-whole fundamental change, including certain corporate transactions such as a change in control, may result in a change in the value of the Notes. Additionally, upon certain change of control transactions, the offsetting Bond Hedge and Warrants that we entered into at the time we issued the Notes may be exercised and/or terminated early. As a result of these provisions, we may be required to make payments to, or renegotiate terms with, holders of the Notes and/or the hedge counterparties.

These features of the Notes and the Bond Hedge and Warrants, including the financial implications of any renegotiation of the above-mentioned provisions, could have the effect of delaying or preventing a change of control, whether or not it is desired by, or beneficial to, our stockholders, and may result in the acquisition of us being on terms less favorable to our stockholders than it would otherwise be, or could require us to pay a portion of the consideration available in such a transaction to holders of the Notes or Warrants or the counterparties to the Bond Hedge.

Item 1B. Unresolved Staff Comments

None.

Item 2. Properties

Leased Properties

As of February 1, 2020, we have approximately 1,735,000 leased gross square feet for 22 Design Galleries, 40 legacy Galleries, 2 RH Modern Galleries, 4 RH Baby & Child Galleries and 15 Waterworks showrooms. We have approximately 1,208,000 leased gross square feet for 38 outlet stores as of February 1, 2020.

The following table summarizes the location and size of our leased fulfillment centers, home delivery center locations and corporate facilities occupied as of February 1, 2020:

<u>Location</u>	<u>Leased Square Footage (Approximate)</u>
<i>RH Furniture Fulfillment Centers</i>	
Patterson, California	1,501,000
Baltimore (North East), Maryland	1,195,000
<i>RH Small Parcel Fulfillment Center</i>	
West Jefferson, Ohio ⁽¹⁾	1,224,000
<i>Home Delivery Center Locations</i> ⁽²⁾	1,384,000
<i>Waterworks Fulfillment Center</i>	
Brookfield, Connecticut	160,000
<i>Corporate Facilities</i>	
Corte Madera, California ⁽¹⁾⁽³⁾	257,000
Pinole, California ⁽⁴⁾	200,000
Danbury, Connecticut ⁽⁵⁾	41,000
Other	101,000

(1) Customer service center and home delivery operations are also performed at this location.

(2) Includes total approximate leased square footage for 13 separate home delivery center locations, 1 of which was not yet operational as of February 1, 2020.

(3) Location of RH Headquarters. Includes approximately 8,000 square feet of warehouse space.

(4) Represents warehouse space.

(5) Location of Waterworks Headquarters.

For additional information regarding leases, refer to “Lease Accounting” within Note 3—*Significant Accounting Policies* and Note 9—*Leases* in our consolidated financial statements within Part II of this Annual Report on Form 10-K.

Owned Properties

We currently own two properties, a 9,000 total square foot property that is the location of our Gallery in San Francisco’s Design District, and a 57,000 total square foot property that is the location of our Minneapolis Design Gallery. Both owned properties are part of our RH Segment.

We believe that our current offices and facilities are in good condition, are being used productively and are adequate to meet our requirements for the foreseeable future.

Item 3. Legal Proceedings

From time to time, we and/or our management are involved in litigation, claims and other proceedings relating to the conduct of our business, including purported class action litigation, as well as securities class action litigation. Such legal proceedings may include claims related to our employment practices, wage and hour

claims, claims of intellectual property infringement, including with respect to trademarks and trade dress, claims asserting unfair competition and unfair business practices, claims with respect to our collection and sale of reproduction products, and consumer class action claims relating to our consumer practices including the collection of zip code or other information from customers. In addition, from time to time, we are subject to product liability and personal injury claims for the products that we sell and the stores we operate. Subject to certain exceptions, our purchase orders generally require the vendor to indemnify us against any product liability claims; however, if the vendor does not have insurance or becomes insolvent, we may not be indemnified. In addition, we could face a wide variety of employee claims against us, including general discrimination, privacy, labor and employment, ERISA and disability claims. Any claims could result in litigation against us and could also result in regulatory proceedings being brought against us by various federal and state agencies that regulate our business, including the U.S. Equal Employment Opportunity Commission. Often these cases raise complex factual and legal issues, which are subject to risks and uncertainties and which could require significant management time. Litigation and other claims and regulatory proceedings against us could result in unexpected expenses and liability and could also materially adversely affect our operations and our reputation.

For additional information regarding certain securities litigation, refer to Note 18—*Commitments and Contingencies* in our consolidated financial statements within Part II of this Annual Report on Form 10-K.

Item 4. Mine Safety Disclosures

Not applicable.

PART II

Item 5. Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

Market Information and Dividend Policy

Our common stock trades under the symbol “RH” on the NYSE.

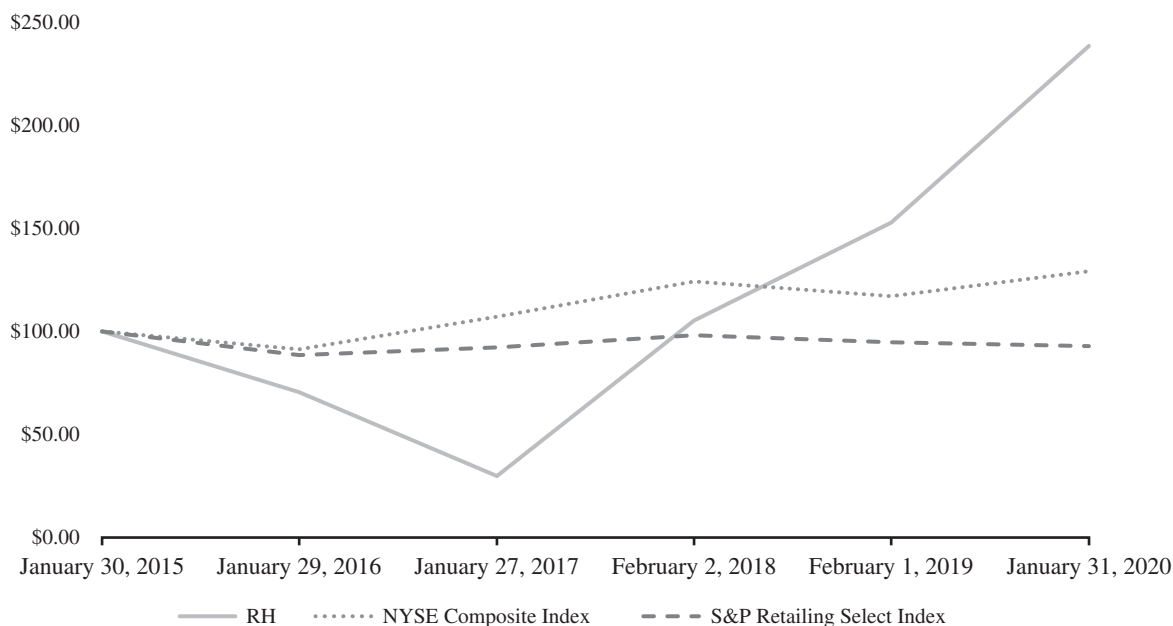
The number of stockholders of record of our common stock as of February 1, 2020 was 19. This number excludes stockholders whose stock is held in nominee or street name by brokers.

No dividends have been declared or paid on our common stock. We do not currently anticipate that we will pay any cash dividends on our common stock in the foreseeable future.

Stock Performance Graph

This performance graph shall not be deemed “soliciting material” or to be “filed” with the SEC for purposes of Section 18 of the Exchange Act, or otherwise subject to the liabilities under that Section, and shall not be deemed to be incorporated by reference into any filing of RH under the Securities Act of 1933, as amended, or the Exchange Act.

The following graph and table compare the cumulative total stockholder return for our common stock during the five-year period ended February 1, 2020 in comparison to the NYSE Composite Index and the S&P Retailing Select Index, our peer group index. The graph and the table below assume that \$100 was invested at the market close on January 30, 2015 in the common stock of RH, the NYSE Composite Index and the S&P Retailing Select Index. Data for the NYSE Composite Index and the S&P Retailing Select Index assumes reinvestments of dividends. The comparisons in the graph and table are required by the SEC and are not intended to be indicative of possible future performance of our common stock.



	<u>1/30/2015</u>	<u>1/29/2016</u>	<u>01/27/2017</u>	<u>02/02/2018</u>	<u>02/01/2019</u>	<u>01/31/2020</u>
RH	100.00	70.40	29.81	105.15	152.68	238.49
NYSE Composite Index	100.00	91.42	107.08	124.18	117.01	129.20
S&P Retailing Select Index	100.00	88.63	92.27	98.29	94.69	92.79

Repurchases of Common Stock

During the three months ended February 1, 2020, we repurchased the following shares of our common stock:

	Number of Shares ⁽¹⁾	Average Purchase Price Per Share	Total Number of Shares Repurchased as Part of Publicly Announced Plans or Programs ⁽²⁾	Approximate Dollar Value of Shares That May Yet Be Purchased Under the Plans or Programs <i>(in millions)</i>
November 3, 2019 to November 30, 2019 . . .	—	\$ —	—	\$450
December 1, 2019 to January 4, 2020	2,445	\$217.45	—	\$450
January 5, 2020 to February 1, 2020	—	\$ —	—	\$450
Total	<u>2,445</u>		<u>—</u>	

(1) Reflects shares withheld from delivery to satisfy exercise price and tax withholding obligations of employee recipients that occur upon the exercise of stock options and vesting of restricted stock units granted under the Company's 2012 Stock Incentive Plan.

(2) Reflects shares repurchased as part of \$950 Million Repurchase Program authorized by the Board of Directors on October 10, 2018 and replenished on March 25, 2019.

Item 6. Selected Consolidated Financial Data

The following tables present RH's consolidated financial and operating data as of the dates and for the periods indicated. The selected consolidated financial data as of February 1, 2020 and February 2, 2019 and for the fiscal years ended February 1, 2020, February 2, 2019 and February 3, 2018 were derived from consolidated financial statements included in *Item 8—Financial Statements and Supplementary Data*. The selected consolidated financial data as of February 3, 2018 and as of and for the periods ended January 28, 2017 and January 30, 2016 were derived from consolidated financial statements for such years not included herein.

The selected financial data as of and for the periods ended February 1, 2020, February 2, 2019 and February 3, 2018 reflect the modified retrospective application of the new lease accounting standard (Accounting Standards Update 2016-02—*Leases*). The selected consolidated financial data as of and for the periods ended January 28, 2017 and January 30, 2016 were not modified to reflect the impact of the new lease accounting standard. For information regarding recently issued accounting pronouncements, refer to Note 3—*Significant Accounting Policies* in our consolidated financial statements within Part II of this Annual Report on Form 10-K.

The fiscal years ended February 1, 2020, February 2, 2019, January 28, 2017 and January 30, 2016 each consisted of 52 weeks. The fiscal year ended February 3, 2018 consisted of 53 weeks.

The selected historical consolidated data presented below should be read in conjunction with *Item 1A—Risk Factors, Item 7—Management’s Discussion and Analysis of Financial Condition and Results of Operations*, our consolidated financial statements and the notes to our consolidated financial statements.

	As Revised Under ASU 2016-02—Leases			As Reported	
	Year Ended			Year Ended	
	February 1, 2020 ⁽¹⁾	February 2, 2019 ⁽¹⁾	February 3, 2018 ⁽¹⁾	January 28, 2017 ⁽²⁾	January 30, 2016 ⁽²⁾
	(dollars in thousands, except per share amounts)				
Consolidated Statements of Operations:					
Net revenues	\$ 2,647,437	\$ 2,505,653	\$ 2,440,174	\$ 2,134,871	\$ 2,109,006
Cost of goods sold	1,552,426	1,520,076	1,600,876	1,455,084	1,356,314
Gross profit	1,095,011	985,577	839,298	679,787	752,692
Selling, general and administrative expenses	732,180	723,841	722,183	626,751	567,131
Income from operations	362,831	261,736	117,115	53,036	185,561
Other expenses					
Interest expense—net	87,177	67,769	56,002	44,482	35,677
Goodwill and tradename impairment	—	32,086	33,700	—	—
Loss on extinguishment of debt—net	6,472	917	4,880	—	—
Total other expenses	93,649	100,772	94,582	44,482	35,677
Income before income taxes	269,182	160,964	22,533	8,554	149,884
Income tax expense	48,807	25,233	25,132	3,153	58,781
Net income (loss)	<u>\$ 220,375</u>	<u>\$ 135,731</u>	<u>\$ (2,599)</u>	<u>\$ 5,401</u>	<u>\$ 91,103</u>
Weighted-average shares used in computing basic net income (loss) per share	19,082,303	21,613,678	27,053,616	40,691,483	40,190,448
Basic net income (loss) per share	\$ 11.55	\$ 6.28	\$ (0.10)	\$ 0.13	\$ 2.27
Weighted-average shares used in computing diluted net income (loss) per share	24,299,034	26,533,225	27,053,616	40,926,840	42,256,559
Diluted net income (loss) per share	\$ 9.07	\$ 5.12	\$ (0.10)	\$ 0.13	\$ 2.16
Other Financial and Operating Data:					
Adjusted net income ⁽³⁾	\$ 276,297	\$ 204,318	\$ 103,822	\$ 51,789	\$ 114,772
Adjusted EBITDA ⁽⁴⁾	\$ 495,418	\$ 400,067	\$ 269,509	\$ 186,225	\$ 273,425
Capital expenditures	\$ 93,623	\$ 79,992	\$ 68,393	\$ 170,031	\$ 127,902
Landlord assets under construction—net of tenant allowances	64,300	59,001	81,065	—	—
Adjusted net capital expenditures	<u>\$ 157,923</u>	<u>\$ 138,993</u>	<u>\$ 149,458</u>	<u>\$ 170,031</u>	<u>\$ 127,902</u>

	As Revised Under ASU 2016-02—Leases			As Reported	
	February 1, 2020 ⁽¹⁾	February 2, 2019 ⁽¹⁾	February 3, 2018 ⁽¹⁾	January 28, 2017 ⁽²⁾	January 30, 2016 ⁽²⁾
	(in thousands)				
Balance Sheet Data:					
Cash and cash equivalents	\$ 47,658	\$ 5,803	\$ 17,907	\$ 87,023	\$ 331,467
Short-term and long-term investments ⁽⁵⁾	—	—	—	175,889	152,855
Working capital (deficit) ⁽⁶⁾	(20,419)	56,062	55,867	722,355	861,304
Total assets	2,445,694	2,423,018	2,234,260	2,192,520	2,067,944
Financing obligations under build-to-suit lease transactions	—	—	—	203,015	146,621
Convertible senior notes due 2019—net ⁽⁷⁾	—	344,146	329,012	314,543	300,711
Convertible senior notes due 2020—net ⁽⁷⁾	291,110	272,919	255,865	239,876	224,887
Convertible senior notes due 2023—net ⁽⁷⁾	270,271	253,689	—	—	—
Convertible senior notes due 2024—net ⁽⁷⁾	268,366	—	—	—	—
Asset based credit facility	—	57,500	199,970	—	—
Term loan	—	—	80,000	—	—
Equipment promissory notes	53,372	—	18,497	—	—
Promissory notes ⁽⁸⁾	53,000	—	13,183	—	—
Notes payable for share repurchases	18,741	19,633	19,390	19,390	19,523
Total debt (including current portion) ⁽⁹⁾	954,860	947,887	915,917	581,318	552,702
Total stockholders' equity (deficit)	18,651	(38,690)	(8,155)	919,869	886,160

- (1) Fiscal periods reflect the modified retrospective application of the new lease accounting standard (Accounting Standards Update 2016-02—Leases). For information regarding recently issued accounting pronouncements, refer to Note 3—Significant Accounting Policies in our consolidated financial statements within Part II of this Annual Report on Form 10-K.
- (2) Fiscal periods were not modified to reflect the impact of the new lease accounting standard.
- (3) Adjusted net income is a supplemental measure of financial performance that is not required by, or presented in accordance with, generally accepted accounting principles (“GAAP”). We define adjusted net income as consolidated net income (loss), adjusted for the impact of certain non-recurring and other items that we do not consider representative of our underlying operating performance. Adjusted net income is included in this filing because management believes that adjusted net income provides meaningful supplemental information for investors regarding the performance of our business and facilitates a meaningful evaluation of actual results on a comparable basis with historical results. Our management uses this non-GAAP financial measure in order to have comparable financial results to analyze changes in our underlying business from quarter to quarter.

The following table presents a reconciliation of net income (loss), the most directly comparable GAAP financial measure, to adjusted net income for the periods indicated below.

	Year Ended				
	February 1, 2020	February 2, 2019	February 3, 2018	January 28, 2017	January 30, 2016
	(in thousands)				
Net income (loss)	\$220,375	\$135,731	\$ (2,599)	\$ 5,401	\$ 91,103
Adjustments pre-tax:					
Amortization of debt discount ^(a)	42,545	39,216	27,926	26,404	19,803
Asset impairments and lease losses ^(b)	21,899	7,218	4,417	12,743	—
Loss on extinguishment of debt—net ^(c)	6,472	917	4,880	—	—
Reorganization related costs ^(d)	1,075	9,977	949	5,698	—
Recall accrual ^(e)	(3,988)	1,619	7,707	4,615	—
Asset held for sale loss (gain) ^(f)	(1,529)	8,497	—	4,767	—
Legal settlements ^(g)	(1,193)	(5,289)	—	—	—
Goodwill and tradename impairment ^(h)	—	32,086	33,700	—	—
Distribution center closures ⁽ⁱ⁾	—	3,046	7,230	—	—
Impact of inventory step-up ^(j)	—	380	2,527	6,835	—
Non-cash compensation ^(k)	—	—	23,872	3,672	—
Anti-dumping exposure ^(l)	—	—	(2,202)	—	—
Gain on sale of building and land ^(m)	—	—	(2,119)	—	—
Legal claim ⁽ⁿ⁾	—	—	—	8,701	19,046
Acquisition related costs ^(o)	—	—	—	2,847	—
Subtotal adjusted items	65,281	97,667	108,887	76,282	38,849
Impact of income tax items ^(p)	(9,359)	(29,080)	(2,466)	(29,894)	(15,180)
Adjusted net income	<u>\$276,297</u>	<u>\$204,318</u>	<u>\$103,822</u>	<u>\$ 51,789</u>	<u>\$114,772</u>

(a) Under GAAP, certain convertible debt instruments that may be settled in cash on conversion are required to be separately accounted for as liability and equity components of the instrument in a manner that reflects the issuer’s non-convertible debt borrowing rate. Accordingly, in accounting for GAAP purposes for the \$350 million aggregate principal amount of convertible senior notes that were issued in June 2014 (the “2019 Notes”), for the \$300 million aggregate principal amount of convertible senior notes that were issued in June and July 2015 (the “2020 Notes”), for the \$335 million aggregate principal amount of convertible senior notes that were issued in June 2018 (the “2023 Notes”) and for the \$350 million aggregate principal amount of convertible senior notes that were issued in September 2019 (the “2024 Notes”), we separated the 2019 Notes, 2020 Notes, 2023 Notes and 2024 Notes into liability (debt) and equity (conversion option) components and we are amortizing as debt discount an amount equal to the fair value of the equity components as interest expense on the 2019 Notes, 2020 Notes, 2023 Notes and 2024 Notes over their expected lives. The equity components represent the difference between the proceeds from the issuance of the 2019 Notes, 2020 Notes, 2023 Notes and 2024 Notes and the fair value of the liability components of the 2019 Notes, 2020 Notes, 2023 Notes and 2024 Notes, respectively. Amounts are presented net of interest capitalized for capital projects of \$3.7 million, \$2.7 million, \$2.5 million, \$2.4 million and \$2.3 million during fiscal 2019, fiscal 2018, fiscal 2017, fiscal 2016 and fiscal 2015, respectively. The 2019 Notes matured on June 15, 2019 and did not impact amortization of debt discount post-maturity.

(b) The adjustments in fiscal 2019 include (i) asset impairments of \$9.1 million, (ii) acceleration of depreciation expense of \$6.2 million due to a change in the estimated useful lives of certain assets and a \$0.5 million charge related to the termination of a service agreement associated with such assets, (iii) an RH Contemporary Art lease impairment of \$4.6 million, resulting from an update to both the timing and the amount of future estimated lease related cash inflows, and (iv) other lease impairments of \$1.5 million due to early exit of leased facilities. The adjustments in fiscal 2018 include (i) an RH

Contemporary Art lease impairment of \$3.4 million, (ii) acceleration of depreciation expense of \$2.6 million due to a change in the estimated useful life of certain assets and (iii) a \$1.2 million inventory impairment charge related to holiday merchandise. The adjustment in fiscal 2017 represents an RH Contemporary Art lease impairment. The adjustment in fiscal 2016 includes the initial impairment associated with RH Contemporary Art, which was integrated into the broader RH platform and was no longer operational as a separate division, which resulted in inventory impairment of \$1.1 million and impairment of \$10.6 million related to the lease, property and equipment disposals, and donations. Fiscal 2016 also includes a \$1.0 million inventory impairment charge associated with RH Kitchen due to the alignment with the Waterworks Kitchen product line strategy.

- (c) The adjustment in fiscal 2019 represents the loss on extinguishment of debt related to a second lien term loan which was repaid in full in September 2019 and the acceleration of debt issuance costs related to early repayment of the FILO term loan, partially offset by the gain on extinguishment of debt upon the maturity and settlement of the 2019 Notes in June 2019. The adjustment in fiscal 2018 represents the loss on extinguishment of debt related to the LILO term loan, the promissory note secured by our aircraft and the equipment security notes, all of which were repaid in full in June 2018. The adjustment in fiscal 2017 represents the loss on extinguishment of debt related to a second lien term loan which was repaid in full in October 2017.
- (d) Represents severance costs and related taxes associated with reorganizations. The fiscal 2017 and fiscal 2016 adjustments are partially offset by a reversal of stock-based compensation expense related to unvested equity awards.
- (e) Represents adjustments to net revenues, cost of goods sold and inventory charges associated with product recalls, as well as accrual adjustments, and vendor and insurance claims. The recall adjustments had the following effect on our income before taxes:

	Year Ended			
	February 1, 2020	February 2, 2019	February 3, 2018	January 28, 2017
(Increase) decrease to net revenues	\$ (391)	\$ 4,733	\$3,207	\$3,441
Increase (decrease) to cost of goods sold	(3,372)	(4,139)	4,315	535
(Increase) decrease to gross profit	(3,763)	594	7,522	3,976
Increase (decrease) to selling, general and administrative expenses	(225)	1,025	185	639
(Increase) decrease to income before income taxes	<u>\$ (3,988)</u>	<u>\$ 1,619</u>	<u>\$7,707</u>	<u>\$4,615</u>

- (f) The adjustment in fiscal 2019 includes gain on real estate related to asset previously classified as held for sale and other land sales. The adjustment in fiscal 2018 represents the impairment recorded upon reclassification of an owned Design Gallery as held for sale. The adjustment in fiscal 2016 represents the impairment recorded upon reclassification of aircraft as asset held for sale.
- (g) Represents legal settlements, net of related legal expenses.
- (h) Represents goodwill and tradename impairment related to the Waterworks reporting unit. Refer to "Impairment" within Note 3—*Significant Accounting Policies* in our consolidated financial statements within Part II of this Annual Report on Form 10-K.
- (i) Represents disposals of inventory and property and equipment, lease related charges, inventory transfer costs and other costs associated with distribution center closures.
- (j) Represents the non-cash amortization of the inventory fair value adjustment recorded in connection with our acquisition of Waterworks.
- (k) The adjustment in fiscal 2017 represents a non-cash compensation charge related to a fully vested option grant made to Mr. Friedman in May 2017. The adjustment in fiscal 2016 represents a non-cash compensation charge related to the fully vested option grants made in connection with our acquisition of Waterworks.

- (l) Represents the release of the remaining reserve for potential claims regarding anti-dumping duties which we believe have lapsed. The reserve related to potential tariff obligations of one of our foreign suppliers following the U.S. Department of Commerce's review on the anti-dumping duty order on wooden bedroom furniture from China for the period from January 1, 2011 through December 31, 2011.
 - (m) Represents the gain on the sale of building and land of one of our previously owned retail Galleries.
 - (n) Represents charges incurred or the estimated cumulative impact of coupons redeemed in connection with a legal claim alleging that the Company violated California's Song-Beverly Credit Card Act of 1971 by requesting and recording ZIP codes from customers paying with credit cards.
 - (o) Represents costs incurred in connection with our acquisition of Waterworks including professional fees.
 - (p) The adjustment in fiscal 2019 is based on an adjusted tax rate of 17.4%, which is calculated using a 21% normalized tax rate for the first and second quarters of fiscal 2019 and the effective tax rates of 13.7% and 14.9% for the third and fourth quarters of fiscal 2019, respectively. Fiscal 2018 and fiscal 2017 assume a normalized tax rate of 21%. Fiscal 2016 assumes a normalized tax rate of 39%. The adjustment in fiscal 2015 represents the tax effect of the adjusted items based on our effective tax rate of 39.2%.
- (4) EBITDA and Adjusted EBITDA are supplemental measures of financial performance that are not required by, or presented in accordance with, GAAP. We define EBITDA as consolidated net income (loss) before depreciation and amortization, interest expense—net and income tax expense. Adjusted EBITDA reflects further adjustments to EBITDA to eliminate the impact of non-cash compensation, as well as certain non-recurring and other items that we do not consider representative of our underlying operating performance. EBITDA and Adjusted EBITDA are included in this filing because management believes that these metrics provide meaningful supplemental information for investors regarding the performance of our business and facilitate a meaningful evaluation of operating results on a comparable basis with historical results. Our management uses these non-GAAP financial measures in order to have comparable financial results to analyze changes in our underlying business from quarter to quarter. Our measures of EBITDA and Adjusted EBITDA are not necessarily comparable to other similarly titled captions for other companies due to different methods of calculation. The following table presents a reconciliation of net income (loss), the most directly comparable GAAP financial measure, to EBITDA and Adjusted EBITDA for the periods indicated below.

	Year Ended				
	February 1, 2020	February 2, 2019	February 3, 2018	January 28, 2017	January 30, 2016
Net income (loss)	\$220,375	\$135,731	\$ (2,599)	\$ 5,401	\$ 91,103
Depreciation and amortization	100,739	91,372	83,176	56,995	44,595
Interest expense—net	87,177	67,769	56,002	44,482	35,677
Income tax expense	48,807	25,233	25,132	3,153	58,781
EBITDA	457,098	320,105	161,711	110,031	230,156
Non-cash compensation ^(a)	21,832	24,122	50,709	29,988	24,223
Asset impairments and lease losses ^(b)	15,651	4,607	4,417	12,743	—
Loss on extinguishment of debt—net ^(b)	6,472	917	4,880	—	—
Reorganization related costs ^(b)	1,075	9,977	949	5,698	—
Recall accrual ^(b)	(3,988)	1,619	7,707	4,615	—
Asset held for sale loss (gain) ^(b)	(1,529)	8,497	—	4,767	—
Legal settlements ^(b)	(1,193)	(5,289)	—	—	—
Goodwill and tradename impairment ^(b)	—	32,086	33,700	—	—
Distribution center closures ^(b)	—	3,046	7,230	—	—
Impact of inventory step-up ^(b)	—	380	2,527	6,835	—
Anti-dumping exposure ^(b)	—	—	(2,202)	—	—
Gain on sale of building and land ^(b)	—	—	(2,119)	—	—
Legal claim ^(b)	—	—	—	8,701	19,046
Acquisition related costs ^(b)	—	—	—	2,847	—
Adjusted EBITDA	<u>\$495,418</u>	<u>\$400,067</u>	<u>\$269,509</u>	<u>\$186,225</u>	<u>\$273,425</u>

- (a) Represents non-cash compensation related to equity awards granted to employees, including the non-cash compensation charge related to a fully vested option grant made to Mr. Friedman in May 2017 and a non-cash compensation charge related to the fully vested option grants made in connection with our acquisition of Waterworks in fiscal 2016.
- (b) Refer to the reconciliation of net income (loss) to adjusted net income table above and the related footnotes for additional information.
- (5) As of the year ended fiscal 2016 and fiscal 2015, \$142.7 million and \$130.8 million, respectively, of our investments were due within one year. As of the year ended fiscal 2016 and fiscal 2015, \$33.2 million and \$22.1 million, respectively, of our investments were due within two years. We held no investments as of fiscal 2019, fiscal 2018 or fiscal 2017.
- (6) Working capital (deficit) is defined as current assets, less current liabilities, excluding the current portion of long-term debt.
- (7) Represents our obligations, net of debt discount, related to the 2019 Notes, 2020 Notes, 2023 Notes and 2024 Notes. The aggregate principal amounts due under the 2020 Notes, 2023 Notes and 2024 Notes are \$300 million, \$335 million and \$350 million, respectively. The aggregate principal amount under the 2019 Notes that matured on June 15, 2019 was \$350 million.
- (8) Represents promissory notes on asset under construction as of February 1, 2020 and an aircraft promissory note as of February 3, 2018.
- (9) Total debt (including current portion) includes the 2019 Notes, 2020 Notes, 2023 Notes and 2024 Notes, net of debt discount, asset based credit facility, term loan, equipment promissory notes, promissory notes and notes payable for share repurchases. Total debt (including current portion) includes capital lease obligations and excludes financing obligations under build-to-suit lease transactions in fiscal 2016 and fiscal 2015.

Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations

Overview

We are a leading luxury retailer in the home furnishings marketplace. Our curated and fully-integrated assortments are presented consistently across our sales channels in sophisticated and unique lifestyle settings that we believe are on par with world-class interior designers. We offer dominant merchandise assortments across a growing number of categories, including furniture, lighting, textiles, bathware, décor, outdoor and garden, and child and teen furnishings. We position our Galleries as showrooms for our brand, while our Source Books and websites act as virtual extensions of our stores. Our retail business is fully integrated across our multiple channels of distribution, consisting of our stores, Source Books, and websites. We have an integrated RH Hospitality experience in eight of our new Design Gallery locations, which include restaurants, wine vaults and barista bars.

Our business is fully integrated across our multiple channels of distribution, consisting of our stores, Source Books and websites. As of February 1, 2020, we operated the following number of Galleries, outlets and showrooms:

	<u>Count</u>
RH	
Design Galleries	22
Legacy Galleries	40
Modern Galleries	2
Baby & Child and Teen Galleries	<u>4</u>
Total Galleries	68
Outlets	38
Waterworks Showrooms	15

We are undertaking substantial changes in our business and operations in response to the recent global outbreak of the coronavirus (COVID-19).

The COVID-19 health crisis poses significant and widespread risks to our business as well as to the business environment and the markets in which we operate our business. We have already experienced significant disruption to our business as a result of the rapid development of the COVID-19 pandemic. The immediate impact from this global health crisis has been both direct in terms of disruption in numerous aspects of our business operations as well as indirect in terms of the adverse effect on overall economic conditions. The magnitude and duration of the negative impact to our business from the COVID-19 pandemic cannot be predicted with certainty. Accordingly, we withdrew all prior guidance and outlook statements that relate to the performance of our business with respect to fiscal 2020.

In response to the public health crisis posed by COVID-19, effective from March 17, 2020, the Company temporarily closed its retail locations for an indeterminate period of time. Although we continue to serve our customers virtually through our Gallery representatives and designers, as well as our online websites, our business operations are being substantially affected by applicable regulatory restrictions including stay-at-home requirements applicable in California where our corporate headquarters is located. Our decision to reopen retail locations will be affected by a number of factors including applicable regulatory restrictions and there is substantial uncertainty regarding the manner and timing in which we can return some or all of our business to more normal business operations. We may face longer term closure requirements and other operational restrictions with respect to some or all of our physical locations for prolonged periods of time due to, among other factors, evolving and increasingly stringent federal, state and local restrictions including shelter-in-place orders. Even once we are able to reopen closed physical locations, changes in consumer behavior and health concerns may continue to impact consumer demand for our products and customer traffic at our Galleries, restaurants and outlets and may make it more difficult to staff our business operations. If we are not able to access capital at the time and on terms that our business requires, we may encounter difficulty funding our

business requirements including debt repayments when due. Given the fast moving nature of the COVID-19 health crisis, and the corresponding impact on financial markets and the economy as a whole, there is an enhanced degree of uncertainty regarding the Company's capital position and availability of capital to fund the Company's liquidity requirements. We may not be able to access liquidity or the terms and conditions of available credit may be substantially more expensive than previously expected due to changes in financial conditions and credit markets. We may require waivers or amendments to our existing credit facilities and these requirements may trigger pricing increases from lenders for available credit. If we are not able to access credit to fund our business requirements for liquidity, or the cost of available credit increases, we may need to curtail our business operations including various business initiatives that require capital investment. We have recently commenced an effort to expand our business internationally by establishing a new retail presence in global markets including Europe and the United Kingdom. In addition, we are in the process of developing a number of new Gallery locations in the U.S. In addition, our RH Guesthouse initiative may be negatively impacted by the disease outbreak as federal, state and local governments have restricted travel, conferences, events and gatherings. Reductions in our liquidity position and the need to use capital for other day to day requirements of our business may affect a number of our business initiatives and long-term investments and as a result we may be required to curtail and/or postpone business investments including those related to international expansion, the pace of opening new Galleries in the U.S. as well as other initiatives that require capital investment.

As a result of the COVID-19 outbreak, and the corresponding reduction in our sales, we have had to institute a number of measures to mitigate expenses and reduce costs. These efforts may not be enough to offset anticipated declines in revenue including the loss of sales related to store closures, and may negatively affect our ability to quickly resume operations when we are able to re-open our Galleries, restaurants and outlets. Substantially all of our management personnel, including those in our corporate office in Corte Madera, CA, are subject to shelter-in-place requirements which have resulted in most of our management team being required to work remotely. These working arrangements as well as other related restrictions including severe limitations on travel may have an impact on our operations and management effectiveness. Although we have technology and other resources to support these new work requirements, there can be no assurance that we will not suffer material risks to our business, operations, production productivity and results of operations as a result of these restrictions. If a significant percentage of our workforce is unable to work, including because of illness or travel or government restrictions in connection with COVID-19, our operations may be negatively impacted, potentially materially adversely affecting our business, liquidity, financial condition or results of operations. The global scale and scope of COVID-19 is unknown and the duration of the business disruption and related financial impact cannot be reasonably estimated at this time. The extent to which the COVID-19 pandemic impacts our results will depend on future developments that are highly uncertain and cannot be predicted, including the duration of our RH Galleries, restaurant and outlet closures, emerging information concerning the severity of COVID-19 and the actions taken by governments and private businesses to attempt to contain COVID-19. However, the Company believes COVID-19 is likely to result in an adverse impact on our business, results of operations and financial condition, particularly if ongoing mitigation actions occur for a significant amount of time. For more information, refer to *Item 1A—Risk Factors— The global outbreak of the COVID-19 virus is likely to have an adverse impact on our business.*

Our net revenue for the fourth quarter of fiscal 2019 was \$665.0 million, compared to \$670.9 million for the fourth quarter of 2018. Net revenue for the fourth quarter of fiscal 2019 was negatively impacted by several factors, including higher than expected backorders due to a year-over-year decrease in inventories as well as our decision to eliminate most seasonal holiday merchandising from our business, which decision we believe contributed a larger than anticipated impact to sales as customers who might otherwise purchase our holiday merchandise chose to shop at other retailers offering holiday merchandise selections and, as a result, our net revenues were less than the prior period not only due to elimination of the sale of the holiday merchandise but also the loss of additional sales of non-holiday merchandise that would typically been made at the same time by customers attracted to our product offerings of holiday merchandise. In addition, prior periods including the fourth quarter of fiscal 2018 included revenue from higher outlet and warehouse sales stemming from our inventory optimization efforts. In fiscal 2019, we resumed introducing product expansions in our merchandise

assortment including a number of new merchandise collections in both RH Interiors and RH Modern, as well as the launch of RH Beach House in the Spring and RH Ski House in the Fall. While we believe that product expansion will provide us with a significant opportunity to increase our market share and revenues, in the fourth quarter of fiscal 2019 we experienced some delays in the delivery of products to our customers due to back orders and special orders, which resulted from insufficient inventory to meet customer demand and slow ramp-ups at the factories that produce such products in response to the demand level from consumers.

Key Value Driving Strategies

In order to drive growth across our business, we are focused on the following long-term key strategies:

- *Transform Our Real Estate Platform.* We believe we have an opportunity to significantly increase our sales by transforming our real estate platform from our existing legacy retail footprint to a portfolio of Design Galleries that are sized to the potential of each market and the size of our assortment.

New sites are identified based on a variety of factors, such as (i) the availability of suitable new site locations based on several store specific factors including geographic location, demographics, and proximity to affluent consumers, (ii) the ability to negotiate favorable economic terms, as well as (iii) the satisfactory and timely completion of real estate development including procurement of permits and completion of construction. Based on our analysis, we believe we have the opportunity to operate Design Galleries in 60 to 70 locations in the United States and Canada. The number of Design Galleries we open in any fiscal year is highly dependent upon these variables and individual new Design Galleries may be subject to delay or postponement depending on the circumstances of specific projects, which we have experienced with some of our recent projects.

We opened our Portland Design Gallery in March 2018, our Nashville Design Gallery in June 2018, our New York Design Gallery and our Yountville Design Gallery in September 2018, our Minneapolis Design Gallery in September 2019, and our Columbus Design Gallery in December 2019. Our Galleries in Nashville, New York, Yountville, Minneapolis and Columbus include integrated restaurants, wine vaults and barista bars.

We have identified key learnings from our real estate transformation that have supported the development of a new multi-tier market approach that we believe will optimize both market share and return on invested capital.

First, we have developed a new RH prototype Design Gallery that is an innovative and flexible blueprint which we believe will enable us to more quickly place our disruptive product assortment and immersive retail experience into the market. The new model is a standard we will utilize in the future that is based on key learnings from more recent Design Gallery openings and will have approximately 38,000 leased selling square feet inclusive of our integrated hospitality experience. This prototype will present our assortments across our businesses and contain interior design offices and presentation rooms where design professionals can work with clients on their projects. This new model will be more capital efficient with less time and cost risk, but yield similar productivity. We anticipate the new prototype Design Galleries will represent the format of most of our upcoming Design Galleries in North America. Our most recently opened Design Galleries in Minneapolis, MN and Columbus, OH are prototype Design Galleries, and upcoming prototype locations include Corte Madera, CA, Charlotte, NC, Jacksonville, FL, Dallas, TX and Oakbrook, IL.

Second, we will continue to develop and open larger Bespoke Design Galleries in the top metropolitan markets, similar to those we opened in New York and Chicago. These iconic locations are highly profitable statements for our brand, and we believe they create a long-term competitive advantage that will be difficult to duplicate.

Third, we will continue to open indigenous Bespoke Galleries in the best second home markets where the wealthy and affluent visit and vacation. These Galleries are tailored to reflect the local culture and

are sized to the potential of each market. Examples of current indigenous Bespoke Galleries include Yountville, CA and Aspen, CO.

Fourth, we are developing a new Gallery model tailored to secondary markets. Targeted to be 10,000 to 18,000 square feet, we believe these smaller expressions of our brand will enable us to gain share in markets currently only served by smaller competitors. Examples of target secondary markets include Oklahoma City, OK and Milwaukee, WI, among others. We expect these Galleries to require a substantially smaller net investment than our larger Design Galleries and to pay back our capital investment in most instances within two years or less. Our plan is to test a few of these Galleries over the next several years, and if proven successful, this format could lead to an increase in our long-term Gallery potential in the United States.

We believe our multi-tier market approach to transforming our real estate will enable us to ramp our opening cadence from 3 to 5 new Galleries per year, to a pace of 5 to 7 new Galleries per year.

Like our evolving multi-tier market approach, we have developed a multi-tier real estate strategy that is designed to significantly increase our unit level profitability and return on invested capital. Our three primary deal constructs are outlined below:

- First, due to the productivity and proof of concept of our recent new Galleries, and the addition of a powerful, traffic-generating hospitality experience, we are able to negotiate “capital light” leasing deals, where as much as 65% to 100% of the capital requirement would be funded by the landlord, versus 35% to 50% previously.
- Second, in select projects we are migrating from a leasing to a development model. We currently have two Galleries, Yountville and Minneapolis, using this new model, and have additional projects in the pipeline. In the case of Yountville and Minneapolis, we have completed or expect to complete sale-leaseback transactions that should allow us to recoup all or a large portion of our capital.
- Third, we are working on joint venture projects, where we share the upside of a development with the developer/landlord. An example of this new model would be our future Gallery and Guesthouse in Aspen, where we are contributing the value of our lease to the development in exchange for a profits interest in the project. The developer will deliver to RH a substantially turnkey Gallery and Guesthouse, while we continue to retain a 20% and 25% profits interest in the properties, respectively. We would expect to monetize the profits interest at the time of sale of the properties during the first five years. The net result should be a minimal capital investment to operationalize the business, with the expectation for a net positive capital benefit at time of monetization of the profits interest.

We anticipate that all of the above deal structures should lead to lower capital requirements, higher unit profitability, and significantly higher return on invested capital versus our prior Gallery development strategies.

- *Pursue International Expansion.* We believe that our luxury brand positioning and unique aesthetic has strong international appeal. As such, we believe there is tremendous opportunity for the RH brand to expand globally and launch RH International in 2021 or 2022 and we are close to completing real estate transactions for approximately 5 initial locations across Europe.
- *Expand Our Offering and Increase Our Market Share.* We believe we have a significant opportunity to increase our market share by:
 - transforming our real estate platform;
 - growing our merchandise assortment and introducing new products and categories;
 - expanding our service offerings, including design services;
 - exploring and testing new business opportunities complementary to our core business; and

- increasing our brand awareness and customer loyalty through our Source Book circulation strategy, membership program, our digital marketing initiatives, advertising, and public relations activities and events.

During fiscal 2017 and fiscal 2018 we deferred the introduction of major new product category expansions other than the ongoing development of RH Hospitality in conjunction with new Design Galleries. In fiscal 2019, we resumed introducing product expansions in our merchandise assortment including a number of new merchandise collections in both RH Interiors and RH Modern, as well as the launch of RH Beach House in the Spring and RH Ski House in the Fall.

We also plan to increase our investment in RH Interior Design with a goal of building the leading interior design firm in North America. We believe there is a significant revenue opportunity by offering world class design and installation services as we move the brand beyond creating and selling products, to conceptualizing and selling spaces.

- *Grow Our Integrated Hospitality Experience.* In 2015 we began to introduce an integrated hospitality experience, including restaurants, wine vaults and barista bars, into a number of our new Gallery locations. The success of our initial hospitality offering in Chicago led us to broaden this initiative by adding hospitality to a number of our other new Gallery locations. We believe this has created a unique new retail experience that cannot be replicated online, and that the addition of hospitality is helping to drive incremental sales of home furnishings in these Galleries. We plan to incorporate hospitality in many of the new Galleries that we open in the future.
- *Architect New Operating Platform.* We have spent the last four years architecting a new operating platform, inclusive of transitioning from a promotional to membership model, our distribution center network redesign, the redesign of our reverse logistics and outlet business, and the reconceptualization of our home delivery and customer experience, which enables us to drive lower costs and inventory levels, and higher earnings and inventory turns. Looking forward, we expect this multi-year effort to result in a dramatically improved customer experience, continued margin enhancement and significant cost savings over the next several years.
- *Maximize Cash Flow and Optimize the Allocation of Capital in the Business.* In fiscal 2017 and 2018, we focused on maximizing cash flow in our business and the allocation of capital. We believe that our operations and current initiatives are providing a significant opportunity to optimize the allocation of capital in our business, including generating free cash flow and optimizing our balance sheet, as well as deploying capital to repay debt and repurchase shares of our common stock, which we believe creates a long term benefit to our shareholders.

During fiscal 2017, we repurchased approximately 20.2 million shares of our common stock under two separate repurchase programs for an aggregate repurchase amount of approximately \$1 billion. During fiscal 2018, we repurchased approximately 2.0 million shares of our common stock under a separate repurchase program for an aggregate repurchase amount of approximately \$250 million. During fiscal 2019, we repurchased approximately 2.2 million shares of our common stock under a separate repurchase program for an aggregate repurchase amount of approximately \$250 million. Total repurchases made in fiscal 2019, fiscal 2018 and fiscal 2017 represent 59.8% of the shares outstanding as of the end of fiscal 2016. Our focus on cash also resulted in our generating \$330 million, \$163 million and \$415 million in free cash flow in fiscal 2019, fiscal 2018 and fiscal 2017, respectively (refer to “Share Repurchase Programs” within *Liquidity and Capital Resources* below for our free cash flow calculation).

- *Increase Operating Margins.* During the period from fiscal 2016 through fiscal 2019, we have substantially increased the operating margins in our business. We anticipate continued improvements in operating margins as a result of our focus on a number of our strategic initiatives including (i) the occupancy leverage we expect to gain from our real estate transformation, (ii) product margin expansion as we continue to drive higher full price selling in our core business, and (iii) the continued cost savings of improvements to our operating platform and organizational structure.

Business Initiatives

We are undertaking a large number of new business initiatives in support of our key value driving strategies. In particular, beginning in fiscal 2016 and continuing through fiscal 2019, we have pursued a range of strategic efforts to improve our business and operations including the following:

- *Introduction of Membership Model.* In March 2016, we introduced the RH Members Program, an exclusive program that reimagines and simplifies the shopping experience. For an annual fee, the RH Members Program provides a set discount every day across all RH brands, excluding RH Hospitality and Waterworks, in addition to other benefits including complimentary interior design services through the RH Interior Design program and eligibility for preferred financing plans on the RH Credit Card, among other benefits. The RH Members Program allows our customers to shop for what they want, when they want, and receive the greatest value, which has resulted in orders and sales being more evenly distributed throughout the year as opposed to the peaks and valleys of orders and sales we experienced under the prior promotional model. We believe the shift to a membership model has enhanced the customer experience, rendered our brand more valuable, improved operational execution and reduced costs.

For the year ended February 1, 2020, our members drove approximately 95% of sales in our core RH business, and we had approximately 415,000 members at year end. Our core RH business reflects the product categories that the membership discount can be applied to, and as a result sales generated via Outlet, Contract, Hospitality or Waterworks are excluded.

We believe that the shift to a membership model has positively affected the financial results of our business. Specifically, we believe some of the benefits include:

Improved customer experience. Our interior design professionals can now work with customers based on their timeline and project deadlines, as opposed to our prior promotional calendar. We believe this will lead to larger overall sales transactions for individual customer design projects.

Lower cancellations and returns. As a result of the elimination of time-limited promotional events and the associated pressure of placing an order before a promotion expires, we believe the shift to a membership model has also resulted in lower rates of cancelled orders and returns.

Improved operational costs. The volume of sales, orders and shipments in our business under the prior promotional model was characterized by large spikes in customer orders based upon promotional events followed by lower orders and sales after the end of an event. This buying pattern also affected numerous other aspects of our business, including staffing and costs as we required elevated staffing levels to service the increased number of customers during peak sales events. Likewise, significant fluctuations in sales had downstream implications for our supply chain related to merchandise orders, manufacturing and production, shipment to our distribution centers and final delivery to our customers. All of these aspects of our operations are experiencing improved efficiencies as a result of the membership model whereby sales are more evenly distributed throughout the year as opposed to the peaks and valleys of orders and sales under the prior model.

- *Luxury In-Home Furniture Delivery Experience.* We believe there is an opportunity to improve the customer experience by enhancing our approach to services in connection with in-home delivery. We are in the process of implementing a number of measures that are designed to increase our level of control and improve service levels throughout the delivery experience to the customer's residence. We believe that we are well positioned to develop improved solutions for in-home delivery to the customer in the luxury market. We have already adopted a number of service improvements that are yielding improvements in the customer experience and reductions in product return and exchange rates. We expect to continue to optimize our service offering to customers in connection with the in-home delivery experience and are confident that our efforts in this regard will continue to achieve substantial results.

- *Elevate the Customer Experience.* We are focused on improving the end-to-end customer experience. As we have elevated our brand, especially at retail, we are also working to enhance the brand experience in other aspects of our business. We are making changes in many aspects of our business processes that affect our customers, including the in-home delivery experience, improvements in product quality and enhancements in sourcing, product availability, and all aspects of customer care and service. We also believe that the introduction of experiential brand-enhancing products and services, such as expanded design ateliers, the RH Interior Design program and the launch of an integrated hospitality experience in a number of our new Galleries, will further enhance our customers' in-store experience, allowing us to further disrupt the highly fragmented home furnishings landscape and achieve market share gains.

In fiscal 2017, fiscal 2018 and continuing into fiscal 2019, we have focused on the allocation of capital. We believe that our operations and current initiatives are providing a significant opportunity to optimize the allocation of capital in our business, including generating free cash flow and optimizing our balance sheet, as well as deploying capital to repay debt and repurchase shares of our common stock, which we believe creates a long-term benefit to our shareholders.

We continue to pursue and test numerous initiatives to improve many aspects of our business including through efforts to optimize inventory, elevate the home delivery experience, simplify our distribution network and improve our organizational design including by streamlining and realigning our home office operations, as well as to expand our product offering and transform our real estate using a range of different models for specific real estate development projects. Many of these initiatives and other initiatives such as our transition to a direct sourcing model for our rug business have improved our operating margins, but other initiatives such as RH Hospitality, RH Guesthouse and international expansion are expected to offset some planned margin improvement next year due to our investments in those platforms. There can be no assurance as to the timing and extent of the operational benefits and financial contributions of these strategic efforts. In addition, our pursuit of multiple initiatives with respect to our business in any given period may result in period-to-period changes in, and increased fluctuation in, our results of operations. We have also experienced delays in development timelines for some of our recent projects, and delays in completion of our real estate development projects or costs overruns could negatively affect our results of operations and revenues. Further, macroeconomic or political events outside of our control could impact our ability to pursue our initiatives or the success of such initiatives. For example, the COVID-19 outbreak and resulting global health crisis and related impact on financial markets have contributed to a period of significant market stress and anticipated illiquidity which is expected to negatively impact the economies and financial markets of many countries and could adversely affect our results of operations. In addition, while we believe that the tariffs imposed to date on most of our goods sourced from China have not had an adverse effect on our results of operations, including our revenues, margins and earnings, there can be no assurance that the existing tariffs and the additional tariffs that will become effective, as well as other future tariffs that may be imposed, will not adversely affect our results of operation in future time periods. In addition, in recent periods the stock market has experienced significant volatility as well as periods of significant decline and is currently in a period of heightened market volatility and decline, which may negatively affect the financial health and demand levels of high-end consumers, and we can provide no assurance as to whether such trends will occur in the future. The housing market is affected by a range of factors including home prices and interest rates and slowdowns in the housing market can have a negative impact on demand for our products. Factors that affect the higher end housing market in particular may have an outsized influence on our levels of consumer demand since our business is geared toward the higher end of the home furnishings market. The above factors and other current and future operational initiatives may create additional uncertainty with respect to our consolidated net revenues and profit in the near term.

Factors Affecting Our Results of Operations

Various factors affected our results for the periods presented in this "Management's Discussion and Analysis of Financial Condition and Results of Operations," and such discussion generally lists the factors in

order of magnitude based on their impact. Due to the global outbreak of the COVID-19 virus as discussed elsewhere in this Annual Report, our operating results in the near-term are difficult to predict. Apart from the impact of the near-term actions we are undertaking in response to the COVID-19 outbreak, below are certain factors that affect our results of operations.

Our Strategic Initiatives. We are in the process of implementing a number of significant business initiatives that have had and will continue to have an impact on our results of operations, including:

- the introduction and expansion of new product categories and services;
- the timing and progress of the opening of new Design Galleries that are under development;
- the launch of RH International;
- the pursuit of our multi-tier market approach to our real estate transformation;
- the redesign of our distribution center network;
- the introduction of RH Hospitality, an integrated hospitality experience, including the roll out of an integrated food and beverage experience in a number of our new Design Galleries and Guesthouse;
- changes in our Source Book circulation strategy including the depth, frequency and timing of mailings as well as the scope of product offerings displayed in our Source Books;
- changes in our reverse logistics model resulting in transferring customer returns direct from our home delivery centers to Outlets;
- efforts to elevate the customer experience including architecting a new fully integrated back-end operating platform, inclusive of the supply chain network, the home delivery experience as well as a new metric driven quality system and company-wide decision data, vendor product initiatives and changes to the way we operate our distribution centers, home delivery centers and customer service centers; and
- leveraging the above strategic initiatives across both our RH Segment and Waterworks to drive the performance of each business.

As a result of the number of current business initiatives we are pursuing, we have experienced in the past and may experience in the future significant period-to-period variability in our financial performance and results of operations. While we anticipate that these initiatives will support the growth of our business, costs and timing issues associated with pursuing these initiatives can negatively affect our growth rates in the short term and may amplify fluctuations in our growth rates from quarter to quarter. In addition, we anticipate that our net revenues, adjusted net income and other performance metrics will remain variable as our business model continues to emphasize high growth and numerous, concurrent and evolving business initiatives.

Our Ability to Source and Distribute Products Effectively. Our net revenues and gross profit are affected by our ability to purchase our merchandise in sufficient quantities at competitive prices. Our current and anticipated demand, and our level of net revenues have been adversely affected in prior periods by constraints in our supply chain, including the inability of our vendors to produce sufficient quantities of some merchandise in a manner that was able to match market demand from our customers, leading to higher levels of customer back orders and lost sales. For example, some of our vendors experienced difficulty in producing goods in sufficient quantity to meet initial customer demand for RH Modern when it was launched in October 2015. Further, the COVID-19 outbreak is anticipated to adversely affect our supply chain. Based on total dollar volume of purchases for fiscal 2019, approximately 70% of our products were sourced in from Asia, 16% from the United States and the remainder from other countries and regions. For fiscal 2019, approximately 38% of our products were sourced from China. For more information, refer to *Item 1A—Risk Factors—The global outbreak of the COVID-19 virus is likely to have an adverse impact on our business.*

Consumer Preferences and Demand. Our ability to maintain our appeal to existing customers and attract new customers depends on our ability to originate, develop and offer a compelling product assortment responsive to customer preferences and design trends. We have successfully introduced a large number of new products in past periods, which we believe has been a contributing factor in our sales growth and results of operations. Periods in which our products have achieved strong customer acceptance generally have had more favorable results. If we misjudge the market for our products or the product lines that we acquire, we may be faced with excess inventories for some products and may be required to become more promotional in our selling activities, which would impact our net revenues and gross profit.

Overall Economic Trends. The industry in which we operate is cyclical, and consequently our net revenues are affected by general economic conditions including conditions that affect the housing market. For example, reduced consumer confidence and lower availability and higher cost of consumer credit reduce demand for our products and limit our ability to increase prices or sustain price increases. We expect that some of the economic factors that are currently in place such as global economic uncertainty and market volatility may continue in future periods. We target consumers of high-end home furnishings. As a result, we believe that our sales are sensitive to a number of macroeconomic factors that influence consumer spending generally, but that our sales are particularly affected by the health of the higher end customer and demand levels from that customer demographic. While the overall home furnishings market may be influenced by factors such as employment levels, interest rates, demographics of new household formation and the affordability of homes for the first time home buyer, the higher end of the housing market may be disproportionately influenced by other factors, including stock market prices, restrictions on travel due to the COVID-19 outbreak, the number of second and third homes being bought and sold, the number of foreign buyers in higher end real estate markets in the U.S., tax policies and interest rates, and the perceived prospect for capital appreciation in higher end real estate. We have in the past experienced volatility in our sales trends related to many of these factors and believe our sales may be impacted by these economic factors in future periods. These headwinds tied to macroeconomic factors may continue in future quarters. For more information, refer to *Item 1A—Risk Factors—Changes in consumer spending and factors that influence spending of the specific categories of consumers that purchase from us, including the health of the high-end housing market, may significantly impact our revenue and results of operations* and — *The global outbreak of the COVID-19 virus is likely to have an adverse impact on our business.*

Fluctuation in Quarterly Results. Our quarterly results vary depending upon a variety of factors, including our product offerings, store openings, shifts in the timing of holidays and the timing of Source Book releases, promotional events and the timing and extent of our realization of the costs and benefits of our numerous strategic initiatives, among other things. As a result of these factors, our working capital requirements and demands on our product distribution and delivery network may fluctuate during the year. Unique factors in any given quarter may affect period-to-period comparisons between the quarters being compared, and the results for any quarter are not necessarily indicative of the results that we may achieve for a full fiscal year.

How We Assess the Performance of Our Business

In assessing the performance of our business, we consider a variety of financial and operating measures that affect our results of operations, including:

Net Revenues. Net revenues reflect our sale of merchandise plus shipping and handling revenue collected from our customers, less returns and discounts. Revenues are recognized when a customer obtains control of the merchandise. We collect annual membership fees related to the RH Members Program, which are recorded as deferred revenue when collected from customers and recognized as revenue based on expected product revenues over the annual membership period.

Gross Profit. Gross profit is equal to our net revenues less cost of goods sold. Gross profit as a percentage of our net revenues is referred to as gross margin. Cost of goods sold include the direct cost of purchased merchandise;

inventory shrinkage, inventory adjustments due to obsolescence, including excess and slow-moving inventory and lower of cost or net realizable value reserves; inbound freight; all freight costs to get merchandise to our stores; design, buying and allocation costs; occupancy costs related to store operations and our supply chain, such as rent and common area maintenance for our leases; depreciation and amortization of leasehold improvements, equipment and other assets in our stores and distribution centers. In addition, cost of goods sold include all logistics costs associated with shipping product to our customers, which are partially offset by shipping income collected from customers (recorded in net revenues). We expect gross profit to increase to the extent that we successfully grow our net revenues and leverage the fixed portion of cost of goods sold.

Our gross profit can be favorably impacted by sales volume increases, as occupancy and certain other costs that are largely fixed do not necessarily increase proportionally with volume increases. Changes in the mix of our products may also impact our gross profit. We review our inventory levels on an ongoing basis in order to identify slow-moving merchandise and use product markdowns and our outlet stores to efficiently sell these products. The timing and level of markdowns are driven primarily by customer acceptance of our merchandise. The primary drivers of the costs of individual goods are raw materials costs, which fluctuate based on a number of factors beyond our control, including commodity prices, changes in supply and demand, general economic conditions, competition, import duties, tariffs and government regulation, logistics costs (which may increase in the event of, for example, expansions of or interruptions in the operation of our distribution centers, furniture home delivery centers and customer service center or damage or interruption to our information systems) and labor costs in the countries where we source our merchandise. We place orders with merchandise vendors primarily in United States dollars and, as a result, are not exposed to significant foreign currency exchange risk.

Our gross profit may not be comparable to other specialty retailers, as some companies may not include all or a portion of the costs related to their distribution network and store occupancy in calculating gross profit as we and many other retailers do, but instead may include them in selling, general and administrative expenses. In addition, certain of our store leases are accounted for as build-to-suit lease transactions which result in our recording a portion of our rent payments under these agreements in interest expense on the consolidated statements of operations.

Selling, General and Administrative Expenses. Selling, general and administrative expenses include all operating costs not included in cost of goods sold. These expenses include payroll and payroll related expenses, store expenses other than occupancy and expenses related to many of our operations at our corporate headquarters, including utilities, depreciation and amortization, credit card fees and marketing expense, which primarily includes Source Book production, mailing and print advertising costs. All store pre-opening costs are included in selling, general and administrative expenses and are expensed as incurred. We expect certain of these expenses to continue to increase as we continue to open new stores, develop new product categories and otherwise pursue our current business initiatives. Selling, general and administrative expenses as a percentage of net revenues are usually higher in lower-volume quarters and lower in higher-volume quarters because a significant portion of the costs are relatively fixed.

In addition, in recent periods we have experienced increased selling, general and administrative expenses, including certain non-cash compensation and costs associated with reorganizations and distribution center closures, product recalls, and asset impairments and lease losses, as discussed in “Basis of Presentation and Results of Operations” below.

Adjusted Operating Income, Adjusted EBITDA and Adjusted Net Income. We believe that adjusted operating income, adjusted EBITDA and adjusted net income are useful measures of operating performance, as the adjustments eliminate non-recurring and other items that are not reflective of underlying business performance, facilitate a comparison of our operating performance on a consistent basis from period-to-period and provide for a more complete understanding of factors and trends affecting our business. We also use adjusted operating income, adjusted EBITDA and adjusted net income as methods for planning and forecasting overall expected performance and for evaluating on a quarterly and annual basis actual results against such expectations.

We define adjusted operating income as consolidated operating income, adjusted for the impact of certain non-recurring and other items that we do not consider representative of our underlying operating performance.

We define EBITDA as consolidated net income (loss) before depreciation and amortization, interest expense—net and income tax expense. Adjusted EBITDA reflects further adjustments to EBITDA to eliminate the impact of non-cash compensation, as well as certain non-recurring and other items that we do not consider representative of our underlying operating performance. Because adjusted EBITDA omits non-cash items, we feel that it is less susceptible to variances in actual performance resulting from depreciation, amortization and other non-cash charges and can be more reflective of our operating performance.

We define adjusted net income as consolidated net income (loss), adjusted for the impact of certain non-recurring and other items that we do not consider representative of our underlying operating performance. Refer to Item 6—*Selected Consolidated Financial Data* for further information.

Basis of Presentation and Results of Operations

The results of operations for the fiscal years ended February 1, 2020, February 2, 2019 and February 3, 2018 reflect the modified retrospective application of the new lease accounting standard (Accounting Standards Update 2016-02—*Leases*). For information regarding recently issued accounting pronouncements, refer to Note 3—*Significant Accounting Policies* in our consolidated financial statements within Part II of this Annual Report on Form 10-K.

The following table sets forth our consolidated statements of operations and other financial and operating data.

	Year Ended		
	February 1, 2020	February 2, 2019	February 3, 2018
Consolidated Statements of Operations:			
Net revenues	\$2,647,437	\$2,505,653	\$2,440,174
Cost of goods sold	<u>1,552,426</u>	<u>1,520,076</u>	<u>1,600,876</u>
Gross profit	1,095,011	985,577	839,298
Selling, general and administrative expenses . . .	<u>732,180</u>	<u>723,841</u>	<u>722,183</u>
Income from operations	362,831	261,736	117,115
Other expenses			
Interest expense—net	87,177	67,769	56,002
Goodwill and tradename impairment	—	32,086	33,700
Loss on extinguishment of debt—net	<u>6,472</u>	<u>917</u>	<u>4,880</u>
Total other expenses	<u>93,649</u>	<u>100,772</u>	<u>94,582</u>
Income before income taxes	269,182	160,964	22,533
Income tax expense	<u>48,807</u>	<u>25,233</u>	<u>25,132</u>
Net income (loss)	<u>\$ 220,375</u>	<u>\$ 135,731</u>	<u>\$ (2,599)</u>

The following table sets forth our consolidated statements of operations as a percentage of total net revenues.

	Year Ended		
	February 1, 2020	February 2, 2019	February 3, 2018
Consolidated Statements of Operations:			
Net revenues	100.0%	100.0%	100.0%
Cost of goods sold	58.6	60.7	65.6
Gross profit	41.4	39.3	34.4
Selling, general and administrative expenses	27.7	28.9	29.6
Income from operations	13.7	10.4	4.8
Other expenses			
Interest expense—net	3.3	2.7	2.3
Goodwill and tradename impairment	—	1.3	1.4
Loss on extinguishment of debt—net	0.2	—	0.2
Total other expenses	3.5	4.0	3.9
Income before income taxes	10.2	6.4	0.9
Income tax expense	1.9	1.0	1.0
Net income (loss)	8.3%	5.4%	(0.1)%

Fiscal 2019 Compared to Fiscal 2018

	Year Ended					
	February 1, 2020			February 2, 2019		
	RH Segment	Waterworks	Total	RH Segment	Waterworks ⁽¹⁾	Total
	<i>(in thousands)</i>					
Net revenues	\$2,514,296	\$133,141	\$2,647,437	\$2,375,472	\$130,181	\$2,505,653
Cost of goods sold	1,475,574	76,852	1,552,426	1,441,667	78,409	1,520,076
Gross profit	1,038,722	56,289	1,095,011	933,805	51,772	985,577
Selling, general and administrative expenses	679,671	52,509	732,180	670,767	53,074	723,841
Income (loss) from operations	\$ 359,051	\$ 3,780	\$ 362,831	\$ 263,038	\$ (1,302)	\$ 261,736

(1) Waterworks results include non-cash amortization of \$0.4 million related to the inventory fair value adjustment recorded in connection with our acquisition of Waterworks during fiscal 2018.

Net revenues

Consolidated net revenues increased \$141.8 million, or 5.7%, to \$2,647.4 million in fiscal 2019 compared to \$2,505.7 million in fiscal 2018.

Consolidated net revenues for fiscal 2019 were positively impacted by \$0.4 million and for fiscal 2018 were negatively impacted by \$4.7 million, in each case related to product recalls. Excluding the product recall adjustments, consolidated net revenues increased \$136.7 million, or 5.4%, to \$2,647.0 million in fiscal 2019 compared to \$2,510.4 million in fiscal 2018. Product recalls and the establishment or adjustment of any related recall accruals can affect our results and cause quarterly fluctuations affecting the period-to-period comparisons of our results. No assurance can be provided that any accruals will be for the appropriate amount, and actual losses could be higher or lower than what we accrue from time to time, which could further affect results.

RH Segment net revenues

RH Segment net revenues increased \$138.8 million, or 5.8%, to \$2,514.3 million in fiscal 2019 compared to \$2,375.5 million in fiscal 2018. The below discussion highlights several significant factors that resulted in increased RH Segment net revenues, which are listed in order of magnitude.

RH Segment core net revenues increased primarily due to existing Galleries, as well as an increase in retail weighted-average selling square footage related to new store openings, including New York, Nashville, Minneapolis, Columbus and Yountville. Net revenues also increased from our RH Hospitality operations and Contract business. In addition, we believe that our net revenues were negatively impacted by a decline in sales in the fourth quarter resulting from several factors, including higher than expected backorders due to a year-over-year decrease in inventories as well as our decision to eliminate most seasonal holiday merchandising from our business, which decision we believe contributed a larger than anticipated impact to sales as customers who might otherwise purchase our holiday merchandise chose to shop at other retailers offering holiday merchandise selections and, as a result, our net revenues were less than the prior period not only due to elimination of the sale of the holiday merchandise but also the loss of additional sales of non-holiday merchandise that would typically be made at the same time by customers attracted to our product offerings of holiday merchandise.

Outlet sales increased \$42.4 million in fiscal 2019 compared to fiscal 2018 primarily due to increased promotional activity as a result of our efforts to reduce inventory subsequent to the distribution center closures as part of the distribution center network redesign.

RH Segment net revenues for fiscal 2019 were positively impacted by \$0.4 million and for fiscal 2018 were negatively impacted by \$4.7 million, in each case related to product recalls.

Waterworks net revenues

Waterworks net revenues increased \$3.0 million, or 2.3%, to \$133.1 million in fiscal 2019 compared to \$130.2 million in fiscal 2018.

Gross profit

Consolidated gross profit increased \$109.4 million, or 11.1%, to \$1,095.0 million in fiscal 2019 compared to \$985.6 million in fiscal 2018. As a percentage of net revenues, gross margin increased 2.1% to 41.4% of net revenues in fiscal 2019 compared to 39.3% of net revenues in fiscal 2018.

RH Segment gross profit for fiscal 2019 was negatively impacted by \$4.9 million related to acceleration of depreciation due to a change in the estimated useful life of certain assets and was positively impacted by \$3.8 million related to product recalls. RH Segment gross profit for fiscal 2018 was negatively impacted by \$2.6 million related to acceleration of depreciation due to a change in the estimated useful life of certain assets, \$1.5 million related to costs associated with distribution center closures, \$1.2 million due to inventory impairment related to Holiday merchandise and \$0.6 million related to product recalls.

Waterworks gross profit for fiscal 2018 was negatively impacted by \$0.4 million of amortization related to the inventory fair value adjustment recorded in connection with the acquisition.

Excluding the accelerated asset depreciation, product recall adjustments, costs associated with the distribution center closures, inventory impairment and impact of the amortization related to the inventory fair value adjustment mentioned above, consolidated gross margin would have increased 1.9% to 41.4% of net revenues in fiscal 2019 compared to 39.5% of net revenues in fiscal 2018.

RH Segment gross profit

RH Segment gross profit increased \$104.9 million, or 11.2%, to \$1,038.7 million in fiscal 2019 compared to \$933.8 million in fiscal 2018. As a percentage of net revenues, RH Segment gross margin increased 2.0% to 41.3% of net revenues in fiscal 2019 compared to 39.3% of net revenues in fiscal 2018.

Excluding the accelerated asset depreciation, product recall adjustments, costs associated with distribution center closures and inventory impairment mentioned above, RH Segment gross margin would have increased 1.9% to 41.4% of net revenues in fiscal 2019 compared to 39.5% of net revenues in fiscal 2018. The increase was primarily related to improvements in our distribution center network redesign resulting in reduced delivery expense and leverage in occupancy costs, as well as improvements in our core merchandise margins. The overall increase was partially offset by lower outlet product margins due to increased promotional activity and higher discounts due to our efforts to reduce inventory.

Waterworks gross profit

Waterworks gross profit increased \$4.5 million, or 8.7%, to \$56.3 million in fiscal 2019 compared to \$51.8 million in fiscal 2018. As a percentage of net revenues, Waterworks gross margin increased 2.5% to 42.3% of net revenues in fiscal 2019 compared to 39.8% of net revenues in fiscal 2018.

Excluding the impact of the amortization related to the inventory fair value adjustment mentioned above, Waterworks gross margin would have increased 2.2% to 42.3% of net revenues in fiscal 2019 compared to 40.1% of net revenues in fiscal 2018.

Selling, general and administrative expenses

Consolidated selling, general and administrative expenses increased \$8.3 million, or 1.2%, to \$732.2 million in fiscal 2019 compared to \$723.8 million in fiscal 2018.

RH Segment selling, general and administrative expenses

RH Segment selling, general and administrative expenses increased \$8.9 million, or 1.3%, to \$679.7 million in fiscal 2019 compared to \$670.8 million in fiscal 2018.

RH Segment selling, general and administrative expenses for fiscal 2019 included impairments of \$15.2 million which consisted of (i) asset impairments of \$9.1 million, (ii) an RH Contemporary Art lease impairment of \$4.6 million, resulting from an update to both the timing and the amount of future estimated lease related cash inflows, and (iii) other lease impairments of \$1.5 million due to early exit of leased facilities. RH Segment selling, general and administrative expenses for fiscal 2019 also included acceleration of depreciation due to a change the estimated useful life of certain assets of \$1.3 million, reorganization related costs of \$1.1 million and a \$0.5 million charge related to the termination of a service agreement, partially offset by a gain on real estate related to asset previously classified as held for sale and other land sales of \$1.5 million, a favorable \$1.2 million legal settlement related to historical freight charges and \$0.2 million related to product recalls.

Additionally, RH Segment selling, general and administrative expenses for fiscal 2019 included advertising and marketing costs which increased \$10.7 million primarily due to an increase in circulation and pages of our Source Books. This was partially offset by a decrease in corporate expenses of \$3.4 million, primarily due to reduced preopening expense associated with our Design Gallery openings, partially offset by an increase in credit card fees and other corporate costs.

RH Segment selling, general and administrative expenses for fiscal 2018 included a \$10.0 million charge related to reorganizations primarily due to streamlining and realigning our home office operations, \$8.5 million

impairment recorded upon reclassification of an owned Design Gallery as asset held for sale, \$3.4 million related to impairment of the RH Contemporary Art lease, \$1.6 million related to costs associated with distribution center closures and \$1.0 million related to product recalls, partially offset by a favorable \$5.3 million legal settlement, net of related legal expenses.

RH Segment selling, general and administrative expenses were 26.4% and 27.4% of net revenues for fiscal 2019 and fiscal 2018, respectively, excluding the asset impairments, accelerated asset depreciation, reorganization related costs, product recall adjustments, costs associated with distribution center closures and legal settlements mentioned above. The decrease in selling, general and administrative expenses as a percentage of net revenues was primarily driven by other corporate costs.

Waterworks selling, general and administrative expenses

Waterworks selling, general and administrative expenses decreased \$0.6 million, or 1.1%, to \$52.5 million in fiscal 2019 compared to \$53.1 million in fiscal 2018. Waterworks selling, general and administrative expenses were 39.4% and 40.8% of net revenues in fiscal 2019 and fiscal 2018, respectively. The decrease in selling, general and administrative expenses as a percentage of net revenues was primarily driven by leverage in corporate costs.

Interest expense—net

Interest expense increased \$19.4 million to \$87.2 million in fiscal 2019 compared to \$67.8 million in fiscal 2018. Interest expense consisted of the following:

	Year Ended	
	February 1, 2020	February 2, 2019
	<i>(in thousands)</i>	
Amortization of convertible senior notes debt discount	\$46,245	\$41,868
Finance lease interest expense	22,608	16,785
Term loans	12,135	1,649
Amortization of debt issuance costs and deferred financing fees	4,341	3,640
Promissory notes	3,854	1,566
Asset based credit facility	2,604	4,661
Other interest expense	1,652	1,573
Capitalized interest for capital projects	(4,930)	(3,139)
Interest income	(1,332)	(834)
Total interest expense—net	<u>\$87,177</u>	<u>\$67,769</u>

Goodwill and tradename impairment

We did not recognize goodwill or tradename impairment in fiscal 2019. We incurred a \$32.1 million goodwill and tradename impairment charge in fiscal 2018 for our Waterworks reporting unit. Refer to “Impairment” within Note 3—*Significant Accounting Policies* in our consolidated financial statements within Part II of this Annual Report on Form 10-K.

Loss on extinguishment of debt—net

We incurred \$6.5 million of loss on extinguishment of debt in fiscal 2019 primarily due to a \$6.7 million loss from the repayment in full of the second lien term loan in September 2019, which resulted in a prepayment penalty of \$4.0 million and acceleration of amortization of debt issuance costs of \$2.7 million. In addition, we

recognized a \$1.0 million gain on extinguishment of debt in fiscal 2019 due to the maturity and settlement of the 2019 Notes in June 2019 and a \$0.8 million loss due to accelerated debt issuance costs related to the early repayment of the FILO term loan. We incurred a \$0.9 million loss on extinguishment of debt in fiscal 2018 due to the repayment in full of the LILO term loan, the promissory note secured by our aircraft and the equipment security notes in June 2018, which resulted in accelerated amortization of debt issuance costs of \$0.6 million and a prepayment penalty of \$0.3 million.

Income tax expense

Income tax expense was \$48.8 million in fiscal 2019 compared to \$25.2 million in fiscal 2018. Our effective tax rate was 18.1% in fiscal 2019 compared to 15.7% in fiscal 2018. The effective tax rate was significantly impacted by discrete tax benefits related to net excess tax windfalls from stock-based compensation of \$21.4 million in fiscal 2019 and \$19.0 million in fiscal 2018 resulting from increased option exercise activity and appreciation of our stock price. Additionally, the effective tax rate in fiscal 2018 was impacted by the goodwill impairment for the Waterworks reporting unit.

Fiscal 2018 Compared to Fiscal 2017

Fiscal 2018 includes results for fifty-two weeks and fiscal 2017 includes results for fifty-three weeks.

	Year Ended					
	February 2, 2019			February 3, 2018		
	RH Segment	Waterworks ⁽¹⁾	Total	RH Segment	Waterworks ⁽¹⁾	Total
	<i>(in thousands)</i>					
Net revenues	\$2,375,472	\$130,181	\$2,505,653	\$2,319,332	\$120,842	\$2,440,174
Cost of goods sold	1,441,667	78,409	1,520,076	1,527,602	73,274	1,600,876
Gross profit	933,805	51,772	985,577	791,730	47,568	839,298
Selling, general and administrative expenses	670,767	53,074	723,841	670,473	51,710	722,183
Income (loss) from operations	<u>\$ 263,038</u>	<u>\$ (1,302)</u>	<u>\$ 261,736</u>	<u>\$ 121,257</u>	<u>\$ (4,142)</u>	<u>\$ 117,115</u>

(1) Waterworks results include non-cash amortization of \$0.4 million and \$2.5 million related to the inventory fair value adjustment recorded in connection with our acquisition of Waterworks during fiscal 2018 and fiscal 2017, respectively.

Net revenues

Consolidated net revenues increased \$65.5 million, or 2.7%, to \$2,505.7 million in fiscal 2018 compared to \$2,440.2 million in fiscal 2017.

Consolidated net revenues for fiscal 2018 and fiscal 2017 were negatively impacted by \$4.7 million and \$3.2 million, respectively, related to product recalls. Excluding the product recall adjustments, consolidated net revenues increased \$67.0 million, or 2.7%, to \$2,510.4 million in fiscal 2018 compared to \$2,443.4 million in fiscal 2017. Product recalls and the establishment or adjustment of any related recall accruals can affect our results and cause quarterly fluctuations affecting the period-to-period comparisons of our results. No assurance can be provided that any accruals will be for the appropriate amount, and actual losses could be higher or lower than what we accrue from time to time, which could further affect results.

RH Segment net revenues

RH Segment net revenues increased \$56.1 million, or 2.4%, to \$2,375.5 million in fiscal 2018 compared to \$2,319.3 million in fiscal 2017. The below discussion highlights several significant factors that resulted in increased RH Segment net revenues, which are listed in order of magnitude.

RH Segment core net revenues increased due to timing and an increase in total pages circulated of our Source Book mailings, as well as the introduction of new products and new product categories, including the strong performance of our Outdoor product line in fiscal 2018 as compared to fiscal 2017. In addition, RH Segment core net revenues increased due to an increase in retail weighted-average leased selling square footage related to new store openings, including New York, West Palm Beach, Toronto, Portland, Nashville and Yountville. RH Segment core net revenues also increased during fiscal 2018 due to increased revenues from our Contract business, RH Hospitality operations and Membership. The overall increase in RH Segment core net revenues was partially offset by additional discounts offered on discontinued merchandise related to the optimization of our inventory and SKU rationalization. In addition, we believe that our net revenues were negatively impacted by a decline in sales in the fourth quarter resulting from stock market fluctuations and negative trends in high-end housing.

Outlet sales decreased \$26.7 million in fiscal 2018 compared to fiscal 2017 primarily as a result of our inventory optimization efforts in fiscal 2017 as we increased our outlet promotional activity and offered higher discounts. Similar promotions and discounts were not offered to the same extent in fiscal 2018. This overall decrease was partially offset by an increase of seven outlet locations year over year, resulting in an approximate 15% increase in outlet selling square footage.

RH Segment net revenues decreased approximately \$40.6 million due to fiscal 2017 representing fifty-three weeks of results, whereas fiscal 2018 included fifty-two weeks of results.

RH Segment net revenues for fiscal 2018 and fiscal 2017 were negatively impacted by \$4.7 million and \$3.2 million, respectively, related to product recalls.

Waterworks net revenues

Waterworks net revenues increased \$9.3 million, or 7.7%, to \$130.2 million in fiscal 2018 compared to \$120.8 million in fiscal 2017, primarily due to new product launches, particularly fittings for bath and kitchen. The overall increase in net revenues is partially offset by a decrease in net revenues due to Waterworks fiscal 2017, which included fifty-three weeks of results, whereas fiscal 2018 included fifty-two weeks of results.

Gross profit

Consolidated gross profit increased \$146.3 million, or 17.4%, to \$985.6 million in fiscal 2018 compared to \$839.3 million in fiscal 2017. As a percentage of net revenues, gross margin increased 4.9% to 39.3% of net revenues in fiscal 2018 compared to 34.4% of net revenues in fiscal 2017.

RH Segment gross profit for fiscal 2018 was negatively impacted by \$2.6 million related to acceleration of depreciation due to a change in the estimated useful life of certain assets, \$1.5 million related to costs associated with distribution center closures, \$1.2 million due to inventory impairment related to Holiday merchandise and \$0.6 million related to product recalls.

RH Segment gross profit for fiscal 2017 was negatively impacted by \$7.5 million related to product recalls and \$1.7 million related to costs associated with distribution center closures. RH Segment gross profit for fiscal 2017 was positively impacted by \$2.2 million related to the release of the remaining reserve for potential claims regarding anti-dumping duties which we believe have lapsed.

Waterworks gross profit for fiscal 2018 and fiscal 2017 was negatively impacted by \$0.4 million and \$2.5 million, respectively, of amortization related to the inventory fair value adjustment recorded in connection with the acquisition.

Excluding the accelerated asset depreciation, costs associated with the distribution center closures, inventory impairment, product recall adjustments, release of the anti-dumping duty reserve and impact of the amortization

related to the inventory fair value adjustment mentioned above, consolidated gross margin would have increased 4.8% to 39.5% of net revenues in fiscal 2018 compared to 34.7% of net revenues in fiscal 2017.

RH Segment gross profit

RH Segment gross profit increased \$142.1 million, or 17.9%, to \$933.8 million in fiscal 2018 compared to \$791.7 million in fiscal 2017. As a percentage of net revenues, RH Segment gross margin increased 5.2% to 39.3% of net revenues in fiscal 2018 compared to 34.1% of net revenues in fiscal 2017.

Excluding the accelerated asset depreciation, costs associated with distribution center closures, inventory impairment, product recall adjustments and release of the anti-dumping duty reserve mentioned above, RH Segment gross margin would have increased 5.1% to 39.5% of net revenues in fiscal 2018 compared to 34.4% of net revenues in fiscal 2017. The increase was related to improvements in our core merchandise margins as our SKU rationalization efforts had a reduced impact on our margins this year compared to last year, as well as increased outlet product margins due to higher outlet and warehouse sales during fiscal 2017 driven by increased promotions and higher discounts versus fiscal 2018. In addition, we achieved leverage in our occupancy costs primarily related to our distribution center network redesign, offset by deleverage in retail occupancy costs. The overall increase in gross margin was partially offset by higher delivery costs and our investment in the ramping of our new RH Hospitality locations.

Waterworks gross profit

Waterworks gross profit increased \$4.2 million, or 8.8%, to \$51.8 million in fiscal 2018 compared to \$47.6 million in fiscal 2017. As a percentage of net revenues, Waterworks gross margin increased 0.4% to 39.8% of net revenues in fiscal 2018 compared to 39.4% of net revenues in fiscal 2017.

Excluding the impact of the amortization related to the inventory fair value adjustment mentioned above, Waterworks gross margin would have decreased 1.4% to 40.1% of net revenues in fiscal 2018 compared to 41.5% of net revenues in fiscal 2017. The decrease in gross margin is primarily due to SKU rationalization efforts in fiscal 2018, as well as deleverage in occupancy costs resulting from lower than expected revenue growth.

Selling, general and administrative expenses

Consolidated selling, general and administrative expenses decreased \$1.7 million, or 0.2%, to \$723.8 million in fiscal 2018 compared to \$722.2 million in fiscal 2017.

RH Segment selling, general and administrative expenses

RH Segment selling, general and administrative expenses increased \$0.3 million to \$670.8 million in fiscal 2018 compared \$670.5 million in fiscal 2017.

RH Segment selling, general and administrative expenses for fiscal 2018 included a \$10.0 million charge related to reorganizations primarily due to streamlining and realigning our home office operations, \$8.5 million impairment recorded upon reclassification of an owned Design Gallery as asset held for sale, \$3.4 million related to impairment of the RH Contemporary Art lease, \$1.6 million related to costs associated with distribution center closures and \$1.0 million related to product recalls, partially offset by a favorable \$5.3 million legal settlement, net of related legal expenses.

RH Segment selling, general and administrative expenses for fiscal 2017 included \$23.9 million related to a fully vested option grant made to Mr. Friedman in May 2017, \$5.5 million costs associated with distribution center closures, \$4.4 million related to impairment of the RH Contemporary Art lease, \$0.9 million charge related to a reorganization, \$0.2 million related to product recalls and a gain of \$2.1 million related to the sale of building and land.

Employment and employee related costs, excluding the fully vested option grant to Mr. Friedman, and the severance costs associated with the reorganizations and distribution center closures mentioned above, increased \$10.5 million during fiscal 2018 as compared to fiscal 2017, primarily related to incentive compensation.

Corporate expenses increased \$9.5 million, primarily due to an increase in preopening expense associated with our Design Gallery openings and, to a lesser extent, an increase in credit card fees due to an increase in revenues.

Advertising and marketing costs decreased \$8.9 million primarily due to the adoption of Topic 606 in the first quarter of fiscal 2018, which resulted in the costs associated with Source Books being fully expensed upon delivery to the carrier, as well as the timing of our Source Book mailings.

RH Segment selling, general and administrative expenses were 27.4% and 27.5% of net revenues for fiscal 2018 and fiscal 2017, respectively, excluding reorganizations, asset impairments, costs associated with distribution center closures, product recall adjustments, legal settlement, the fully vested option grant made to Mr. Friedman in May 2017 and the gain related to the sale of building and land mentioned above. The decrease in selling, general and administrative expenses as a percentage of net revenues was primarily driven by advertising and marketing, partially offset by preopening expense associated with our Design Gallery openings.

Waterworks selling, general and administrative expenses

Waterworks selling, general and administrative expenses increased \$1.4 million, or 2.6%, to \$53.1 million in fiscal 2018 compared to \$51.7 million in fiscal 2017. Waterworks selling, general and administrative expenses were 40.8% and 42.8% of net revenues in fiscal 2018 and fiscal 2017, respectively. The decrease in selling, general and administrative expenses as a percentage of net revenues was primarily driven by leverage in corporate costs.

Interest expense—net

Interest expense increased \$11.8 million to \$67.8 million in fiscal 2018 compared to \$56.0 million in fiscal 2017. Interest expense consisted of the following:

	Year Ended	
	February 2, 2019	February 3, 2018
	<i>(in thousands)</i>	
Amortization of convertible senior notes debt discount	\$41,868	\$30,457
Finance lease interest expense	16,785	11,154
Asset based credit facility	4,661	5,726
Amortization of debt issuance costs and deferred financing fees	3,640	4,705
Term loans	1,649	4,526
Promissory notes	1,566	1,691
Other interest expense	1,573	1,561
Capitalized interest for capital projects	(3,139)	(3,304)
Interest income	(834)	(514)
Total interest expense—net	<u>\$67,769</u>	<u>\$56,002</u>

Goodwill and tradename impairment

We incurred a \$32.1 million goodwill and tradename impairment charge in fiscal 2018 and a \$33.7 million goodwill impairment charge in fiscal 2017 for our Waterworks reporting unit. Refer to “Impairment” within Note 3—*Significant Accounting Policies* in our consolidated financial statements within Part II of this Annual Report on Form 10-K.

Loss on extinguishment of debt—net

We incurred a \$0.9 million loss on extinguishment of debt in fiscal 2018 due to the repayment in full of the LILO term loan, the promissory note secured by our aircraft and the equipment security notes in June 2018, which includes acceleration of amortization of debt issuance costs of \$0.6 million and a prepayment penalty of \$0.3 million. We incurred a \$4.9 million loss on extinguishment of debt in fiscal 2017 due to the repayment in full of the second lien term loan in October 2017, which resulted in a prepayment penalty of \$3.0 million and accelerated amortization of debt issuance costs of \$1.9 million.

Income tax expense

Income tax expense was \$25.2 million in fiscal 2018 compared to \$25.1 million in fiscal 2017. Our effective tax rate was 15.7% in fiscal 2018 compared to 111.5% in fiscal 2017. The effective tax rate in fiscal 2018 was significantly impacted by discrete tax benefits related to net excess tax windfalls from stock-based compensation of \$19.0 million resulting from increased option exercise activity and appreciation of the stock price, was impacted by the goodwill impairment for the Waterworks reporting unit. The effective tax rate in fiscal 2017 was significantly impacted by non-deductible stock-based compensation related to the May 2017 grant to Mr. Friedman of an option to purchase 1,000,000 shares of the Company's common stock. Refer to "Chairman and Chief Executive Officer Option Grant" within Note 16—*Stock-Based Compensation* in our consolidated financial statements within Part II of this Annual Report on Form 10-K. In addition, the effective tax rate in fiscal 2017 was impacted by tax reform and the Waterworks reporting unit goodwill impairment. The fiscal 2017 effective tax rate was favorably impacted by net excess tax benefits from stock-based compensation of \$7.0 million.

The United States enacted the Tax Cuts and Jobs Act (the "Tax Act") on December 22, 2017. The new legislation contains several key tax provisions that affect us and, as required, we have included reasonable estimates of the income tax effects of the changes in tax law and tax rate in our fiscal 2017 financial results. Since the Tax Act was passed in the fourth quarter of fiscal 2017, we considered the accounting for the transition tax, deferred tax re-measurements, and other items to be provisional. We finalized our estimates within the one-year measurement period allowed by the SEC and completed our accounting for the tax effects of enactment of the Tax Act.

Our provision for income taxes in fiscal 2017 included \$7.1 million of income tax expense as a result of the Tax Act, including \$6.1 million for the provisional re-measurement of our net deferred tax assets for the reduction in the U.S. corporate income tax rate from 35% to 21% and a \$1.0 million charge for our provisional estimate of the transition tax. We completed our accounting for re-measurement of our deferred tax assets and recorded \$0.5 million of income tax expense as a result. No additional income tax expense or benefit was recorded relating to the completion of our transition tax liability.

Quarterly Results

The following table sets forth our historical quarterly consolidated statements of operations for each of the last eight fiscal quarters ended through February 1, 2020. This quarterly information has been prepared on the same basis as our annual audited financial statements and includes all adjustments that we consider necessary to fairly state the financial information for the fiscal quarters presented. The quarterly data should be read in conjunction with our consolidated financial statements and the related notes included in *Item 8—Financial Statements and Supplementary Data*.

Our quarterly results vary depending upon a variety of factors, including our product offerings, store openings, shifts in the timing of holidays, the timing of Source Book releases and promotional events, among other things. As a result of these factors, our working capital requirements and demands on our product distribution and delivery network may fluctuate during the year and results of a period shorter than a full year may not be indicative of results expected for the entire year.

	Fiscal 2018				Fiscal 2019			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
	(in thousands)							
Net revenues	\$557,406	\$640,798	\$636,558	\$670,891	\$598,421	\$706,514	\$677,526	\$664,976
Cost of goods sold	348,073	372,454	386,537	413,012	365,607	411,556	393,360	381,903
Gross profit	209,333	268,344	250,021	257,879	232,814	294,958	284,166	283,073
Selling, general and administrative expenses	161,186	186,521	207,793	168,341	164,181	190,977	194,929	182,093
Income from operations	48,147	81,823	42,228	89,538	68,633	103,981	89,237	100,980
Other expenses								
Interest expense—net	15,098	15,467	17,695	19,509	21,118	24,513	21,564	19,982
Goodwill and tradename impairment	—	—	—	32,086	—	—	—	—
Loss (gain) on extinguishment of debt	—	917	—	—	—	(954)	6,857	569
Total other expenses	15,098	16,384	17,695	51,595	21,118	23,559	28,421	20,551
Income before income taxes	33,049	65,439	24,533	37,943	47,515	80,422	60,816	80,429
Income tax expense	7,588	2,533	4,419	10,693	11,793	16,665	8,353	11,996
Net income	\$ 25,461	\$ 62,906	\$ 20,114	\$ 27,250	\$ 35,722	\$ 63,757	\$ 52,463	\$ 68,433
Adjusted net income ⁽¹⁾	\$ 32,652	\$ 54,509	\$ 43,184	\$ 73,973	\$ 48,241	\$ 71,430	\$ 65,446	\$ 91,180
Adjusted EBITDA ⁽²⁾	\$ 77,740	\$103,054	\$ 87,755	\$131,518	\$100,385	\$133,716	\$116,312	\$145,005

(1) Adjusted net income is a supplemental measure of financial performance that is not required by, or presented in accordance with, GAAP. We define adjusted net income as consolidated net income, adjusted for the impact of certain non-recurring and other items that we do not consider representative of our underlying operating performance. Adjusted net income is included in this filing because management believes that adjusted net income provides meaningful supplemental information for investors regarding the performance of our business and facilitates a meaningful evaluation of actual results on a comparable basis with historical results. Our management uses this non-GAAP financial measure in order to have comparable financial results to analyze changes in our underlying business from quarter to quarter. The following table presents a reconciliation of net income, the most directly comparable GAAP financial measure, to adjusted net income for the periods indicated below.

	Fiscal 2018				Fiscal 2019			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
	(in thousands)							
Net income	\$25,461	\$ 62,906	\$20,114	\$27,250	\$35,722	\$63,757	\$52,463	\$68,433
Adjustments pre-tax:								
Amortization of debt discount ^(a)	7,272	9,000	11,283	11,661	11,689	9,918	9,638	11,300
Asset impairments and lease losses ^(b)	—	—	3,411	3,807	3,476	2,545	1,031	14,847
Loss (gain) on extinguishment of debt ^(c)	—	917	—	—	—	(954)	6,857	569
Reorganization related costs ^(d)	—	1,721	7,564	692	—	—	1,075	—
Recall accrual ^(e)	(254)	(1,064)	3,986	(1,049)	(1,615)	(320)	(2,053)	—
Asset held for sale loss (gain) ^(f)	—	—	—	8,497	—	—	(1,529)	—
Legal settlements ^(g)	1,915	(7,204)	—	—	—	(1,193)	—	—
Goodwill and tradename impairment ^(h)	—	—	—	32,086	—	—	—	—
Distribution center closures ⁽ⁱ⁾	(840)	—	3,886	—	—	—	—	—
Impact of inventory step-up ^(j)	190	190	—	—	—	—	—	—
Subtotal adjusted items	8,283	3,560	30,130	55,694	13,550	9,996	15,019	26,716
Impact of income tax items ^(k)	(1,092)	(11,957)	(7,060)	(8,971)	(1,031)	(2,323)	(2,036)	(3,969)
Adjusted net income	\$32,652	\$ 54,509	\$43,184	\$73,973	\$48,241	\$71,430	\$65,446	\$91,180

- (a) Under GAAP, certain convertible debt instruments that may be settled in cash on conversion are required to be separately accounted for as liability and equity components of the instrument in a manner that reflects the issuer's non-convertible debt borrowing rate. Accordingly, in accounting for GAAP purposes for the \$350 million aggregate principal amount of convertible senior notes that were issued in June 2014 (the "2019 Notes"), for the \$300 million aggregate principal amount of convertible senior notes that were issued in June and July 2015 (the "2020 Notes"), for the \$335 million aggregate principal amount of convertible senior notes that were issued in June 2018 (the "2023 Notes") and for the \$350 million aggregate principal amount of convertible senior notes that were issued in September 2019 (the "2024 Notes"), we separated the 2019 Notes, 2020 Notes, 2023 Notes and 2024 Notes into liability (debt) and equity (conversion option) components and we are amortizing as debt discount an amount equal to the fair value of the equity components as interest expense on the 2019 Notes, 2020 Notes, 2023 Notes and 2024 Notes over their expected lives. The equity components represent the difference between the proceeds from the issuance of the 2019 Notes, 2020 Notes, 2023 Notes and 2024 Notes and the fair value of the liability components of the 2019 Notes, 2020 Notes, 2023 Notes and 2024 Notes, respectively. Amounts are presented net of interest capitalized for capital projects of \$0.6 million, \$0.8 million, \$0.7 million and \$0.6 million during the first, second, third and fourth quarters of fiscal 2018, respectively. Amounts are presented net of interest capitalized for capital projects of \$0.7 million, \$0.7 million, \$0.9 million and \$1.4 million during the first, second, third and fourth quarters of fiscal 2019, respectively. The 2019 Notes matured on June 15, 2019 and did not impact amortization of debt discount post-maturity.
- (b) The adjustment in the third quarter of fiscal 2018 represents an RH Contemporary Art lease impairment, resulting from an update to both the timing and the amount of future estimated lease related cash inflows. The adjustment in the fourth quarter of fiscal 2018 includes acceleration of depreciation expense of \$2.6 million due to a change in the estimated useful life of certain assets and a \$1.2 million inventory impairment charge related to holiday merchandise. The adjustment in the first quarter of fiscal 2019 includes acceleration of depreciation expense of \$3.0 million due to a change in the estimated useful lives of certain assets and a \$0.5 million charge related to the termination of a service agreement associated with such assets. The adjustment in the second quarter of fiscal 2019 includes acceleration of depreciation expense of \$1.9 million due to a change in the estimated useful

lives of certain assets and lease impairments of \$0.7 million due to early exit of leased facilities. The adjustment in the third quarter of fiscal 2019 includes lease impairments of \$0.8 million due to early exit of leased facilities and asset impairments of \$0.2 million. The adjustment in the fourth quarter of fiscal 2019 includes asset impairments of \$8.9 million, an RH Contemporary Art lease impairment of \$4.6 million and acceleration of depreciation expense of \$1.3 million due to a change in the estimated useful lives of certain assets.

- (c) The adjustment in the second quarter of fiscal 2018 represents the loss on extinguishment of debt related to the LILO term loan, the promissory note secured by our aircraft and the equipment security notes, all of which were repaid in full in June 2018. The adjustment in the second quarter of fiscal 2019 represents the gain on extinguishment of debt upon the maturity and settlement of the 2019 Notes in June 2019. The adjustment in the third quarter of fiscal 2019 includes the loss on extinguishment of debt related to a second lien term loan which was repaid in full in September 2019. The adjustments in the third and fourth quarters of fiscal 2019 include the acceleration of debt issuance costs related to early repayment of the FILO term loan.
 - (d) Represents severance costs and related taxes associated with reorganizations.
 - (e) Represents adjustments to net revenues, cost of goods sold and inventory charges associated with product recalls, as well as accrual adjustments, and vendor and insurance claims.
 - (f) The adjustment in the fourth quarter of fiscal 2018 represents the loss recorded upon reclassification of an owned Design Gallery as held for sale. The adjustment in the third quarter of fiscal 2019 represents a gain on real estate related to asset previously classified as held for sale and other land sales.
 - (g) Represents legal settlements, net of related legal expenses.
 - (h) Represents goodwill and tradename impairment related to the Waterworks reporting unit. Refer to “Impairment” within Note 3—*Significant Accounting Policies* in our consolidated financial statements within Part II of this Annual Report on Form 10-K.
 - (i) Represents disposals of inventory and property and equipment, lease related charges, inventory transfer costs and other costs associated with distribution center closures.
 - (j) Represents the non-cash amortization of the inventory fair value adjustment recorded in connection with our acquisition of Waterworks.
 - (k) The adjustment in the third and fourth quarters of fiscal 2019 represents the tax effect of the adjusted items based on our effective tax rates of 13.7% and 14.9%, respectively. The first and second quarters of fiscal 2019 and all quarters in fiscal 2018 assume a normalized tax rate of 21%.
- (2) EBITDA and Adjusted EBITDA are supplemental measures of financial performance that are not required by, or presented in accordance with, GAAP. We define EBITDA as consolidated net income before depreciation and amortization, interest expense—net and income tax expense. Adjusted EBITDA reflects further adjustments to EBITDA to eliminate the impact of non-cash compensation, as well as certain non-recurring and other items that we do not consider representative of our underlying operating performance. EBITDA and Adjusted EBITDA are included in this filing because management believes that these metrics provide meaningful supplemental information for investors regarding the performance of our business and facilitate a meaningful evaluation of operating results on a comparable basis with historical results. Our management uses these non-GAAP financial measures in order to have comparable financial results to analyze changes in our underlying business from quarter to quarter. Our measures of EBITDA and Adjusted EBITDA are not necessarily comparable to other similarly titled captions for other companies due to different methods of calculation. The following table presents a reconciliation of net income, the most directly comparable GAAP financial measure, to EBITDA and Adjusted EBITDA for the periods indicated below.

	Fiscal 2018				Fiscal 2019			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
	(in thousands)							
Net income	\$25,461	\$ 62,906	\$20,114	\$ 27,250	\$ 35,722	\$ 63,757	\$ 52,463	\$ 68,433
Depreciation and amortization	20,585	21,354	22,995	26,438	27,189	25,321	23,435	24,794
Interest expense—net	15,098	15,467	17,695	19,509	21,118	24,513	21,564	19,982
Income tax expense	7,588	2,533	4,419	10,693	11,793	16,665	8,353	11,996
EBITDA	68,732	102,260	65,223	83,890	95,822	130,256	105,815	125,205
Non-cash compensation ^(a)	7,997	6,234	3,685	6,206	5,695	5,298	5,116	5,723
Asset impairment and lease losses ^(b)	—	—	3,411	1,196	483	629	1,031	13,508
Loss (gain) on extinguishment of debt ^(b)	—	917	—	—	—	(954)	6,857	569
Reorganization related costs ^(b)	—	1,721	7,564	692	—	—	1,075	—
Recall accrual ^(b)	(254)	(1,064)	3,986	(1,049)	(1,615)	(320)	(2,053)	—
Asset held for sale loss (gain) ^(b)	—	—	—	8,497	—	—	(1,529)	—
Legal settlements ^(b)	1,915	(7,204)	—	—	—	(1,193)	—	—
Goodwill and tradename impairment ^(b)	—	—	—	32,086	—	—	—	—
Distribution center closures ^(b)	(840)	—	3,886	—	—	—	—	—
Impact of inventory step-up ^(b)	190	190	—	—	—	—	—	—
Adjusted EBITDA	\$77,740	\$103,054	\$87,755	\$131,518	\$100,385	\$133,716	\$116,312	\$145,005

(a) Represents non-cash compensation related to equity awards granted to employees.

(b) Refer to the reconciliation of net income to adjusted net income table above and the related footnotes for additional information.

Liquidity and Capital Resources

General

The primary cash needs of our business have historically been for merchandise inventories, payroll, Source Books, store rent, capital expenditures associated with opening new stores and updating existing stores, as well as the development of our infrastructure and information technology. We seek out and evaluate opportunities for effectively managing and deploying capital in ways that improve working capital and support and enhance our business initiatives and strategies. In fiscal 2017, we completed two share repurchase programs in an aggregate amount of \$1 billion. A \$300 million share repurchase was completed during the first quarter of fiscal 2017 and a \$700 million share repurchase was completed during the second quarter of fiscal 2017. In October 2018, our Board of Directors approved a new \$700 million share repurchase program, of which \$250 million in share repurchases were completed in fiscal 2018, and the \$700 million authorization amount was replenished by the Board of Directors in March 2019. During the first quarter of fiscal 2019, we repurchased approximately 2.2 million shares of our common stock for an aggregate repurchase amount of approximately \$250 million, with \$450 million still available under the \$700 million repurchase program. Refer to “Share Repurchase Programs” below. We evaluate our capital allocation from time to time and may engage in future share repurchases in circumstances where buying shares of our common stock represents a good value and provides a favorable return for our shareholders.

We have \$985 million in aggregate principal amount of convertible notes outstanding as of February 1, 2020, of which \$300 million mature in July 2020, \$335 million mature in June 2023 and \$350 million mature in September 2024. The \$300 million principal amount of convertible notes that we issued in fiscal 2015 mature on July 15, 2020 and are convertible through the close of business on the second scheduled trading day immediately

preceding July 15, 2020. We expect to repay the \$300 million outstanding principal amount of the convertible notes in cash, whether in connection with a conversion of such notes or repayment at maturity in July 2020. We also expect to repay the outstanding principal amount of our other convertible notes at maturity in June 2023 and September 2024 in cash, in each case to minimize dilution. While we anticipate using excess cash, free cash flow and borrowings on our asset based credit facility to repay the convertible notes in cash to minimize dilution, we may need to pursue additional sources of liquidity to repay such convertible notes in cash at their respective maturity dates or upon early conversion, as applicable. There can be no assurance as to the availability of capital to fund such repayments, or that if capital is available through additional debt issuances or refinancing of the convertible notes, that such capital will be available on terms that are favorable to us.

Our business has relied on cash flows from operations, net cash proceeds from the issuance of the convertible senior notes, as well as borrowings under our credit facilities as our primary sources of liquidity. Our liquidity will be impacted by the outbreak of COVID-19. In response to the public health crisis posed by COVID-19, effective from March 17, 2020, the Company temporarily closed its retail locations for an indeterminate period of time. Although we continue to serve our customers virtually through our Gallery representatives and designers, as well as our online websites, our business operations are being substantially affected by applicable regulatory restrictions including stay-at-home requirements applicable in California where our corporate headquarters is located. Our decision to reopen retail locations will be affected by a number of factors including applicable regulatory restrictions and there is substantial uncertainty regarding the manner and timing in which we can return some or all of our business to more normal business operations. We may face longer term closure requirements and other operational restrictions with respect to some or all of our physical locations for prolonged periods of time due to, among other factors, evolving and increasingly stringent federal, state and local restrictions including shelter-in-place orders. Even once we are able to reopen closed physical locations, changes in consumer behavior and health concerns may continue to impact consumer demand for our products and customer traffic at our Galleries, restaurants and outlets and may make it more difficult to staff our business operations. As a result of these developments, the Company expects an unfavorable impact on its sales, results of operations and cash flows in fiscal 2020. In addition, our near term decisions regarding the sources and uses of capital in our business will reflect and adapt to changes in market conditions and disruption in our business related to COVID-19.

In response to the impact of COVID-19, we are implementing a number of measures to minimize cash outlays, including managing workforce costs, delaying planned capital expenditures, deferring new business introductions, adjusting the timing and circulation of Source Books and minimizing discretionary expenses. We also intend to negotiate with third parties to whom we have payment obligations. These negotiations may include changes in the cadence of payments to vendors, modifications to rent and other obligations. We plan to utilize our asset based credit facility, and we may pursue other sources of capital that may include other forms of external financing, in order to increase our cash position and preserve financial flexibility in response to the uncertainty in the United States and global markets resulting from COVID-19. We had outstanding borrowings under our asset based credit facility of \$35.0 million as of March 27, 2020 and the amount under the revolving line of credit borrowing base that could be available pursuant to the asset based credit facility was \$307.9 million, net of \$13.2 million in outstanding letters of credit. We believe that these actions mitigate risks arising from COVID-19 and will be sufficient to repay our debt obligations as they become due, meet working capital requirements and fulfill other capital needs for more than the next 12 months.

Our decision to reopen retail locations will be affected by a number of factors including applicable regulatory restrictions and there is substantial uncertainty regarding the manner and timing in which we can return to normal business operations. The precise impact on our business from the disruption of financial markets and the weakening of overall economic conditions is unknown.

We extended and amended our asset based credit facility in June 2017, which has a total availability of \$600 million, of which \$10 million is available to Restoration Hardware Canada, Inc., and includes a \$200 million accordion feature under which the revolving line of credit may be expanded by agreement of the

parties from \$600 million to up to \$800 million if and to the extent the lenders revise their credit commitments to encompass a larger facility. The revolving line of credit has a maturity date of June 28, 2022.

During the first quarter of fiscal 2017, we received cash of \$4.9 million for the sale of an aircraft, net of \$0.3 million of costs to dispose of the aircraft, which was classified as an asset held for sale, and during the second quarter of fiscal 2017 we received cash of \$10.2 million for the sale of a real estate parcel that we owned on which one of our retail Galleries was located, which was classified as an asset held for sale. During the third quarter of fiscal 2019, we executed a sale-leaseback transaction for the Yountville Design Gallery for sales proceeds of \$23.5 million, which qualified for sale-leaseback accounting in accordance with ASC 842. We may pursue strategies in the future, through the use of existing assets and debt facilities, or through the pursuit of new external sources of liquidity and debt financing, to fund our strategies to enhance stockholder value. There can be no assurance that additional capital, whether raised through the sale of assets, utilization of our existing debt financing sources, or pursuit of additional debt financing sources, will be available to us on a timely manner, on favorable terms or at all. To the extent we pursue additional debt as a source of liquidity, our capitalization profile may change and may include significant leverage, and as a result we may be required to use future liquidity to repay such indebtedness and may be subject to additional terms and restrictions which affect our operations and future uses of capital.

In addition, our capital needs may change in the future due to changes in our business or new opportunities that we choose to pursue. We have invested significant capital expenditures in remodeling and opening new Design Galleries, and these capital expenditures have increased in the past and may continue to increase in future periods as we open additional Design Galleries, which may require us to undertake upgrades to historical buildings or construction of new buildings. We anticipate substantial reductions to the level of our fiscal 2020 capital expenditures in response to the change in business conditions as a result of the global health crisis from COVID-19, but the exact scope of changes in our capital plans is evolving and will depend on a variety of factors.

Our adjusted net capital expenditures include (i) capital expenditures from investing activities and (ii) cash outflows of capital related to construction activities to design and build landlord leased assets, net of tenant allowances received. Adjusted net capital expenditures in fiscal 2019 were \$157.9 million, inclusive of cash received related to landlord tenant allowances of \$28.3 million, and we had proceeds from sales of real estate assets of \$24.1 million.

Certain lease arrangements require the landlord to fund a portion of the construction related costs through payments directly to us. Other lease arrangements for our new Design Galleries require the landlord to fund a portion of the construction related costs directly to third parties, rather than through traditional construction allowances and accordingly, under these arrangements we do not expect to receive contributions directly from our landlords related to the building of our Design Galleries. As we develop new Galleries, as well as other potential strategic initiatives in the future like our integrated hospitality experience, we may explore other models for our real estate, which could include longer lease terms or further purchases of, or joint ventures or other forms of equity ownership in, real estate interests associated with new sites and buildings. These approaches might require greater capital investment on our part than a traditional store lease with a landlord. We also believe there is an opportunity to transition our real estate strategy from a leasing model to a development model, where we potentially buy and develop our Design Galleries then recoup the investments through a sale-leaseback arrangement resulting in lower capital investment and lower rent. In the event that such capital and other expenditures require us to pursue additional funding sources, we can provide no assurances that we will be successful in securing additional funding on attractive terms or at all. In addition, the effects of COVID-19 on our business, including decisions by us to curtail the deployment of capital and due to actions taken by federal, state and local government authorities, and in some instances mall and shopping center owners, in response to the outbreak, may require changes to our real estate strategy and related capital expenditure and financing plans. For example, we may be required to suspend or defer planned construction projects and Gallery openings and delay expansions into new markets including our anticipated international expansion. In addition, we may continue to

be required to make lease payments in whole or in part for our Galleries, restaurants and outlets that have been closed. Our efforts to mitigate the costs of construction delays and deferrals, store closures and other operational difficulties resulting from COVID-19, including negotiating with landlords and other third parties regarding the timing and amount of payments under existing contractual arrangements, may not be successful, and as a result, our real estate strategy may have ongoing significant liquidity needs even as we scale back our operations and expansion cadence.

There can be no assurance that we will have sufficient financial resources, or will be able to arrange financing on favorable terms to the extent necessary to fund all of our initiatives, or that sufficient incremental debt will be available to us in order to fund our cash payments in respect of the repayment of our outstanding convertible senior notes in an aggregate principal amount of \$985 million at maturity of such senior convertible notes. In addition, agreements governing existing or new debt facilities may restrict our ability to operate our business in the manner we currently expect or to make required payments with respect to existing commitments including the repayment of the principal amount of our convertible senior notes in cash upon maturity of such senior notes. To the extent we need to seek waivers from any provider of debt financing, or we fail to observe the covenants or other requirements of existing or new debt facilities, any such event could have an impact on our other commitments and obligations including triggering cross defaults or other consequences with respect to other indebtedness. Our current level of indebtedness, and any additional indebtedness that we may incur, exposes us to certain risks with regards to interest rate increases and fluctuations. Our ability to make interest payments or to refinance any of our indebtedness to manage such interest rates may be limited or negatively affected by credit market conditions, macroeconomic trends and other risks.

Given the fast moving nature of the COVID-19 health crisis, and the corresponding impact on financial markets and the economy as a whole, there is an enhanced degree of uncertainty regarding the Company's capital position and availability of capital to fund the Company's liquidity requirements. In recognition of the significant threat to the liquidity of financial markets posed by COVID-19, the Federal Reserve and Congress have taken dramatic actions to provide liquidity to businesses and the banking system in the U.S. For example, on March 27, 2020, the President signed into law the Coronavirus Aid, Relief, and Economic Security Act (the "CARES Act"), a sweeping stimulus bill intended to bolster the U.S. economy, among other things, and provide emergency assistance to qualifying businesses and individuals. There can be no assurance that these interventions by the government will be successful, and the financial markets may experience significant contractions in available liquidity. While the Company may receive financial, tax or other relief and other benefits under and as a result of the CARES Act, it is not possible to estimate at this time the availability, extent or impact of any such relief. In addition, store closures and other operational difficulties faced by the Company may negatively affect the Company's financial condition and restrict the availability of liquidity for its operational needs, including due to, among other reasons, increased and unforeseeable liquidity needs and limited flexibility to control expenses in line with potential decreases in revenue. Any further weakening of, or other adverse developments in, the U.S. or global credit markets could affect our ability to manage our debt obligations and our ability to access future debt. We cannot assure you that we will be able to raise necessary funds on favorable terms, if at all, or that future financing requirements would not require us to raise money through an equity financing or by other means that could be dilutive to holders of our capital stock. If we fail to raise sufficient additional funds, we may be required to delay or abandon some of our planned future expenditures or aspects of our current operations.

Cash Flow Analysis

A summary of operating, investing, and financing activities is set forth in the following table:

	Year Ended		
	February 1, 2020	February 2, 2019	February 3, 2018
		(in thousands)	
Provided by operating activities	\$ 339,188	\$ 249,603	\$ 474,505
Provided by (used in) investing activities	(122,545)	(79,992)	122,531
Used in financing activities	(174,804)	(188,992)	(686,941)
Increase (decrease) in cash and cash equivalents and restricted cash equivalents	41,855	(19,511)	(89,753)
Cash and cash equivalents and restricted cash equivalents at end of period	47,658	5,803	25,314

Net Cash Provided By Operating Activities

Operating activities consist primarily of net income adjusted for non-cash items including depreciation and amortization, impairments, stock-based compensation, amortization of debt discount and the effect of changes in working capital and other activities.

For fiscal 2019, net cash provided by operating activities was \$339.2 million and consisted of net income of \$220.4 million and non-cash items of \$199.3 million, partially offset by a decrease in cash used for working capital and other activities of \$80.5 million. Working capital and other activities consisted primarily of decreases in operating lease liabilities of \$77.0 million primarily due to payments made under the agreements, increases in landlord assets under construction of \$64.3 million, and decreases in other current liabilities and other non-current obligations of \$45.8 million and \$25.1 million, respectively. These decreases to working capital were partially offset by decreases in merchandise inventories of \$93.3 million and decreases in prepaid expenses and other current assets of \$28.4 million.

For fiscal 2018, net cash provided by operating activities was \$249.6 million and consisted of net income of \$135.7 million and non-cash items of \$296.5 million, partially offset by an increase in cash used for working capital and other activities of \$182.6 million. Working capital and other activities consisted primarily of increases in prepaid expenses and other current assets of \$88.4 million related to (i) adoption of Topic 606, (ii) vendor deposits and (iii) federal and state tax receivables due to prepayments, decreases in operating lease liabilities of \$70.9 million, increases in landlord assets under construction of \$59.0 million and decreases in other non-current obligations of \$18.1 million. These decreases to working capital were partially offset by increases in other current liabilities of \$51.2 million.

For fiscal 2017, net cash provided by operating activities was \$474.5 million and consisted of non-cash items of \$317.4 million and an increase in cash provided by working capital and other activities of \$159.7 million, partially offset by a net loss of \$2.6 million. Working capital and other activities consisted primarily of decreases in inventory of \$220.8 million due to our SKU rationalization initiative, outlet inventory optimization efforts and revised supply chain strategy, increases in accounts payable and accrued liabilities of \$65.1 million related to timing of payments, and decreases in prepaid expenses and other current assets of \$27.9 million. These increases to working capital were partially offset by increases in landlord assets under construction of \$81.1 million and decreases in operating lease liabilities of \$70.5 million.

Net Cash Provided By (Used In) Investing Activities

Investing activities consist primarily of investments in capital expenditures related to investments in retail stores, information technology and systems infrastructure, as well as supply chain investments. In addition, investing activities include proceeds from assets held for sale and activities associated with investing in available-for-sale securities.

For fiscal 2019, net cash used in investing activities was \$122.5 million, of which \$93.6 million primarily related to investments in retail stores, information technology and systems infrastructure, and supply chain investments. In addition, we made deposits on an asset under construction of \$53.0 million, offset by net proceeds from the sale of building and land of \$24.1 million.

For fiscal 2018, net cash used in investing activities was \$80.0 million due to investments in retail stores, information technology and systems infrastructure, and supply chain investments.

For fiscal 2017, net cash provided by investing activities was \$122.5 million primarily as a result of sales of investments and maturities of investments of \$145.0 million and \$46.9 million, respectively, the proceeds of which were used to fund the share repurchases made under the \$300 Million Repurchase Program. In addition, we had net proceeds from the sale of building and land and the sale of an aircraft of \$10.2 million and \$4.9 million, respectively. These increases to cash were partially offset by investments in retail stores, information technology and systems infrastructure, and supply chain investments of \$68.4 million, as well as purchases of investments in available-for-sale securities of \$16.1 million.

Net Cash Used In Financing Activities

Financing activities consist primarily of borrowings related to convertible senior notes, credit facilities and other financing arrangements, as well as share repurchases, principal payments under finance lease agreements and other equity related transactions.

For fiscal 2019, net cash used in financing activities was \$174.8 million. The \$350.0 million 2019 Notes matured in June 2019, of which \$278.6 million is presented within net cash used in financing activities and \$70.5 million is reflected as non-cash accretion of debt discount upon settlement of debt presented in net cash provided by operating activities. Net cash used in financing activities included repurchases of approximately 2.2 million shares of our common stock for an aggregate repurchase amount of \$250.0 million, as well as net repayments of \$57.5 million under the asset based credit facility. Net cash used in financing activities included borrowings under a \$350.0 million convertible senior notes agreement issued in September 2019, which provided net proceeds of \$304.1 million after taking into consideration the convertible note hedge and warrant transactions, as well as discounts upon original issuance and offering costs. Net repayments under the term loan facilities (as defined below) were \$4.0 million, and net borrowings under promissory and equipment notes of \$105.5 million were comprised of \$52.5 million of promissory notes secured by certain equipment and \$53.0 million related to promissory notes on asset under construction. Equity related transactions provided \$20.1 million due to \$27.1 million of proceeds from exercise of employee stock options, partially offset by \$7.1 million of cash paid for employee taxes related to net settlement of equity awards. Principal payments under finance lease agreements totaled \$9.7 million.

For fiscal 2018, net cash used in financing activities was \$189.0 million primarily due to net repayments of debt of \$254.4 million under the asset based credit facility, LILO term loan, equipment loans and promissory note secured by our aircraft, as well as due to \$250 million of share repurchases made under the \$950 Million Repurchase Program. The repayments of debt described above were partially funded by the \$335 million convertible senior notes issued in June 2018, which provided net proceeds of \$287.8 million after taking into consideration the convertible note hedge and warrant transactions, as well as discounts upon original issuance and offering costs. Equity related transactions provided \$34.5 million due to \$44.0 million of proceeds from exercise of employee stock options, partially offset by \$9.5 million of cash paid for employee taxes related to net settlement of equity awards. Principal payments under finance lease agreements totaled \$6.9 million.

For fiscal 2017, net cash used in financing activities was \$686.9 million primarily due to \$1.0 billion of share repurchases made under the \$300 Million Repurchase Program and \$700 Million Repurchase Program. Cash funding for the share repurchase programs was provided by available cash balances, net borrowings under the asset based credit facility of \$200.0 million, as well as net borrowings under the term loans of \$77.0 million

and net borrowings under promissory and equipment notes of \$31.7 million. Equity related transactions provided \$19.1 million due to \$24.9 million of proceeds from exercise of employee stock options, partially offset by \$5.8 million of cash paid for employee taxes related to net settlement of equity awards. Principal payments under finance lease agreements totaled \$6.1 million.

Non-Cash Transactions

Non-cash transactions consist of non-cash additions of property and equipment and landlord assets, reclassification of assets from landlord assets under construction to finance lease right-of-use assets and issuance of non-current notes payable related to share repurchases from former employees.

Convertible Senior Notes

0.00% Convertible Senior Notes due 2024

In September 2019, we issued in a private offering \$300 million principal amount of 0.00% convertible senior notes due 2024 and issued an additional \$50 million principal amount in connection with the overallotment option granted to the initial purchasers as part of the offering (collectively, the “2024 Notes”). The 2024 Notes are governed by the terms of an indenture between the Company and U.S. Bank National Association, as the Trustee. The 2024 Notes will mature on September 15, 2024, unless earlier purchased by us or converted. The 2024 Notes will not bear interest, except that the 2024 Notes will be subject to “special interest” in certain limited circumstances in the event of our failure to perform certain of our obligations under the indenture governing the 2024 Notes. The 2024 Notes are unsecured obligations and do not contain any financial covenants or restrictions on the payments of dividends, the incurrence of indebtedness or the issuance or repurchase of securities by us or any of our subsidiaries. Certain events are also considered “events of default” under the 2024 Notes, which may result in the acceleration of the maturity of the 2024 Notes, as described in the indenture governing the 2024 Notes. Events of default under the indenture for the 2024 Notes include, among other things, the occurrence of an event of default by us as defined under any mortgage, indenture or instrument under which there may be issued, or by which there may be secured or evidenced, any indebtedness of the Company or any of its significant subsidiaries for money borrowed, if that event of default (i) constitutes the failure to pay when due indebtedness in the aggregate principal amount in excess of \$20 million and (ii) such event of default continues for a period of 30 days after written notice is delivered to the Company by the Trustee or to the Company and the Trustee by the holders of at least 25% of the aggregate principal amount of the 2024 Notes then outstanding.

The initial conversion rate applicable to the 2024 Notes is 4.7304 shares of common stock per \$1,000 principal amount of 2024 Notes, which is equivalent to an initial conversion price of approximately \$211.40 per share. The conversion rate will be subject to adjustment upon the occurrence of certain specified events, but will not be adjusted for any accrued and unpaid special interest. In addition, upon the occurrence of a “make-whole fundamental change” as defined in the indenture, we will, in certain circumstances, increase the conversion rate by a number of additional shares for a holder that elects to convert its 2024 Notes in connection with such make-whole fundamental change.

Prior to June 15, 2024, the 2024 Notes are convertible only under the following circumstances: (1) during any calendar quarter commencing after December 31, 2019, if, for at least 20 trading days (whether or not consecutive) during the 30 consecutive trading day period ending on the last trading day of the immediately preceding calendar quarter, the last reported sale price of our common stock on such trading day is greater than or equal to 130% of the applicable conversion price on such trading day; (2) during the five consecutive business day period after any ten consecutive trading day period in which, for each day of that period, the trading price per \$1,000 principal amount of 2024 Notes for such trading day was less than 98% of the product of the last reported sale price of our common stock and the applicable conversion rate on such trading day; or (3) upon the occurrence of specified corporate transactions. As of February 1, 2020, none of these conditions have occurred

and, as a result, the 2024 Notes were not convertible as of February 1, 2020. On and after June 15, 2024, until the close of business on the second scheduled trading day immediately preceding the maturity date, holders may convert all or a portion of their 2024 Notes at any time, regardless of the foregoing circumstances. Upon conversion, the 2024 Notes will be settled, at our election, in cash, shares of our common stock, or a combination of cash and shares of our common stock.

We may not redeem the 2024 Notes; however, upon the occurrence of a fundamental change (as defined in the indenture governing the notes), holders may require us to purchase all or a portion of their 2024 Notes for cash at a price equal to 100% of the principal amount of the 2024 Notes to be purchased plus any accrued and unpaid special interest to, but excluding, the fundamental change purchase date.

Under GAAP, certain convertible debt instruments that may be settled in cash on conversion are required to be separately accounted for as liability and equity components of the instrument in a manner that reflects the issuer's non-convertible debt borrowing rate. Accordingly, in accounting for the issuance of the 2024 Notes, we separated the 2024 Notes into liability and equity components. The carrying amount of the liability component was calculated by measuring the fair value of a similar liability that does not have an associated convertible feature. The carrying amount of the equity component, which is recognized as a debt discount, represents the difference between the proceeds from the issuance of the 2024 Notes and the fair value of the liability component of the 2024 Notes. The excess of the principal amount of the liability component over its carrying amount ("debt discount") will be amortized to interest expense using an effective interest rate of 5.74% over the expected life of the 2024 Notes. The equity component is not remeasured as long as it continues to meet the conditions for equity classification.

Debt issuance costs related to the 2024 Notes were comprised of discounts upon original issuance of \$3.5 million and third party offering costs of \$1.3 million. In accounting for the debt issuance costs related to the issuance of the 2024 Notes, we allocated the total amount incurred to the liability and equity components based on their relative values. Debt issuance costs attributable to the liability component are amortized to interest expense using the effective interest method over the expected life of the 2024 Notes, and debt issuance costs attributable to the equity component are netted with the equity component in stockholders' equity (deficit). Discounts and third party offering costs attributable to the liability component are recorded as a contra-liability and are presented net against the convertible senior notes due 2024 balance on the consolidated balance sheets.

2024 Notes—Convertible Bond Hedge and Warrant Transactions

In connection with the offering of the 2024 Notes and exercise of the overallotment option in September 2019, we entered into convertible note hedge transactions whereby we have the option to purchase a total of approximately 1.7 million shares of our common stock at a price of approximately \$211.40 per share. The total cost of the convertible note hedge transactions was approximately \$91.4 million. In addition, we sold warrants whereby the holders of the warrants have the option to purchase a total of approximately 1.7 million shares of our common stock at a price of \$338.24 per share. The warrants contain certain adjustment mechanisms whereby the total number of shares to be purchased under such warrants may be increased up to a cap of approximately 3.3 million shares of common stock (which cap may also be subject to adjustment). We received approximately \$50.2 million in cash proceeds from the sale of these warrants. Taken together, the purchase of the convertible note hedges and sale of the warrants are intended to offset any actual earnings dilution from the conversion of the 2024 Notes until our common stock is above approximately \$338.24 per share. As these transactions meet certain accounting criteria, the convertible note hedges and warrants are recorded in stockholders' equity, are not accounted for as derivatives and are not remeasured each reporting period. The net costs incurred in connection with the convertible note hedge and warrant transactions were recorded as a reduction to additional paid-in capital on the consolidated balance sheets.

We recorded a deferred tax liability of \$21.7 million in connection with the debt discount associated with the 2024 Notes and recorded a deferred tax asset of \$22.7 million in connection with the convertible note hedge

transactions. The deferred tax liability and deferred tax asset are recorded in deferred tax assets on the consolidated balance sheets.

0.00% Convertible Senior Notes due 2023

In June 2018, we issued in a private offering \$300 million principal amount of 0.00% convertible senior notes due 2023 and issued an additional \$35 million principal amount in connection with the over-allotment option granted to the initial purchasers as part of the offering (collectively, the “2023 Notes”). The 2023 Notes are governed by the terms of an indenture between us and U.S. Bank National Association, as the Trustee. The 2023 Notes will mature on June 15, 2023, unless earlier purchased by us or converted. The 2023 Notes will not bear interest, except that the 2023 Notes will be subject to “special interest” in certain limited circumstances in the event of our failure to perform certain of our obligations under the indenture governing the 2023 Notes. The 2023 Notes are unsecured obligations and do not contain any financial covenants or restrictions on the payments of dividends, the incurrence of indebtedness or the issuance or repurchase of securities by us or any of our subsidiaries. Certain events are also considered “events of default” under the 2023 Notes, which may result in the acceleration of the maturity of the 2023 Notes, as described in the indenture governing the 2023 Notes. Events of default under the indenture for the 2023 Notes include, among other things, the occurrence of an event of default by us as defined under any mortgage, indenture or instrument under which there may be issued, or by which there may be secured or evidenced, any indebtedness of the Company or any of its significant subsidiaries for money borrowed, if that event of default (i) constitutes the failure to pay when due indebtedness in the aggregate principal amount in excess of \$20 million and (ii) such event of default continues for a period of 30 days after written notice is delivered to the Company by the Trustee or to the Company and the Trustee by the holders of at least 25% of the aggregate principal amount of the 2023 Notes then outstanding.

The initial conversion rate applicable to the 2023 Notes is 5.1640 shares of common stock per \$1,000 principal amount of 2023 Notes, which is equivalent to an initial conversion price of approximately \$193.65 per share. The conversion rate will be subject to adjustment upon the occurrence of certain specified events, but will not be adjusted for any accrued and unpaid special interest. In addition, upon the occurrence of a “make-whole fundamental change” as defined in the indenture, we will, in certain circumstances, increase the conversion rate by a number of additional shares for a holder that elects to convert its 2023 Notes in connection with such make-whole fundamental change.

Prior to March 15, 2023, the 2023 Notes are convertible only under the following circumstances: (1) during any calendar quarter commencing after September 30, 2018, if, for at least 20 trading days (whether or not consecutive) during the 30 consecutive trading day period ending on the last trading day of the immediately preceding calendar quarter, the last reported sale price of our common stock on such trading day is greater than or equal to 130% of the applicable conversion price on such trading day; (2) during the five consecutive business day period after any ten consecutive trading day period in which, for each day of that period, the trading price per \$1,000 principal amount of 2023 Notes for such trading day was less than 98% of the product of the last reported sale price of our common stock and the applicable conversion rate on such trading day; or (3) upon the occurrence of specified corporate transactions. As of February 1, 2020, none of these conditions have occurred and, as a result, the 2023 Notes were not convertible as of February 1, 2020. On and after March 15, 2023, until the close of business on the second scheduled trading day immediately preceding the maturity date, holders may convert all or a portion of their 2023 Notes at any time, regardless of the foregoing circumstances. Upon conversion, the 2023 Notes will be settled, at our election, in cash, shares of our common stock, or a combination of cash and shares of our common stock.

We may not redeem the 2023 Notes; however, upon the occurrence of a fundamental change (as defined in the indenture governing the notes), holders may require us to purchase all or a portion of their 2023 Notes for cash at a price equal to 100% of the principal amount of the 2023 Notes to be purchased plus any accrued and unpaid special interest to, but excluding, the fundamental change purchase date.

Under GAAP, certain convertible debt instruments that may be settled in cash on conversion are required to be separately accounted for as liability and equity components of the instrument in a manner that reflects the issuer's non-convertible debt borrowing rate. Accordingly, in accounting for the issuance of the 2023 Notes, we separated the 2023 Notes into liability and equity components. The carrying amount of the liability component was calculated by measuring the fair value of a similar liability that does not have an associated convertible feature. The carrying amount of the equity component, which is recognized as a debt discount, represents the difference between the proceeds from the issuance of the 2023 Notes and the fair value of the liability component of the 2023 Notes. The excess of the principal amount of the liability component over its carrying amount ("debt discount") will be amortized to interest expense using an effective interest rate of 6.35% over the expected life of the 2023 Notes. The equity component is not remeasured as long as it continues to meet the conditions for equity classification.

Debt issuance costs related to the 2023 Notes were comprised of discounts upon original issuance of \$1.7 million and third party offering costs of \$4.6 million. In accounting for the debt issuance costs related to the issuance of the 2023 Notes, we allocated the total amount incurred to the liability and equity components based on their relative values. Debt issuance costs attributable to the liability component are amortized to interest expense using the effective interest method over the expected life of the 2023 Notes, and debt issuance costs attributable to the equity component are netted with the equity component in stockholders' equity (deficit). Discounts and third party offering costs attributable to the liability component were recorded as a contra-liability and are presented net against the convertible senior notes due 2023 balance on the consolidated balance sheets.

2023 Notes—Convertible Bond Hedge and Warrant Transactions

In connection with the offering of the 2023 Notes and the exercise of the overallotment option in June 2018, we entered into convertible note hedge transactions whereby we have the option to purchase a total of approximately 1.7 million shares of our common stock at a price of approximately \$193.65 per share. The total cost of the convertible note hedge transactions was \$91.9 million. In addition, we sold warrants whereby the holders of the warrants have the option to purchase a total of approximately 1.7 million shares of our common stock at a price of \$309.84 per share. The warrants contain certain adjustment mechanisms whereby the total number of shares to be purchased under such warrants may be increased up to a cap of 3.5 million shares of common stock (which cap may also be subject to adjustment). We received \$51.0 million in cash proceeds from the sale of these warrants. Taken together, the purchase of the convertible note hedges and sale of the warrants are intended to offset any actual earnings dilution from the conversion of the 2023 Notes until our common stock is above approximately \$309.84 per share. As these transactions meet certain accounting criteria, the convertible note hedges and warrants are recorded in stockholders' equity (deficit), are not accounted for as derivatives and are not remeasured each reporting period. The net costs incurred in connection with the convertible note hedge and warrant transactions were recorded as a reduction to additional paid-in capital on the consolidated balance sheets.

We recorded a deferred tax liability of \$22.3 million in connection with the debt discount associated with the 2023 Notes and recorded a deferred tax asset of \$22.5 million in connection with the convertible note hedge transactions. The deferred tax liability and deferred tax asset are recorded in deferred tax assets on the consolidated balance sheets.

0.00% Convertible Senior Notes due 2020

In June 2015, we issued in a private offering \$250 million principal amount of 0.00% convertible senior notes due 2020 and, in July 2015, we issued an additional \$50 million principal amount pursuant to the exercise of the overallotment option granted to the initial purchasers as part of our June 2015 offering (collectively, the "2020 Notes"). The 2020 Notes are governed by the terms of an indenture between us and U.S. Bank National Association, as the Trustee. The 2020 Notes will mature on July 15, 2020, unless earlier purchased by us or converted. The 2020 Notes will not bear interest, except that the 2020 Notes will be subject to "special interest"

in certain limited circumstances in the event of our failure to perform certain of our obligations under the indenture governing the 2020 Notes. The 2020 Notes are unsecured obligations and do not contain any financial covenants or restrictions on the payments of dividends, the incurrence of indebtedness or the issuance or repurchase of securities by us or any of our subsidiaries. Certain events are also considered “events of default” under the 2020 Notes, which may result in the acceleration of the maturity of the 2020 Notes, as described in the indenture governing the 2020 Notes. Events of default under the indenture for the 2020 Notes include, among other things, the occurrence of an event of default by us as defined under any mortgage, indenture or instrument under which there may be issued, or by which there may be secured or evidenced, any indebtedness of the Company or any of its significant subsidiaries for money borrowed, if that event of default (i) constitutes the failure to pay when due indebtedness in the aggregate principal amount in excess of \$20 million and (ii) such event of default continues for a period of 30 days after written notice is delivered to the Company by the Trustee or to the Company and the Trustee by the holders of at least 25% of the aggregate principal amount of the 2020 Notes then outstanding. The 2020 Notes are guaranteed by our primary operating subsidiary, Restoration Hardware, Inc., as Guarantor. The guarantee is the unsecured obligation of the Guarantor and is subordinated to the Guarantor’s obligations from time to time with respect to its credit agreement and ranks equal in right of payment with respect to Guarantor’s other obligations.

The initial conversion rate applicable to the 2020 Notes is 8.4656 shares of common stock per \$1,000 principal amount of 2020 Notes, which is equivalent to an initial conversion price of approximately \$118.13 per share. To the extent the stock price is less than \$118.13 per share, the Company is required to settle the par value in cash, subject to the cash settlement averaging period under the indenture. To the extent the stock price is greater than \$118.13 per share, the Company may settle the par value at the Company’s election, in cash, shares of the Company’s common stock, or a combination of cash and shares of the Company’s common stock. The conversion rate will be subject to adjustment upon the occurrence of certain specified events, but will not be adjusted for any accrued and unpaid special interest. In addition, upon the occurrence of a “make-whole fundamental change” as defined in the indenture, we will, in certain circumstances, increase the conversion rate by a number of additional shares for a holder that elects to convert its 2020 Notes in connection with such make-whole fundamental change.

Prior to March 15, 2020, the 2020 Notes are convertible only under the following circumstances: (1) during any calendar quarter commencing after September 30, 2015, if, for at least 20 trading days (whether or not consecutive) during the 30 consecutive trading day period ending on the last trading day of the immediately preceding calendar quarter, the last reported sale price of our common stock on such trading day is greater than or equal to 130% of the applicable conversion price on such trading day; (2) during the five consecutive business day period after any ten consecutive trading day period in which, for each day of that period, the trading price per \$1,000 principal amount of 2020 Notes for such trading day was less than 98% of the product of the last reported sale price of our common stock and the applicable conversion rate on such trading day; or (3) upon the occurrence of specified corporate transactions. The first condition was satisfied during the quarter ended December 31, 2019 and, accordingly, holders may convert their 2020 Notes during the calendar quarter ending March 31, 2020. Regardless of the foregoing circumstances, on and after March 15, 2020, until the close of business on the second scheduled trading day immediately preceding the maturity date, holders may convert all or a portion of their 2020 Notes at any time. Upon conversion, the 2020 Notes will be settled, at our election, in cash, shares of our common stock, or a combination of cash and shares of our common stock to the extent the Company’s stock price is greater than \$118.13 per share. If the Company has not delivered a notice of its election of settlement method prior to the final conversion period it will be deemed to have elected combination settlement with a dollar amount per note to be received upon conversion of \$1,000. We expect to repay the \$300 million outstanding principal amount of the convertible notes in cash, whether in connection with a conversion of such notes or repayment at maturity in July 2020.

We may not redeem the 2020 Notes; however, upon the occurrence of a fundamental change (as defined in the indenture governing the notes), holders may require us to purchase all or a portion of their 2020 Notes for

cash at a price equal to 100% of the principal amount of the 2020 Notes to be purchased plus any accrued and unpaid special interest to, but excluding, the fundamental change purchase date.

Under GAAP, certain convertible debt instruments that may be settled in cash on conversion are required to be separately accounted for as liability and equity components of the instrument in a manner that reflects the issuer's non-convertible debt borrowing rate. Accordingly, in accounting for the issuance of the 2020 Notes, we separated the 2020 Notes into liability and equity components. The carrying amount of the liability component was calculated by measuring the fair value of a similar liability that does not have an associated convertible feature. The carrying amount of the equity component, which is recognized as a debt discount, represents the difference between the proceeds from the issuance of the 2020 Notes and the fair value of the liability component of the 2020 Notes. The debt discount will be amortized to interest expense using an effective interest rate of 6.47% over the expected life of the 2020 Notes. The equity component is not remeasured as long as it continues to meet the conditions for equity classification.

Debt issuance costs related to the 2020 Notes were comprised of discounts upon original issuance of \$3.8 million and third party offering costs of \$2.3 million. In accounting for the debt issuance costs related to the issuance of the 2020 Notes, we allocated the total amount incurred to the liability and equity components based on their relative values. Debt issuance costs attributable to the liability component are amortized to interest expense using the effective interest method over the expected life of the 2020 Notes, and debt issuance costs attributable to the equity component are netted with the equity component in stockholders' equity (deficit). Discounts and third party offering costs attributable to the liability component were recorded as a contra-liability and are presented net against the convertible senior notes due 2020 balance on the consolidated balance sheets.

2020 Notes—Convertible Bond Hedge and Warrant Transactions

In connection with the offering of the 2020 Notes in June 2015 and the exercise in full of the overallotment option in July 2015, we entered into convertible note hedge transactions whereby we have the option to purchase a total of approximately 2.5 million shares of our common stock at a price of approximately \$118.13 per share. The total cost of the convertible note hedge transactions was \$68.3 million. In addition, we sold warrants whereby the holders of the warrants have the option to purchase a total of approximately 2.5 million shares of our common stock at a price of \$189.00 per share. The warrants contain certain adjustment mechanisms whereby the total number of shares to be purchased under such warrants may be increased up to a cap of 5.1 million shares of common stock (which cap may also be subject to adjustment). We received \$30.4 million in cash proceeds from the sale of these warrants. Taken together, the purchase of the convertible note hedges and sale of the warrants are intended to offset any actual earnings dilution from the conversion of the 2020 Notes until our common stock is above approximately \$189.00 per share. As these transactions meet certain accounting criteria, the convertible note hedges and warrants are recorded in stockholders' equity (deficit), are not accounted for as derivatives and are not remeasured each reporting period. The net costs incurred in connection with the convertible note hedge and warrant transactions were recorded as a reduction to additional paid-in capital on the consolidated balance sheets.

We recorded a deferred tax liability of \$32.8 million in connection with the debt discount associated with the 2020 Notes and recorded a deferred tax asset of \$26.6 million in connection with the convertible note hedge transactions. The deferred tax liability and deferred tax asset are recorded in deferred tax assets on the consolidated balance sheets.

Our provision for income taxes in fiscal 2017 included \$1.1 million of income tax benefit as a result of the Tax Act for the provisional re-measurement of the deferred tax asset and liability related to the 2020 Notes for the reduction in the U.S. corporate income tax rate from 35% to 21%.

0.00% Convertible Senior Notes due 2019

In June 2014, we issued \$350 million aggregate principal amount of 0.00% convertible senior notes due 2019 (the "2019 Notes") in a private offering. The 2019 Notes were governed by the terms of an indenture

between us and U.S. Bank National Association, as the Trustee. The 2019 Notes did not bear interest, except that the 2019 Notes were subject to “special interest” in certain limited circumstances in the event of our failure to perform certain of our obligations under the indenture governing the 2019 Notes. The 2019 Notes were unsecured obligations and did not contain any financial covenants or restrictions on the payments of dividends, the incurrence of indebtedness or the issuance or repurchase of securities by us or any of our subsidiaries. Certain events were also considered “events of default” under the 2019 Notes, which could result in the acceleration of the maturity of the 2019 Notes, as described in the indenture governing the 2019 Notes. The 2019 Notes matured on June 15, 2019.

The initial conversion rate applicable to the 2019 Notes was 8.6143 shares of common stock per \$1,000 principal amount of 2019 Notes, which was equivalent to an initial conversion price of approximately \$116.09 per share. The conversion rate was subject to adjustment upon the occurrence of certain specified events, but was not adjusted for any accrued and unpaid special interest. In addition, upon the occurrence of a “make-whole fundamental change,” we would, in certain circumstances, increase the conversion rate by a number of additional shares for a holder that elected to convert its 2019 Notes in connection with such make-whole fundamental change.

In June 2019, upon the maturity of the 2019 Notes, \$350.0 million in aggregate principal amount of the 2019 Notes were settled for \$349.0 million in cash and 42 shares of our common stock. As a result, we recognized a gain on extinguishment of debt of \$1.0 million. As of February 1, 2020, the 2019 Notes are no longer outstanding.

Under GAAP, certain convertible debt instruments that may be settled in cash on conversion are required to be separately accounted for as liability and equity components of the instrument in a manner that reflects the issuer’s non-convertible debt borrowing rate. Accordingly, in accounting for the issuance of the 2019 Notes, we separated the 2019 Notes into liability and equity components. The carrying amount of the liability component was calculated by measuring the fair value of a similar liability that does not have an associated convertible feature. The carrying amount of the equity component, which is recognized as a debt discount, represents the difference between the proceeds from the issuance of the 2019 Notes and the fair value of the liability component of the 2019 Notes. The debt discount was amortized to interest expense using an effective interest rate of 4.51% over the expected life of the 2019 Notes. The equity component was not remeasured as long as it continued to meet the conditions for equity classification.

Debt issuance costs related to the 2019 Notes were comprised of discounts and commissions payable to the initial purchasers of \$4.4 million and third party offering costs of \$1.0 million. In accounting for the debt issuance costs related to the issuance of the 2019 Notes, we allocated the total amount incurred to the liability and equity components based on their relative values. Debt issuance costs attributable to the liability component were amortized to interest expense using the effective interest method over the expected life of the 2019 Notes, and debt issuance costs attributable to the equity component were netted with the equity component in stockholders’ equity (deficit). Discounts, commissions payable to the initial purchasers and third party offering costs attributable to the liability component were recorded as a contra-liability and are presented net against the convertible senior notes due 2019 balance on the consolidated balance sheets.

2019 Notes—Convertible Bond Hedge and Warrant Transactions

In connection with the offering of the 2019 Notes, we entered into convertible note hedge transactions whereby we have the option to purchase a total of approximately 3.0 million shares of our common stock at a price of approximately \$116.09 per share. The total cost of the convertible note hedge transactions was \$73.3 million. In addition, we sold warrants whereby the holders of the warrants had the option to purchase a total of approximately 3.0 million shares of our common stock at a price of \$171.98 per share. We received \$40.4 million in cash proceeds from the sale of these warrants. Taken together, the purchase of the convertible note hedges and sale of the warrants were intended to offset any actual dilution from the conversion of the 2019

Notes and to effectively increase the overall conversion price from \$116.09 per share to \$171.98 per share. As these transactions meet certain accounting criteria, the convertible note hedges and warrants were recorded in stockholders' equity (deficit) and were not accounted for as derivatives. The net costs incurred in connection with the convertible note hedge and warrant transactions were recorded as a reduction to additional paid-in capital on the consolidated balance sheets.

During fiscal 2019, we delivered approximately 167,100 shares upon exercise of the warrants under the terms of the warrant agreements. The warrant agreements expired on December 6, 2019.

We recorded a deferred tax liability of \$27.5 million in connection with the debt discount associated with the 2019 Notes and recorded a deferred tax asset of \$28.6 million in connection with the convertible note hedge transactions. The deferred tax liability and deferred tax asset are recorded in deferred tax assets on the consolidated balance sheets. There is no deferred tax asset or liability remaining as of February 1, 2020 due to the maturity of the 2019 Notes.

Our provision for income taxes in fiscal 2017 included \$0.1 million of income tax expense as a result of the Tax Act for the provisional re-measurement of the deferred tax asset and liability related to the 2019 Notes for the reduction in the U.S. corporate income tax rate from 35% to 21%.

Asset Based Credit Facility and Term Loan Facilities

On June 28, 2017, Restoration Hardware, Inc. entered into an eleventh amended and restated credit agreement (the "Credit Agreement") among Restoration Hardware, Inc., Restoration Hardware Canada, Inc., various subsidiaries of RH named therein as borrowers or guarantors, the lenders party thereto and Bank of America, N.A. as administrative agent and collateral agent ("First Lien Administrative Agent"). The Credit Agreement has a revolving line of credit with initial availability of up to \$600.0 million, of which \$10.0 million is available to Restoration Hardware Canada, Inc., and includes a \$200.0 million accordion feature under which the revolving line of credit may be expanded by agreement of the parties from \$600.0 million to up to \$800.0 million if and to the extent the lenders, whether existing lenders or new lenders, agree to increase their credit commitments. In addition, the Credit Agreement established an \$80.0 million last in, last out ("LILO") term loan facility. The Credit Agreement has a maturity date of June 28, 2022.

In June 2018, we repaid the LILO term loan in full. As a result of the repayment, we incurred a \$0.5 million loss on extinguishment of debt in fiscal 2018, which represents the acceleration of amortization of debt issuance costs. We did not incur any prepayment penalties upon the early extinguishment of the LILO term loan.

On June 12, 2018, Restoration Hardware, Inc. entered into a First Amendment to the Credit Agreement (the "First Amendment"). The First Amendment (a) changed the Credit Agreement's definition of "Eligible In-Transit Inventory" to clarify the requirements to be fulfilled by the borrowers with respect to such in-transit inventory, and (b) clarified that no default or event of default was caused by any prior non-compliance with such requirements with respect to in-transit inventory. Eligible In-Transit Inventory consists of inventory being shipped from vendor locations outside of the United States. Qualifying in-transit inventory is included within the borrowing base for eligible collateral for purposes of determining the amount of borrowing available to borrowers under the Credit Agreement.

On November 23, 2018, Restoration Hardware, Inc. entered into a Consent and Second Amendment to the Credit Agreement (the "Second Amendment"). The Second Amendment included certain clarifying changes to, among other things: (a) address the processing of payments from insurance proceeds in connection with casualty or other insured losses with respect to property or assets of a Loan Party, and (b) add an additional category of permitted restricted payment to allow the lead borrower to make annual restricted payments of up to \$3 million per fiscal year to cover payments of certain administrative and other obligations of RH in the ordinary course of business.

On April 4, 2019, Restoration Hardware, Inc., entered into a third amendment to the Credit Agreement (the “Third Amendment”). The Third Amendment, among other things, (a) established a \$120.0 million first in, last out (“FILO”) term loan facility, which amount was fully borrowed as of April 4, 2019 and which incurs interest at a rate that is 1.25% greater than the interest rate applicable to the revolving loans provided for under the Credit Agreement, (b) provided for additional Permitted Indebtedness, as defined in the Credit Agreement, that the loan parties can incur, and (c) modified the borrowing availability under the Credit Agreement in certain circumstances.

We repaid the full amount of the FILO term loan as of February 1, 2020 and, as a result, incurred a \$0.8 million loss on extinguishment of debt in fiscal 2019, which represents the acceleration of amortization of debt issuance costs. We did not incur any prepayment penalties upon the early extinguishment of the FILO term loan.

On May 31, 2019, Restoration Hardware, Inc. entered into a fourth amendment to the Credit Agreement (the “Fourth Amendment”). The Fourth Amendment, among other things, amended the Credit Agreement to (a) extend the time to deliver monthly financial statements to the lenders for the fiscal months ending February 2019 and March 2019 until June 19, 2019; (b) remove the requirement to deliver monthly financial statements to the lenders for the last fiscal month of any fiscal quarter; and (c) waive any default or event of default under the Credit Agreement relating to the delivery of monthly financial statements or other information to lenders for the fiscal months ending February 2019 and March 2019.

All obligations under the Credit Agreement are secured by substantially all of the assets, including accounts receivable, inventory, intangible assets, property, equipment, goods and fixtures of Restoration Hardware, Inc., Restoration Hardware Canada, Inc., RH US, LLC, Waterworks Operating Co., LLC and Waterworks IP Co., LLC.

Borrowings under the revolving line of credit are subject to interest, at the borrowers’ option, at either the bank’s reference rate or London Inter-bank Offered Rate (“LIBOR”) (or, in the case of the revolving line of credit, the Bank of America “BA” Rate or the Canadian Prime Rate, as such terms are defined in the Credit Agreement, for Canadian borrowings denominated in Canadian dollars or the United States Index Rate or LIBOR for Canadian borrowings denominated in United States dollars) plus an applicable margin rate, in each case.

In addition, under the Credit Agreement, we are required to meet specified financial ratios in order to undertake certain actions, and we may be required to maintain certain levels of excess availability or meet a specified consolidated fixed-charge coverage ratio (“FCCR”). Subject to certain exceptions, the trigger for the FCCR occurs if the domestic availability under the revolving line of credit is less than the greater of (i) \$40.0 million and (ii) 10% of the lesser of (x) the domestic revolving commitments under the Credit Agreement and (y) the domestic revolving borrowing base. If the availability under the Credit Agreement is less than the foregoing amount, then Restoration Hardware, Inc. is required subject to certain exceptions to maintain an FCCR of at least one to one. As of February 1, 2020, Restoration Hardware, Inc. was in compliance with all applicable financial covenants of the Credit Agreement.

The Credit Agreement requires a daily sweep of all cash receipts and collections to prepay the loans under the agreement while (i) an event of default exists or (ii) the availability under the revolving line of credit for extensions of credit is less than the greater of (A) \$40.0 million and (B) 10% of the lesser of (x) the domestic revolving borrowing base.

The Credit Agreement includes customary events of default, in certain cases subject to customary periods to cure. The occurrence of an event of default, including an event of default in connection with certain events constituting a “Material Adverse Effect” (as defined in the Credit Agreement) would permit the lenders to, among other things, terminate any existing commitments under the Credit Agreement and declare the unpaid principal, accrued and unpaid interest and all other amounts payable under the Credit Agreement to be immediately due and payable.

As of February 1, 2020, we had no outstanding borrowings under the revolving credit facility portion of the Credit Agreement. The availability of credit at any given time under the Credit Agreement is limited by reference to a borrowing base formula based upon numerous factors, including the value of eligible inventory and eligible accounts receivable. As a result of the borrowing base formula, actual borrowing availability under the revolving line of credit could be less than the stated amount of the revolving line of credit (as reduced by the actual borrowings and outstanding letters of credit under the revolving line of credit). Under the terms of such provisions, the amount under the revolving line of credit borrowing base that could be available pursuant to the Credit Agreement as of February 1, 2020 was \$321.7 million, net of \$13.2 million in outstanding letters of credit.

The Credit Agreement contains various restrictive covenants, including, among others, required financial reporting, limitations on the ability to incur liens, make loans or other investments, incur additional debt, issue additional equity, merge or consolidate with or into another person, sell assets, pay dividends or make other distributions, or enter into transactions with affiliates, along with other restrictions and limitations typical to credit agreements of this type and size. The Credit Agreement also contains various affirmative covenants, including the obligation to deliver notice to the First Lien Administrative Agent following the Company's obtaining knowledge of any matter that has resulted or could reasonably be expected to result in a "Material Adverse Effect" (as defined in the Credit Agreement).

Second Lien Credit Agreement

On April 10, 2019, Restoration Hardware, Inc., entered into a credit agreement, dated as of April 9, 2019 and effective as of April 10, 2019 (the "Second Lien Credit Agreement"), among (i) Restoration Hardware, Inc., as lead borrower, (ii) the guarantors party thereto, (iii) the lenders party thereto, each of whom were managed or advised by either Benefit Street Partners L.L.C. and its affiliated investment managers or Apollo Capital Management, L.P. and its affiliated investment managers, and (iv) BSP Agency, LLC, as administrative agent and collateral agent (the "Second Lien Administrative Agent") with respect to a second lien term loan in an aggregate principal amount equal to \$200.0 million with a maturity date of April 9, 2024 (the "Second Lien Term Loan"). The second lien term loan of \$200.0 million in principal was repaid in full on September 20, 2019. As a result of the repayment, we incurred a \$6.7 million loss on extinguishment of debt, which includes a prepayment penalty of \$4.0 million and acceleration of amortization of debt issuance costs of \$2.7 million.

The Second Lien Term Loan bore interest at an annual rate generally based on LIBOR plus 6.50%. This rate was a floating rate that reset periodically based upon changes in LIBOR rates during the life of the Second Lien Term Loan. At the date of the initial borrowing, the rate was set at one-month LIBOR plus 6.50%.

Intercreditor Agreement

On April 10, 2019, in connection with the Second Lien Credit Agreement, Restoration Hardware, Inc. entered into an Intercreditor Agreement (the "Intercreditor Agreement"), dated as of April 9, 2019 and effective as of April 10, 2019, with the First Lien Administrative Agent and the Second Lien Administrative Agent. The Intercreditor Agreement established various customary inter-lender terms, including, without limitation, with respect to priority of liens, permitted actions by each party, application of proceeds, exercise of remedies in case of default, releases of liens and certain limitations on the amendment of the Credit Agreement and the Second Lien Credit Agreement without the consent of the other party. The Intercreditor Agreement is no longer in effect after repayment of the Second Lien Term Loan on September 20, 2019.

Equipment Loan Facility

On September 5, 2017, Restoration Hardware, Inc. entered into a Master Loan and Security Agreement with Banc of America Leasing & Capital, LLC ("BAL") pursuant to which BAL and we agreed that BAL would finance certain equipment of ours from time to time, with each such equipment financing to be evidenced by an

equipment security note setting forth the terms for each particular equipment loan. Each equipment loan is secured by a purchase money security interest in the financed equipment. As of February 1, 2020, we had \$53.4 million in aggregate amounts outstanding under the equipment security notes, of which \$22.0 million was included in other current liabilities and \$31.4 million was included in other non-current obligations on the consolidated balance sheets. The maturity dates of the equipment security notes vary, but generally have a maturity of three or four years. We are required to make monthly installment payments under the equipment security notes.

Share Repurchase Programs

We regularly review share repurchase activity and consider various factors in determining whether and when to execute share repurchases, including, among others, current cash needs, capacity for leverage, cost of borrowings, results of operations and the market price of the our common stock.

During fiscal 2017, we repurchased approximately 20.2 million shares of our common stock under two separate repurchase programs for an aggregate repurchase amount of approximately \$1 billion. During fiscal 2018, we repurchased approximately 2.0 million shares of our common stock under a separate repurchase program for an aggregate repurchase amount of approximately \$250 million. During fiscal 2019, we repurchased approximately 2.2 million shares of our common stock under a separate repurchase program for an aggregate repurchase amount of approximately \$250 million. Total repurchases made in fiscal 2019, fiscal 2018 and fiscal 2017 represent 59.8% of the shares outstanding as of the end of fiscal 2016.

We believe that these share repurchase programs will continue to be an excellent allocation of capital for the long-term benefit of our shareholders. We may undertake other repurchase programs in the future with respect to our securities.

We generated \$330 million, \$163 million and \$415 million in free cash flow in fiscal 2019, fiscal 2018 and fiscal 2017, respectively, which supported our share repurchase programs. Free cash flow is calculated as net cash provided by operating activities, the non-cash accretion of debt discount upon settlement of debt and proceeds from sale of assets, less capital expenditures and principal payments under finance leases. Free cash flow excludes all non-cash items. Free cash flow is included in this filing because management believes that free cash flow provides meaningful supplemental information for investors regarding the performance of our business and facilitates a meaningful evaluation of operating results on a comparable basis with historical results. Our management uses this non-GAAP financial measure in order to have comparable financial results to analyze changes in our underlying business from quarter to quarter. A reconciliation of our net cash provided by operating activities to free cash flow is as follows:

	Year Ended		
	February 2, 2020	February 2, 2019	February 3, 2018
	(in thousands)		
Net cash provided by operating activities	\$339,188	\$249,603	\$474,505
Accretion of debt discount upon settlement of debt	70,482	—	—
Proceeds from sale of assets	24,078	—	15,123
Capital expenditures	(93,623)	(79,992)	(68,393)
Principal payments under finance leases	(9,682)	(6,885)	(6,105)
Free cash flow	<u>\$330,443</u>	<u>\$162,726</u>	<u>\$415,130</u>

\$300 Million Share Repurchase Program (Completed)

On February 21, 2017, our Board of Directors authorized a share repurchase program of up to \$300 million (the “\$300 Million Repurchase Program”) through open market purchases, privately negotiated transactions or

other means, including through Rule 10b18 open market repurchases, Rule 10b5-1 trading plans or through the use of other techniques such as accelerated share repurchases. In the first quarter of fiscal 2017, we repurchased approximately 7.8 million shares of our common stock under the \$300 Million Repurchase Program at an average price of \$38.24 per share, for an aggregate repurchase amount of approximately \$300 million. No additional shares will be repurchased in future periods under the \$300 Million Repurchase Program.

\$700 Million Share Repurchase Program (Completed)

Following completion of the \$300 Million Repurchase Program, our Board of Directors authorized on May 2, 2017 an additional share repurchase program of up to \$700 million (the “\$700 Million Repurchase Program”) through open market purchases, privately negotiated transactions or other means, including through Rule 10b18 open market repurchases, Rule 10b5-1 trading plans or through the use of other techniques such as accelerated share repurchases including through privately-negotiated arrangements in which a portion of the share repurchase program is committed in advance through a financial intermediary and/or in transactions involving hedging or derivatives. In the second quarter of fiscal 2017, we repurchased approximately 12.4 million shares of our common stock under the \$700 Million Repurchase Program at an average price of \$56.60 per share, for an aggregate repurchase amount of approximately \$700 million. No additional shares will be repurchased in future periods under the \$700 Million Repurchase Program.

\$950 Million Share Repurchase Program (Existing)

On October 10, 2018, our Board of Directors authorized a share repurchase program of up to \$700 million through open market purchases, privately negotiated transactions or other means, including through Rule 10b18 open market repurchases, Rule 10b5-1 trading plans or through the use of other techniques such as accelerated share repurchases including through privately-negotiated arrangements in which a portion of the share repurchase program is committed in advance through a financial intermediary and/or in transactions involving hedging or derivatives, of which \$250.0 million in share repurchases were completed in fiscal 2018. The \$700 million authorization amount was replenished by the Board of Directors on March 25, 2019 (as replenished, the “\$950 Million Repurchase Program”). In the first quarter of fiscal 2019, we repurchased approximately 2.2 million shares of our common stock under the \$950 Million Repurchase Program at an average price of \$115.36 per share, for an aggregate repurchase amount of approximately \$250.0 million. As of February 1, 2020, there was \$450 million remaining for future share repurchases under this program.

Contractual Obligations

As of February 1, 2020, our future contractual cash obligations were as follows:

	Payments Due by Fiscal Year				
	Total	2020	2021-2022	2023-2024	Thereafter
	(in thousands)				
Asset based credit facility ⁽¹⁾	\$ —	\$ —	\$ —	\$ —	\$ —
Equipment promissory notes ⁽²⁾	53,372	22,009	30,819	544	—
Convertible senior notes due 2020	300,000	300,000	—	—	—
Convertible senior notes due 2023	335,000	—	—	335,000	—
Convertible senior notes due 2024	350,000	—	—	350,000	—
Notes payable for share repurchases	18,741	—	15,920	2,578	243
Promissory notes on asset under construction ⁽³⁾ . . .	53,000	53,000	—	—	—
Operating lease liabilities ⁽⁴⁾	560,860	75,634	130,054	108,690	246,482
Finance lease liabilities ⁽⁵⁾	744,894	32,138	71,070	72,830	568,856
Letters of credit	13,186	13,186	—	—	—
Total	\$2,429,053	\$495,967	\$247,863	\$869,642	\$815,581

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- (1) Under the Credit Agreement, the asset based credit facility has a maturity date of June 28, 2022. As of February 1, 2020, we had no outstanding borrowings under our asset based credit facility.
 - (2) Equipment promissory note obligations do not include interest of \$2.0 million and \$1.1 million for the fiscal periods 2020 and 2021-2022, respectively.
 - (3) The promissory notes on asset under construction is not expected to be settled in cash. Refer to “Lease Accounting” within Note 3—*Significant Accounting Policies* in our consolidated financial statements within Part II of this Annual Report on Form 10-K.
 - (4) We enter into operating and finance leases in the normal course of business. Most lease arrangements provide us with the option to renew the leases at defined terms. The table above includes future obligations for renewal options that are reasonably certain to be exercised and are included in the measurement of the lease liability. Amounts above do not include future lease payments under leases that have not commenced or estimated contingent rent due under operating and finance leases. As of February 1, 2020, our obligation for legally binding payments for leases signed but not yet commenced and contingent rent was \$360.9 million and \$6.1 million, respectively. Refer to Note 9—*Leases* in our consolidated financial statements within Part II of this Annual Report on Form 10-K.

Other Commitments

The Company enters into various cancellable commitments related to the procurement of merchandise inventory. As of February 1, 2020, these merchandise inventory purchase commitments were \$368.2 million.

As of February 1, 2020, the liability of \$8.5 million for unrecognized tax benefits associated with uncertain tax positions (refer to Note 13—*Income Taxes* in our consolidated financial statements within Part II of this Annual Report on Form 10-K) has not been included in the contractual obligations table above as we are not able to reasonably estimate when cash payments for these liabilities will occur or the amount by which these liabilities will increase or decrease over time.

Off Balance Sheet Arrangements

We have no material off balance sheet arrangements as of February 1, 2020.

Critical Accounting Policies and Estimates

The preparation of financial statements in accordance with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect amounts reported in our consolidated financial statements and related notes, as well as the related disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Management evaluates its accounting policies, estimates, and judgments on an on-going basis. Management bases its estimates and judgments on historical experience and various other factors that are believed to be reasonable under the circumstances. Actual results may differ from these estimates under different assumptions and conditions and such differences could be material to the consolidated financial statements.

Information on all of our significant accounting policies can be found in Note 3—*Significant Accounting Policies* in our audited consolidated financial statements. Management evaluates the development and selection of its critical accounting policies and estimates and believes that certain of our significant accounting policies involve a higher degree of judgment or complexity and are most significant to reporting our consolidated results of operations and financial position, and are therefore discussed as critical. The following critical accounting policies reflect the significant estimates and judgments used in the preparation of our consolidated financial statements. The following items require significant estimation or judgment in the preparation of the consolidated financial statements.

Merchandise Inventories—Reserves

Our merchandise inventories are comprised of finished goods and are carried at the lower of cost or net realizable value, with cost determined on a weighted-average cost method. To determine if the value of inventory should be marked down below original cost, we use estimates to determine the lower of cost or net realizable value, which considers current and anticipated demand, customer preference and the merchandise age. The inventory value is adjusted periodically to reflect current market conditions, which requires management judgments that may significantly affect the ending inventory valuation, as well as gross margin. The estimates used in inventory valuation are lower of cost or net realizable value reserves and obsolescence (including excess and slow-moving inventory).

Our inventory reserves contain uncertainties that require management to make assumptions and to apply judgment regarding a number of factors, including market conditions, the selling environment, historical results and current inventory trends. We adjust our inventory reserves for net realizable value and obsolescence based on trends, aging reports, specific identification and estimates of future retail sales prices. If actual results change from our prior estimates, we adjust our inventory reserves accordingly throughout the period. We have not made any material changes to our assumptions included in the calculations of the lower of cost or net realizable value reserves during the periods presented.

Impairment

Tradenames, Trademarks and Domain Names

We annually evaluate whether tradenames, trademarks and domain names continue to have an indefinite life. Tradenames, trademarks and domain names are reviewed for impairment annually in the fourth quarter and may be reviewed more frequently if indicators of impairment are present. Conditions that may indicate impairment include, but are not limited to, a significant adverse change in customer demand or business climate that could affect the value of an asset, a product recall or an adverse action or assessment by a regulator.

We qualitatively assesses indefinite-lived intangible asset impairment to determine whether it is more likely than not that the fair value of the asset is less than its carrying amount. If tradenames, trademarks and domain names are not qualitatively assessed or if such intangible assets are qualitatively assessed and it is determined it is not more likely than not that the asset's fair value is greater than its carrying amount, an impairment review is performed by comparing the carrying value to the estimated fair value, determined using a discounted cash flow methodology, which requires management judgments that may significantly affect the ending asset valuation. Factors used in the valuation of intangible assets with indefinite lives include, but are not limited to, management's plans for future operations, brand initiatives, recent results of operations and projected future cash flows.

In the event we quantitatively assess a reporting unit's indefinite-lived intangible asset for impairment, we perform an impairment test which utilizes the discounted cash flow methodology under the relief-from-royalty method. Under the relief-from-royalty method, our significant assumptions include the forecasted future revenues and the estimated royalty rate, expressed as a percentage of revenues.

Long-Lived Assets

Long-lived assets, such as property and equipment and lease right-of-use assets, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Conditions that may indicate impairment include, but are not limited to, a significant adverse change in customer demand or business climate that could affect the value of an asset, change in the intended use of an asset, a product recall or an adverse action or assessment by a regulator. If the sum of the estimated undiscounted future cash flows over the remaining life of the primary asset is less than the carrying value, we recognize a loss equal to the difference between the carrying value and the fair value, usually determined by the

estimated discounted cash flow analysis of the asset or asset group. The asset group is defined as the lowest level for which identifiable cash flows are available and largely independent of the cash flows of other groups of assets, which for our stores is the individual gallery level.

Since there is typically no active market for our long-lived assets, we estimate fair values based on the expected future cash flows of the asset or asset group, using a discount rate commensurate with the related risk. The estimate of fair value requires management judgments that may significantly affect the ending asset valuation. Future cash flows are estimated based on gallery-level historical results, current trends, and operating and cash flow projections. Our estimates are subject to uncertainty and may be affected by a number of factors outside our control, including general economic conditions and the competitive environment. While we believe our estimates and judgments about future cash flows are reasonable, future impairment charges may be required if the expected cash flow estimates, as projected, do not occur or if events change requiring us to revise our estimates.

Lease Accounting

Reasonably Certain Lease Term

In recognizing the lease right-of-use assets and lease liabilities, we utilize the lease term for which we are reasonably certain to use the underlying asset, including consideration of options to extend or terminate the lease. At lease commencement, we evaluate whether we are reasonably certain to exercise available options based on consideration of a variety of economic factors and the circumstances related to the leased asset. Factors considered include, but are not limited to, (i) the contractual terms compared to estimated market rates, (ii) the uniqueness or importance of the asset or its location, (iii) the potential costs of obtaining an alternative asset, (iv) the potential costs of relocating or ceasing use of the asset, including the consideration of leasehold improvements and other invested capital, and (v) any potential tax consequences.

The determination of the reasonably certain lease term affects the inclusion of rental payments utilized in the incremental borrowing rate calculations, the results of the lease classification test, and our consideration of certain assets held for sale or planned for sale-leaseback. The reasonably certain lease term may materially impact our financial position related to certain Design Galleries or distribution center facilities which typically have greater lease payments. Although the above factors are considered in our analysis, the assessment involves subjectivity considering our strategy, expected future events and market conditions. While we believe our estimates and judgments in determining the lease term are reasonable, future events may occur which may require us to reassess this determination.

Incremental Borrowing Rate

As most of our leases do not include an implicit interest rate, we determine the discount rate for each lease based upon the incremental borrowing rate (“IBR”) in order to calculate the present value of the lease liability at the commencement date. The IBR is computed as the rate of interest that we would have to pay to (i) borrow on a collateralized basis (ii) over a similar term (iii) an amount equal to the total lease payments (iv) in a similar economic environment. We utilize our asset based credit facility as the basis for determining the applicable IBR for each lease. We estimate the incremental borrowing rate for each lease primarily by reference to (i) yield rates on debt issuances by companies of a similar credit rating; (ii) the weighted-average lease term; and (iii) adjustments for differences between the yield rates and the actual term of the credit facility. In determining the yield rates, we utilize market information as of the beginning of the quarter in which the lease commenced. For Design Galleries, we utilize market information on the lease commencement date.

Fair Market Value

We determine the fair value of the underlying asset, and the lease components such as land and building, for purposes of determining the lease classification and allocating our contractual rental payments to the lease

components. The fair value of the underlying asset and lease components also impact our assets held for sale and sale-leaseback transactions. The fair value assessments may materially impact our financial position related to certain Design Galleries or distribution center facilities which typically have greater fair values.

The determination of fair value requires subjectivity and estimates, including the use of multiple valuation techniques and uncertain inputs, such as market price per square foot and assumed capitalization rates or the replacement cost of the assets, where applicable. Where real estate valuation expertise is required we obtain independent third-party appraisals to determine the fair value of the underlying asset and lease components. While determining fair value requires a variety of input assumptions and judgment, we believe our estimates of fair market value are reasonable.

Recently Issued Accounting Pronouncements

Refer to “Recently Issued Accounting Standards” within Note 3—*Significant Accounting Policies* in our consolidated financial statements within Part II of this Annual Report on Form 10-K.

Item 7A. Quantitative and Qualitative Disclosure of Market Risks

Interest Rate Risk

We currently do not engage in any interest rate hedging activity and we have no intention to do so in the foreseeable future.

We are subject to interest rate risk in connection with borrowings under our revolving line of credit under the Credit Agreement which bears interest at variable rates and we may incur additional indebtedness that bears interest at variable rates. At February 1, 2020, no amounts were outstanding under the revolving line of credit. The Credit Agreement provides for a borrowing amount based on the value of eligible collateral and a formula linked to certain borrowing percentages based on certain categories of collateral. Under the terms of such provisions, the amount under the revolving line of credit borrowing base that could be available pursuant to the Credit Agreement as of February 1, 2020 was \$321.7 million, net of \$13.2 million in outstanding letters of credit. Based on the average interest rate on the revolving line of credit at February 1, 2020, and to the extent that borrowings were outstanding on such line of credit, we do not believe that a 10% change in the interest rate would have a material effect on our consolidated results of operations or financial condition. To the extent that we incur additional indebtedness, we may increase our exposure to risk from interest rate fluctuations.

A number of our current debt agreements, including the Credit Agreement, have an interest rate tied to LIBOR, which is expected to be discontinued after 2021. A number of alternatives to LIBOR have been proposed or are being developed, but it is not clear which, if any, will be adopted. Any of these alternative methods may result in interest payments that are higher than expected or that do not otherwise correlate over time with the payments that would have been made on such indebtedness for the interest periods if the applicable LIBOR rate was available in its current form.

As of February 1, 2020, we had \$300 million principal amount of 0.00% convertible senior notes due 2020 outstanding (the “2020 Notes”). As this instrument does not bear interest, we do not have interest rate risk exposure related to this debt.

As of February 1, 2020, we had \$335 million principal amount of 0.00% convertible senior notes due 2023 outstanding (the “2023 Notes”). As this instrument does not bear interest, we do not have interest rate risk exposure related to this debt.

As of February 1, 2020, we had \$350 million principal amount of 0.00% convertible senior notes due 2024 outstanding (the “2024 Notes”). As this instrument does not bear interest, we do not have interest rate risk exposure related to this debt.

Market Price Sensitive Instruments

0.00% Convertible Senior Notes due 2019

In connection with the issuance of the 0.00% convertible senior notes due 2019 (the “2019 Notes”), we entered into privately-negotiated convertible note hedge transactions with certain counterparties. The 2019 Notes matured on June 15, 2019, and the convertible note hedge terminated upon the maturity date of the 2019 Notes. We also entered into separate warrant transactions with the same group of counterparties initially relating to the number of shares of our common stock underlying the convertible note hedge transactions, subject to customary anti-dilution adjustments. The strike price of the warrant transactions was initially \$171.98 per share. Refer to Note 10—*Convertible Senior Notes* in our consolidated financial statements within Part II of this Annual Report on Form 10-K.

During fiscal 2019, we delivered approximately 167,100 shares upon exercise of the warrants under the terms of the warrant agreements. The warrants expired on December 6, 2019.

0.00% Convertible Senior Notes due 2020

In connection with the issuance of the 2020 Notes, we entered into privately-negotiated convertible note hedge transactions with certain counterparties. The convertible note hedge transactions relate to, collectively, 2.5 million shares of our common stock, which represents the number of shares of our common stock underlying the 2020 Notes, subject to anti-dilution adjustments substantially similar to those applicable to the 2020 Notes. These convertible note hedge transactions are expected to reduce the potential earnings dilution with respect to our common stock upon conversion of the 2020 Notes and/or reduce our exposure to potential cash or stock payments that may be required upon conversion of the 2020 Notes.

We also entered into separate warrant transactions with the same group of counterparties initially relating to the number of shares of our common stock underlying the convertible note hedge transactions, subject to customary anti-dilution adjustments. The warrant transactions will have a dilutive effect with respect to our common stock to the extent that the price per share of our common stock exceeds the strike price of the warrants unless we elect, subject to certain conditions, to settle the warrants in cash. The strike price of the warrant transactions is initially \$189.00 per share. Refer to Note 10—*Convertible Senior Notes* in our consolidated financial statements within Part II of this Annual Report on Form 10-K.

0.00% Convertible Senior Notes due 2023

In connection with the issuance of the 2023 Notes, we entered into privately-negotiated convertible note hedge transactions with certain counterparties. The convertible note hedge transactions relate to, collectively, 1.7 million shares of our common stock, which represents the number of shares of our common stock underlying the 2023 Notes, subject to anti-dilution adjustments substantially similar to those applicable to the 2023 Notes. These convertible note hedge transactions are expected to reduce the potential earnings dilution with respect to our common stock upon conversion of the 2023 Notes and/or reduce our exposure to potential cash or stock payments that may be required upon conversion of the 2023 Notes.

We also entered into separate warrant transactions with the same group of counterparties initially relating to the number of shares of our common stock underlying the convertible note hedge transactions, subject to customary anti-dilution adjustments. The warrant transactions will have a dilutive effect with respect to our common stock to the extent that the price per share of our common stock exceeds the strike price of the warrants unless we elect, subject to certain conditions, to settle the warrants in cash. The strike price of the warrant transactions is initially \$309.84 per share. Refer to Note 10—*Convertible Senior Notes* in our consolidated financial statements within Part II of this Annual Report on Form 10-K.

0.00% Convertible Senior Notes due 2024

In connection with the issuance of the 2024 Notes, we entered into privately-negotiated convertible note hedge transactions with certain counterparties. The convertible note hedge transactions relate to, collectively, 1.7 million shares of our common stock, which represents the number of shares of our common stock underlying the 2024 Notes, subject to anti-dilution adjustments substantially similar to those applicable to the 2024 Notes. These convertible note hedge transactions are expected to reduce the potential earnings dilution with respect to our common stock upon conversion of the 2024 Notes and/or reduce our exposure to potential cash or stock payments that may be required upon conversion of the 2024 Notes.

We also entered into separate warrant transactions with the same group of counterparties initially relating to the number of shares of our common stock underlying the convertible note hedge transactions, subject to customary anti-dilution adjustments. The warrant transactions will have a dilutive effect with respect to our common stock to the extent that the price per share of our common stock exceeds the strike price of the warrants unless we elect, subject to certain conditions, to settle the warrants in cash. The strike price of the warrant transactions is initially \$338.24 per share. Refer to Note 10—*Convertible Senior Notes* in our consolidated financial statements.

Impact of Inflation

Our results of operations and financial condition are presented based on historical cost. While it is difficult to accurately measure the impact of inflation due to the imprecise nature of the estimates required, we believe the effects of inflation, if any, on our consolidated results of operations and financial condition have been immaterial.

Item 8. Financial Statements and Supplementary Data

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of RH

Opinions on the Financial Statements and Internal Control over Financial Reporting

We have audited the accompanying consolidated balance sheets of RH and its subsidiaries (the “Company”) as of February 1, 2020 and February 2, 2019, and the related consolidated statements of operations, comprehensive income (loss), stockholders’ equity (deficit) and cash flows for each of the three years in the period ended February 1, 2020, including the related notes (collectively referred to as the “consolidated financial statements”). We also have audited the Company’s internal control over financial reporting as of February 1, 2020, based on criteria established in Internal Control - Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Company as of February 1, 2020 and February 2, 2019, and the results of its operations and its cash flows for each of the three years in the period ended February 1, 2020 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of February 1, 2020, based on criteria established in Internal Control - Integrated Framework (2013) issued by the COSO.

Changes in Accounting Principles

As discussed in Note 3 to the consolidated financial statements, the Company changed the manner in which it accounts for leases in fiscal 2019 and the manner in which it accounts for revenues from contracts with customers in fiscal 2018. The adoption of the accounting standard on leases is also discussed below as a critical audit matter.

Basis for Opinions

The Company’s management is responsible for these consolidated financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in Management’s Report on Internal Control over Financial Reporting appearing under Item 9A. Our responsibility is to express opinions on the Company’s consolidated financial statements and on the Company’s internal control over financial reporting based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) (PCAOB) and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement, whether due to error or fraud, and whether effective internal control over financial reporting was maintained in all material respects.

Our audits of the consolidated financial statements included performing procedures to assess the risks of material misstatement of the consolidated financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the consolidated financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements. Our audit of internal control over financial reporting included obtaining an

understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

Emphasis of Matter

As discussed in Note 20 to the consolidated financial statements, in response to the public health crisis posed by COVID-19, effective from March 17, 2020, the Company temporarily closed its retail locations for an indeterminate period of time. As a result of these developments, the Company expects an unfavorable impact on its sales, results of operations and cash flows in fiscal 2020. Management's evaluation of the events and conditions and management's plans to mitigate these matters are also described in Note 20.

Definition and Limitations of Internal Control over Financial Reporting

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Critical Audit Matters

The critical audit matter communicated below is a matter arising from the current period audit of the consolidated financial statements that was communicated or required to be communicated to the audit committee and that (i) relates to accounts or disclosures that are material to the consolidated financial statements and (ii) involved our especially challenging, subjective, or complex judgments. The communication of critical audit matters does not alter in any way our opinion on the consolidated financial statements, taken as a whole, and we are not, by communicating the critical audit matter below, providing a separate opinion on the critical audit matter or on the accounts or disclosures to which it relates.

Adoption of Accounting Standard on Leases

As described above and in Note 3 to the consolidated financial statements, the Company adopted the new accounting standard on leases using a modified retrospective approach. Under this adoption method, the results of prior comparative periods are presented with an adjustment to opening retained earnings of the earliest comparative period presented. As of February 3, 2019, the adoption of the new accounting standard on leases resulted in an increase of \$617 million and \$633 million to consolidated total assets and liabilities, respectively. In addition, the Company recorded an increase to the fiscal 2017 (the earliest comparative period presented) opening retained earnings balance of \$4.0 million, inclusive of the tax impact. The adoption of the new accounting standard on leases included the derecognition of non-Company owned properties that were capitalized under previously existing build-to-suit accounting policies and are now classified as either an

operating or finance lease upon lease commencement. In addition, any capital amounts contributed by the Company toward the construction of the leased asset are recorded as landlord assets under construction within other non-current assets. Upon lease commencement, the Company reclassifies amounts of the construction project determined to be the landlord asset to lease right-of-use assets.

The principal considerations for our determination that performing procedures relating to adoption of the new accounting standard on leases is a critical audit matter are that there was significant judgment by management when (i) identifying and evaluating the impact of varying terms and conditions within leasing contracts, highlighted by the treatment of non-Company owned properties that were capitalized under previously existing build-to-suit accounting policies, and (ii) applying the transition guidance to all current and comparative periods presented in accordance with the modified retrospective method. This in turn led to significant auditor judgment, subjectivity and effort in performing audit procedures relating to the accounting treatment for each lease arrangement and the application of the transition guidance to all current and comparative periods presented. The audit effort involved the use of professionals with specialized skill and knowledge.

Addressing the matter involved performing procedures and evaluating audit evidence in connection with forming our overall opinion on the consolidated financial statements. These procedures included testing the effectiveness of controls relating to the adoption of the new accounting standard on leases, including the treatment of non-Company owned properties and the transition guidance to all current and comparative periods presented. These procedures also included, among others, evaluating management's lease classification and accounting treatment of all non-Company owned properties that were capitalized under previously existing build-to-suit accounting policies and the recognition of right-of-use assets and liabilities to all current and comparative periods presented. Professionals with specialized skill and knowledge were used to assist in evaluating the Company's technical application of the accounting standard related to non-Company owned properties that were capitalized under previously existing build-to-suit accounting policies, and the application of the transition guidance to all current and comparative periods presented.

/s/ PricewaterhouseCoopers LLP

San Francisco, California
March 30, 2020

We have served as the Company's auditor since 2008.

RH
CONSOLIDATED BALANCE SHEETS
(In thousands, except share amounts)

	February 1, 2020	February 2, 2019
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 47,658	\$ 5,803
Accounts receivable—net	48,979	40,224
Merchandise inventories	438,696	531,947
Asset held for sale	—	21,795
Prepaid expense and other current assets	61,619	104,198
	<hr/>	<hr/>
Total current assets	596,952	703,967
Property and equipment—net	967,599	952,957
Operating lease right-of-use assets	410,904	440,504
Goodwill	124,367	124,379
Tradenames, trademarks and domain names	86,022	86,022
Deferred tax assets	45,005	35,603
Other non-current assets	214,845	79,586
	<hr/>	<hr/>
Total assets	<u>\$2,445,694</u>	<u>\$2,423,018</u>
LIABILITIES AND STOCKHOLDERS' DEFICIT		
Current liabilities:		
Accounts payable and accrued expenses	\$ 330,309	\$ 320,497
Deferred revenue and customer deposits	162,433	152,595
Convertible senior notes due 2019—net	—	343,789
Convertible senior notes due 2020—net	290,532	—
Operating lease liabilities	58,924	66,249
Other current liabilities	140,714	109,456
	<hr/>	<hr/>
Total current liabilities	982,912	992,586
Asset based credit facility	—	57,500
Equipment promissory notes—net	31,053	—
Convertible senior notes due 2020—net	—	271,157
Convertible senior notes due 2023—net	266,658	249,151
Convertible senior notes due 2024—net	264,982	—
Non-current operating lease liabilities	409,930	437,557
Non-current finance lease liabilities	442,988	421,245
Other non-current obligations	28,520	32,512
	<hr/>	<hr/>
Total liabilities	<u>2,427,043</u>	<u>2,461,708</u>
Commitments and contingencies (Note 18)		
Stockholders' (deficit):		
Preferred stock—\$0.0001 par value per share, 10,000,000 shares authorized, no shares issued or outstanding as of February 1, 2020 and February 2, 2019	—	—
Common stock—\$0.0001 par value per share, 180,000,000 shares authorized, 19,236,681 shares issued and outstanding as of February 1, 2020; 20,480,613 shares issued and 20,477,813 shares outstanding as of February 2, 2019	2	2
Additional paid-in capital	430,662	356,422
Accumulated other comprehensive loss	(2,760)	(2,334)
Accumulated deficit	(409,253)	(392,537)
Treasury stock—at cost, no shares as of February 1, 2020 and 2,800 shares as of February 2, 2019	—	(243)
	<hr/>	<hr/>
Total stockholders' (deficit)	18,651	(38,690)
	<hr/>	<hr/>
Total liabilities and stockholders' (deficit)	<u>\$2,445,694</u>	<u>\$2,423,018</u>

The accompanying notes are an integral part of these Consolidated Financial Statements.

RH
CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands, except share and per share amounts)

	Year Ended		
	February 1, 2020	February 2, 2019	February 3, 2018
Net revenues	\$ 2,647,437	\$ 2,505,653	\$ 2,440,174
Cost of goods sold	1,552,426	1,520,076	1,600,876
Gross profit	1,095,011	985,577	839,298
Selling, general and administrative expenses	732,180	723,841	722,183
Income from operations	362,831	261,736	117,115
Other expenses			
Interest expense—net	87,177	67,769	56,002
Goodwill and tradename impairment	—	32,086	33,700
Loss on extinguishment of debt—net	6,472	917	4,880
Total other expenses	93,649	100,772	94,582
Income before income taxes	269,182	160,964	22,533
Income tax expense	48,807	25,233	25,132
Net income (loss)	\$ 220,375	\$ 135,731	\$ (2,599)
Weighted-average shares used in computing basic net income (loss) per share	19,082,303	21,613,678	27,053,616
Basic net income (loss) per share	\$ 11.55	\$ 6.28	\$ (0.10)
Weighted-average shares used in computing diluted net income (loss) per share	24,299,034	26,533,225	27,053,616
Diluted net income (loss) per share	\$ 9.07	\$ 5.12	\$ (0.10)

The accompanying notes are an integral part of these Consolidated Financial Statements.

RH
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)
(In thousands)

	Year Ended		
	February 1, 2020	February 2, 2019	February 3, 2018
Net income (loss)	\$220,375	\$135,731	\$(2,599)
Net (losses) gains from foreign currency translation	(426)	(2,163)	1,510
Net unrealized gains on investment securities	—	—	11
Total comprehensive income (loss)	<u>\$219,949</u>	<u>\$133,568</u>	<u>\$(1,078)</u>

The accompanying notes are an integral part of these Consolidated Financial Statements.

RH
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY (DEFICIT)

(In thousands, except share amounts)

	Common Stock		Additional Paid-In Capital	Accumulated Other Comprehensive Income (Loss)	Retained Earnings (Accumulated Deficit)	Treasury Stock		Total Stockholders' Equity (Deficit)
	Shares	Amount				Shares	Amount	
Balances—January 28, 2017 ..	40,828,633	\$ 4	\$ 790,866	\$(1,692)	\$ 154,174	294,888	\$ (19,523)	\$ 923,829
Stock-based compensation	—	—	50,283	—	—	—	—	50,283
Issuance of restricted stock	15,631	—	—	—	—	—	—	—
Vested and delivered restricted stock units	197,660	—	(4,504)	—	—	—	—	(4,504)
Exercise of stock options	695,546	—	23,643	—	—	—	—	23,643
Repurchases of common stock	(20,220,132)	(2)	—	—	—	20,220,132	(1,000,326)	(1,000,328)
Retirement of treasury stock	—	—	(19,523)	—	—	(294,888)	19,523	—
Net loss	—	—	—	—	(2,599)	—	—	(2,599)
Net gains from foreign currency translation	—	—	—	1,510	—	—	—	1,510
Net unrealized holding gains on investments	—	—	—	11	—	—	—	11
Balances—February 3, 2018	21,517,338	\$ 2	\$ 840,765	\$(171)	\$ 151,575	20,220,132	\$(1,000,326)	\$ (8,155)
Stock-based compensation	—	—	23,557	—	—	—	—	23,557
Issuance of restricted stock	6,405	—	—	—	—	—	—	—
Vested and delivered restricted stock units	122,177	—	(9,502)	—	—	—	—	(9,502)
Exercise of stock options	882,272	—	44,024	—	—	—	—	44,024
Repurchases of common stock	(2,050,379)	—	—	—	—	2,050,379	(250,243)	(250,243)
Retirement of treasury stock	—	—	(591,519)	—	(658,807)	(22,267,711)	1,250,326	—
Equity component value of convertible note issuance— net	—	—	89,933	—	—	—	—	89,933
Sale of common stock warrant	—	—	51,021	—	—	—	—	51,021
Purchase of convertible note hedge	—	—	(91,857)	—	—	—	—	(91,857)
Impact of Topic 606 adoption	—	—	—	—	(21,036)	—	—	(21,036)
Net income	—	—	—	—	135,731	—	—	135,731
Net losses from foreign currency translation	—	—	—	(2,163)	—	—	—	(2,163)
Balances—February 2, 2019	20,477,813	\$ 2	\$ 356,422	\$(2,334)	\$(392,537)	2,800	\$(243)	\$(38,690)
Stock-based compensation	—	—	21,406	—	—	—	—	21,406
Issuance of restricted stock	7,014	—	—	—	—	—	—	—
Vested and delivered restricted stock units	109,062	—	(7,069)	—	—	—	—	(7,069)
Exercise of stock options	643,090	—	27,138	—	—	—	—	27,138
Repurchases of common stock	(2,167,396)	—	—	—	—	2,167,396	(250,032)	(250,032)
Retirement of treasury stock	—	—	(13,180)	—	(237,091)	(2,170,154)	250,271	—
Shares issued in connection with warrant agreements	167,056	—	—	—	—	—	—	—
Equity component value of convertible note issuance— net	—	—	87,070	—	—	—	—	87,070
Sale of common stock warrant	—	—	50,225	—	—	—	—	50,225
Purchase of convertible note hedge	—	—	(91,350)	—	—	—	—	(91,350)
Conversion of convertible senior notes	42	—	—	—	—	(42)	4	4
Net income	—	—	—	—	220,375	—	—	220,375
Net losses from foreign currency translation	—	—	—	(426)	—	—	—	(426)
Balances—February 1, 2020 ..	19,236,681	\$ 2	\$ 430,662	\$(2,760)	\$(409,253)	—	\$ —	\$ 18,651

The accompanying notes are an integral part of these Consolidated Financial Statements.

RH
CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)

	Year Ended		
	February 1, 2020	February 2, 2019	February 3, 2018
CASH FLOWS FROM OPERATING ACTIVITIES			
Net income (loss)	\$ 220,375	\$ 135,731	\$ (2,599)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:			
Depreciation and amortization	100,739	91,372	83,176
Non-cash operating lease cost	65,195	68,612	75,610
Asset impairments	15,168	6,533	8,876
Goodwill and tradename impairment	—	32,086	33,700
Asset held for sale loss (gain)	(1,529)	8,497	—
Amortization of debt discount	46,245	41,868	30,457
Accretion of debt discount upon settlement of debt	(70,482)	—	—
Stock-based compensation expense	21,832	23,983	50,709
Non-cash finance lease interest expense	22,608	16,785	11,154
Product recalls	(3,517)	6,874	7,707
Net non-cash charges resulting from inventory step-up	—	380	2,527
Amortization of purchase premiums and accretion of purchase discount—net	—	—	99
Deferred income taxes	(7,709)	(5,018)	3,733
Loss on extinguishment of debt—net	6,472	917	4,880
Other non-cash interest expense	4,334	3,639	4,768
Change in assets and liabilities:			
Accounts receivable	(7,309)	(8,583)	2,458
Merchandise inventories	93,266	(7,399)	220,767
Prepaid expense and other assets	28,404	(88,434)	27,920
Landlord assets under construction—net of tenant allowances	(64,300)	(59,001)	(81,065)
Accounts payable and accrued expenses	7,445	10,148	65,105
Deferred revenue and customer deposits	9,799	8,413	3,366
Other current liabilities	(45,767)	51,214	5,008
Current and non-current operating lease liabilities	(77,004)	(70,875)	(70,541)
Other non-current obligations	(25,077)	(18,139)	(13,310)
Net cash provided by operating activities	339,188	249,603	474,505
CASH FLOWS FROM INVESTING ACTIVITIES			
Capital expenditures	(93,623)	(79,992)	(68,393)
Deposits on asset under construction	(53,000)	—	—
Proceeds from sale of assets	24,078	—	15,123
Purchase of investments	—	—	(16,109)
Maturities of investments	—	—	46,890
Sales of investments	—	—	145,020
Net cash provided by (used in) investing activities	(122,545)	(79,992)	122,531
CASH FLOWS FROM FINANCING ACTIVITIES			
Borrowings under asset based credit facility	322,500	866,500	600,000
Repayments under asset based credit facility	(380,000)	(1,008,970)	(400,030)
Borrowings under term loans	320,000	—	180,000
Repayments under term loans	(324,000)	(80,000)	(103,000)
Borrowings under promissory and equipment security notes	122,000	—	34,000
Repayments under promissory and equipment security notes	(16,520)	(31,974)	(2,319)
Debt issuance costs	(4,636)	—	(8,298)
Proceeds from issuance of convertible senior notes	350,000	335,000	—
Proceeds from issuance of warrants	50,225	51,021	—
Purchase of convertible note hedges	(91,350)	(91,857)	—
Debt issuance costs related to convertible senior notes	(4,818)	(6,349)	—
Repayments of convertible senior notes	(278,560)	—	—
Principal payments under finance leases	(9,682)	(6,885)	(6,105)
Repurchases of common stock—including commissions	(250,032)	(250,000)	(1,000,326)
Proceeds from exercise of stock options	27,138	44,024	24,896
Tax withholdings related to issuance of stock-based awards	(7,069)	(9,502)	(5,759)
Net cash used in financing activities	(174,804)	(188,992)	(686,941)
Effects of foreign currency exchange rate translation	16	(130)	152
Net increase (decrease) in cash and cash equivalents and restricted cash equivalents	41,855	(19,511)	(89,753)
Cash and cash equivalents and restricted cash equivalents			
Beginning of period—cash and cash equivalents	5,803	17,907	87,023
Beginning of period—restricted cash equivalents (construction related deposits)	—	7,407	28,044
Beginning of period—cash and cash equivalents and restricted cash equivalents	\$ 5,803	\$ 25,314	\$ 115,067
End of period—cash and cash equivalents	47,658	5,803	17,907
End of period—restricted cash equivalents (construction related deposits)	—	—	7,407
End of period—cash and cash equivalents and restricted cash equivalents	\$ 47,658	\$ 5,803	\$ 25,314
Cash paid for interest	\$ 43,278	\$ 31,154	\$ 28,180
Cash paid for taxes	40,126	41,289	4,025
Non-cash transactions:			
Property and equipment additions in accounts payable and accrued expenses at period-end	\$ 5,161	\$ 7,837	7,640
Landlord asset additions in accounts payable and accrued expenses at period-end	19,640	12,142	17,543
Landlord asset additions from unpaid construction related deposits	195	2,807	5,091
Reclassification of assets from landlord assets under construction to finance lease right-of-use assets	19,503	79,685	57,990
Issuance of non-current notes payable related to share repurchases from former employees	—	243	—

The accompanying notes are an integral part of these Consolidated Financial Statements.

RH
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1—NATURE OF BUSINESS

RH, a Delaware corporation, together with its subsidiaries (collectively, the “Company”), is a luxury home furnishings retailer that offers a growing number of categories, including furniture, lighting, textiles, bathware, décor, outdoor and garden, and child and teen furnishings. These products are sold through the Company’s stores, catalogs and websites.

As of February 1, 2020, the Company operated a total of 68 RH Galleries and 38 RH outlet stores in 31 states, the District of Columbia and Canada, as well as 15 Waterworks showrooms throughout the United States and in the U.K., and had sourcing operations in Shanghai and Hong Kong.

NOTE 2—ORGANIZATION

The Company was formed on August 18, 2011 and capitalized on September 2, 2011 as a holding company for the purposes of facilitating an initial public offering of common equity and was at such time a direct subsidiary of Home Holdings, LLC, a Delaware limited liability company (“Home Holdings”).

On November 1, 2012, the Company acquired all of the outstanding shares of capital stock of Restoration Hardware, Inc., a Delaware corporation, and Restoration Hardware, Inc. became a direct, wholly owned subsidiary of the Company. Restoration Hardware, Inc. was a direct, wholly owned subsidiary of Home Holdings prior to the Company’s initial public offering. Outstanding units issued by Home Holdings under its equity compensation plan, referred to as the Team Resto Ownership Plan, were replaced with common stock of the Company at the time of its initial public offering. These transactions are referred to as the “Reorganization.” On November 7, 2012, the Company completed its initial public offering.

On December 15, 2016, Restoration Hardware Holdings, Inc. filed a Certificate of Amendment to its Amended and Restated Certificate of Incorporation with the Secretary of State of the State of Delaware to change its name to “RH,” effective January 1, 2017.

Convertible Senior Notes

In September 2019, the Company issued in a private offering \$350 million principal amount of 0.00% convertible senior notes due 2024 (the “2024 Notes”). In connection with the issuance of these notes, the Company entered into convertible note hedge transactions for which it paid an aggregate amount of \$91.4 million. In connection with the issuance of the 2024 Notes, the Company sold warrants to purchase shares of common stock of the Company, for which it received aggregate proceeds of approximately \$50.2 million. Taken together, the Company received total cash proceeds of \$304.1 million, net of discounts upon original issuance and offering costs of \$4.8 million, from the issuance of the 2024 Notes and the related warrants. Refer to Note 10—*Convertible Senior Notes*.

Subsequent Event

In March 2020, the World Health Organization declared the outbreak of a novel coronavirus disease (“COVID-19”) as a pandemic, which continues to spread throughout the United States and globally. Refer to Note 20—*Subsequent Event* for further information.

NOTE 3—SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

These consolidated financial statements are prepared in conformity with accounting principles generally accepted in the United States (“GAAP”). The consolidated financial statements include the accounts of the

Company and its wholly owned subsidiaries. Accordingly, all intercompany balances and transactions have been eliminated through the consolidation process.

Revision

As previously disclosed within the Company’s quarterly reports on Form 10-Q for its fiscal quarters during the year ended February 1, 2020, during the adoption process of the new lease accounting standard (refer to “Recently Issued Accounting Standards—Leases” below), the Company identified a lease agreement that was incorrectly accounted for as an impaired lease under Accounting Standard Codification (“ASC”) 420—*Exit or Disposal Cost Obligations* in fiscal 2017 and the first quarter of fiscal 2018. This error resulted in an overstatement of net income of \$1.4 million and \$0.9 million for fiscal 2017 and fiscal 2018, respectively. This error also resulted in an overstatement of retained earnings as of February 3, 2018 of \$1.4 million, from \$152.4 million as reported to \$151.0 million as revised, and understatement of accumulated deficit of \$2.3 million, from \$376.8 million as reported to \$379.1 million, prior to the impact of the modified retrospective application of the new lease accounting standard as further discussed under “Recently Issued Accounting Standards—Leases” below. In addition, as of February 2, 2019, this error resulted in an understatement of other non-current obligations of \$3.3 million, and an overstatement of other current liabilities of \$1.0 million, as revised. Although these errors are not considered to be material to any of the previously issued financial statements, the Company has revised the accompanying consolidated financial statements to reflect the correction of these errors.

In addition, during the adoption process of the new lease accounting standard, the Company identified an error in its previously reported consolidated statement of cash flows for fiscal 2018. This error resulted in an understatement of \$9.2 million of net cash provided by operating activities and an understatement of \$9.2 million of net cash used in investing activities for fiscal 2018. There was no impact on the consolidated balance sheets, consolidated statements of operations or the consolidated statement of stockholders’ equity (deficit) related to this error. Although these errors are not considered to be material to any of the previously issued financial statements, the Company has revised the accompanying consolidated financial statements to reflect the correction of these errors.

The following are selected line items from the Company’s consolidated statements of cash flows illustrating the effect of the corrections, prior to the adoption of the modified retrospective application of the new lease accounting standard (*in thousands*):

	Year Ended February 2, 2019		
	<u>As Reported</u>	<u>Adjustment</u>	<u>As Revised</u>
Cash flows from operating activities:			
Change in accounts payable and accrued expenses	\$ (452)	\$ 9,201	\$ 8,749
Net cash provided by operating activities	300,556	9,201	309,757
Cash flows from investing activities:			
Capital expenditures	(136,736)	(9,201)	(145,937)
Net cash used in investing activities	(136,736)	(9,201)	(145,937)

Fiscal Years

The Company’s fiscal year ends on the Saturday closest to January 31. As a result, the Company’s fiscal year may include 53 weeks. The fiscal years ended February 1, 2020 (“fiscal 2019”) and February 2, 2019 (“fiscal 2018”) each consisted of 52 weeks. The fiscal year ended February 3, 2018 (“fiscal 2017”) consisted of 53 weeks.

Use of Accounting Estimates

The preparation of the Company’s consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and

disclosures of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates and such differences could be material to the consolidated financial statements.

Cash and Cash Equivalents

The Company considers all highly liquid investments with original maturities of 90 days or less to be cash equivalents.

Concentration of Credit Risk

The Company maintains its cash and cash equivalent accounts in financial institutions in both U.S. dollar and Canadian dollar denominations. Accounts at the U.S. institutions are insured by the Federal Deposit Insurance Corporation (“FDIC”) up to \$250,000 and accounts at the Canadian institutions are insured by the Canada Deposit Insurance Corporation (“CDIC”) up to \$100,000 Canadian dollars. As of February 1, 2020 and February 2, 2019, and at various times throughout these fiscal years, the Company had cash in financial institutions in excess of the amount insured by the FDIC and CDIC. The Company performs ongoing evaluations of these institutions to limit its concentration of credit risk.

Accounts Receivable

Accounts receivable consist primarily of receivables from the Company’s credit card processors for sales transactions, receivables related to the Company’s contract business and other miscellaneous receivables. Accounts receivable is presented net of allowance for doubtful accounts, which is recorded on a specific identification basis. The allowance for doubtful accounts was \$2.2 million and \$1.9 million as of February 1, 2020 and February 2, 2019, respectively.

Merchandise Inventories

The Company’s merchandise inventories are comprised of finished goods and are carried at the lower of cost or net realizable value, with cost determined on a weighted-average cost method. To determine if the value of inventory should be marked down below original cost, the Company uses estimates to determine the lower of cost or net realizable value, which considers current and anticipated demand, customer preference and the merchandise age. The inventory value is adjusted periodically to reflect current market conditions, which requires management judgments that may significantly affect the ending inventory valuation, as well as gross margin. The estimates used in inventory valuation are lower of cost or net realizable value reserves and obsolescence (including excess and slow-moving inventory). Additionally, the Company estimates and accrues for inventory shrinkage for the period between the last physical count and the balance sheet date.

The Company’s inventory reserves contain uncertainties that require management to make assumptions and to apply judgment regarding a number of factors, including market conditions, the selling environment, historical results and current inventory trends. The Company adjusts inventory reserves for net realizable value and obsolescence based on trends, aging reports, specific identification and estimates of future retail sales prices.

Reserves for shrinkage are estimated and recorded throughout the year as a percentage of shipped sales for the direct channels, and a percentage of cost of goods sold for the outlet business, based on historical shrinkage results and current inventory levels. Actual shrinkage is recorded throughout the year based upon periodic cycle counts and the results of the Company’s annual physical inventory counts. Actual inventory shrinkage and obsolescence can vary from estimates due to factors including the mix of the Company’s inventory (which ranges from large furniture to décor) and execution against loss prevention initiatives in the Company’s stores, distribution centers, home delivery center locations, off-site storage locations and with its third-party transportation providers. Accordingly, there is no shrinkage reserve at year-end, with the exception of a cycle

count reserve for the Company's distribution centers and home delivery center locations based on the historical cycle count results.

If actual net realizable value, obsolescence or shrinkage estimates change from the Company's original estimates, the Company will adjust its inventory reserves accordingly throughout the period. The Company's inventory reserve balances were \$25.6 million and \$30.7 million as of February 1, 2020 and February 2, 2019, respectively.

Product Recalls

During fiscal 2019, fiscal 2018 and fiscal 2017, the Company initiated product recalls for certain of its products, as well as adjusted accruals related to certain product recalls previously initiated due to changes in estimates based on customer response and vendor and insurance recoveries. Product recalls had the following effect on the Company's income before income taxes (*in thousands*):

	Year Ended		
	February 1, 2020	February 2, 2019	February 3, 2018
(Increase) decrease to net revenues	\$ (391)	\$ 4,733	\$3,207
Increase (decrease) to cost of goods sold	(3,372)	(4,139)	4,315
(Increase) decrease to gross profit	(3,763)	594	7,522
Increase (decrease) to selling, general and administrative expenses	(225)	1,025	185
(Increase) decrease to income before income taxes	<u>\$(3,988)</u>	<u>\$ 1,619</u>	<u>\$7,707</u>

The product recall accrual as of February 1, 2020 and February 2, 2019 was \$2.1 million and \$7.8 million, respectively, and is included in other current liabilities on the consolidated balance sheets.

Advertising Expenses

Advertising expenses primarily represent the costs associated with the Company's catalog mailings, as well as print and website marketing. Total advertising expense, which is recorded in selling, general and administrative expenses on the consolidated statements of operations, was \$107.6 million, \$97.0 million and \$106.6 million in fiscal 2019, fiscal 2018 and fiscal 2017, respectively.

Capitalized Catalog Costs

Capitalized catalog costs consist primarily of third-party incremental direct costs to prepare, print and distribute Source Books. Such costs are capitalized and recognized as expense upon the delivery of the Source Books to the carrier. In the case of multiple printings of a Source Book, the creative costs will be expensed in full upon the initial delivery of Source Books to the carrier.

The Company had \$13.7 million and \$16.2 million of capitalized catalog costs as of February 1, 2020 and February 2, 2019, respectively, which are included in prepaid expense and other current assets on the consolidated balance sheets.

Website and Print Advertising

Website and print advertising expenses, which include e-commerce advertising, web creative content and direct marketing activities such as print media, radio and other media advertising, are expensed as incurred or upon the release of the content or the initial advertisement.

Property and Equipment

Property and equipment is recorded at cost, net of accumulated depreciation and amortization. Depreciation is calculated using the straight-line method, generally using the following useful lives:

<u>Category of Property and Equipment</u>	<u>Useful Life</u>
Building and building improvements	40 years
Machinery, equipment and aircraft	3 to 10 years
Furniture, fixtures and equipment	3 to 7 years
Computer software	3 to 10 years

The cost of leasehold improvements is amortized over the lesser of the useful life of the asset or the applicable lease term, which could include option periods reasonably certain to be exercised.

The Company expenses all internal-use software costs incurred in the preliminary project stage and capitalizes certain direct costs associated with the development and purchase of internal-use software, including external costs of materials and services and internal payroll costs related to the software project, within property and equipment. Capitalized costs are amortized on a straight-line basis over the estimated useful lives of the software, generally between three and ten years.

Interest is capitalized on construction in progress and software projects during the period in which expenditures have been made, activities are in progress to prepare the asset for its intended use and interest expense is being incurred. The Company capitalized interest of \$4.9 million, \$3.1 million and \$3.3 million in fiscal 2019, fiscal 2018 and fiscal 2017, respectively. During fiscal 2019, \$3.7 million of the \$4.9 million capitalized interest relates to the capitalization of non-cash interest associated with the amortization of the convertible senior notes debt discount. During fiscal 2018, \$2.7 million of the \$3.1 million capitalized interest relates to the capitalization of non-cash interest associated with the amortization of the convertible senior notes debt discount. During fiscal 2017, \$2.5 million of the \$3.3 million capitalized interest relates to the capitalization of non-cash interest associated with the amortization of the convertible senior notes debt discount.

Land purchased by the Company is recorded at cost and is a non-depreciable asset.

Property and equipment is reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of assets may not be recoverable. For further discussion regarding the impairment accounting policy refer to “Impairment—*Long-Lived Assets*” below.

Asset Held for Sale

Upon designation as an asset held for sale, the carrying value of the asset is recorded at the lower of its carrying value or its estimated fair value less estimated costs to sell, and the Company ceases depreciating the asset.

Lease Accounting

The Company leases nearly all of its retail and outlet store locations, corporate headquarters, distribution and home delivery facilities, as well as other storage and office space. The initial lease terms of the Company’s real estate leases generally range from ten to fifteen years, and certain leases contain renewal options for up to an additional 25 years, the exercise of which is at the Company’s sole discretion. The Company also leases certain equipment with lease terms generally ranging from three to seven years. The Company’s lease agreements generally do not contain any material residual value guarantees or material restrictions or covenants.

The Company accounts for lease and non-lease components as a single lease component for real estate leases, and for all other asset classes the Company accounts for the components separately. The Company

determines the lease classification and begins to recognize lease and any related financing expenses upon the lease's commencement, which for real estate leases is generally upon store opening or, to a lesser extent, when the Company takes possession or control of the asset.

The Company subleases certain real estate locations to third parties under operating leases and recognizes rental income received on a straight-line basis over the lease term, which is recorded as an offset to selling, general and administrative expenses on the consolidated statements of operations.

Lease arrangements may require the landlord to provide tenant allowances directly to the Company. Standard tenant allowances received from landlords, typically those received under operating lease agreements, are recorded as cash and cash equivalents with an offset recorded in lease right-of-use assets on the consolidated balance sheets. Tenant allowances that are reasonably certain to be received subsequent to lease commencement are reflected as a reduction of both the lease liabilities and right-of-use assets on the consolidated balance sheets at the commencement date.

In certain instances tenant allowances are provided for the Company to design and build the leased asset. Tenant allowances received from landlords during the construction phase of a leased asset and prior to lease commencement are recorded as cash and cash equivalents with an offset recorded in other non-current assets (to the extent the Company has incurred related capital expenditure for construction costs) or in other current liabilities (to the extent that payments are received prior to capital construction expenditures by the Company) on the consolidated balance sheets. After the leased asset is constructed and the lease commences, the Company reclassifies the tenant allowance from other non-current assets or other current liabilities to lease right-of-use assets on the consolidated balance sheets, and such allowances are amortized over the reasonably certain lease term.

Lease Classification

Certain of the Company's real estate and equipment leases are classified as finance leases. Lease characteristics that the Company evaluates to determine lease classification include, but are not limited to, the reasonably certain lease term, and the economic life and fair value of the leased asset. Lease related assets under such classification are included in finance lease right-of-use assets within property and equipment—net on the consolidated balance sheets.

Leases that do not meet the definition of a finance lease are considered operating leases. Lease related assets classified as operating leases are included in operating lease right-of-use assets on the consolidated balance sheets.

Reasonably Certain Lease Term

In recognizing the lease right-of-use assets and lease liabilities, the Company utilizes the lease term for which it is reasonably certain to use the underlying asset, including consideration of options to extend or terminate the lease. At lease commencement, the Company evaluates whether it is reasonably certain to exercise available options based on consideration of a variety of economic factors and the circumstances related to the leased asset. Factors considered include, but are not limited to, (i) the contractual terms compared to estimated market rates, (ii) the uniqueness or importance of the asset or its location, (iii) the potential costs of obtaining an alternative asset, (iv) the potential costs of relocating or ceasing use of the asset, including the consideration of leasehold improvements and other invested capital, and (v) any potential tax consequences.

The determination of the reasonably certain lease term affects the inclusion of rental payments utilized in the incremental borrowing rate calculations, the results of the lease classification test, and consideration of certain assets held for sale or planned for sale-leaseback. The reasonably certain lease term may materially impact the Company's financial position related to certain Design Galleries or distribution center facilities which

typically have greater lease payments. Although the above factors are considered in management's analysis, the assessment involves subjectivity considering the Company's strategy, expected future events and market conditions. While the Company believes its estimates and judgments in determining the lease term are reasonable, future events may occur which may require the Company to reassess this determination.

Leases, or lease extensions, with a term of twelve months or less are not recorded on the consolidated balance sheets, and the Company recognizes lease expense for these leases on a straight-line basis over the lease term.

Lease Payments

The majority of the Company's real estate lease agreements include minimum rent payments which are subject to stated lease escalations over the lease term and eligible renewal periods. These fixed payments through the reasonably certain lease term are included in the Company's measurement of the lease right-of-use assets and lease liabilities upon lease commencement.

Certain of the Company's lease agreements include rental payments based on a percentage of retail sales over contractual levels. Additionally, certain lease agreements include rental payments based solely on a percentage of retail sales. Due to the variable and unpredictable nature of such payments, the Company does not recognize a lease right-of-use asset and lease liability related to such payments. Estimated variable rental payments are included in accounts payable and accrued expenses on the consolidated balance sheets in the period they are incurred and until such payments are made, and the related lease cost is included in cost of goods sold on the consolidated statements of operations.

The Company has a small group of real estate leases that include rental payments periodically adjusted for inflation (e.g., based on the consumer price index). The Company includes these variable payments in the initial measurement of the lease right-of-use asset and lease liability according to the index or rate at the commencement date and incorporates adjustments to rental payments in future periods if such increases have a minimum rent escalation (e.g., floor). Changes due to differences between the variable lease payments estimated at least commencement and actual amounts incurred are recognized in the consolidated statement of operations in the period such costs are incurred.

Incremental Borrowing Rate

As the Company's real estate leases and most of its equipment leases do not include an implicit interest rate, the Company determines the discount rate for each lease based upon the incremental borrowing rate ("IBR") in order to calculate the present value of lease payments at the commencement date. The IBR is computed as the rate of interest that the Company would have to pay to (i) borrow on a collateralized basis (ii) over a similar term (iii) an amount equal to the total lease payments (iv) in a similar economic environment. The Company utilizes its asset based credit facility as the basis for determining the applicable IBR for each lease. The Company estimates the incremental borrowing rate for each lease primarily by reference to (i) yield rates on debt issuances by companies of a similar credit rating; (ii) the weighted-average lease term; and (iii) adjustments for differences between the yield rates and the actual term of the credit facility. In determining the yield rates for leases other than new Design Galleries, the Company utilizes market information as of the beginning of the quarter in which the lease commenced. For Design Galleries, the Company utilizes market information on the lease commencement date.

Fair Market Value

The Company determines the fair value of the underlying asset, and the lease components such as land and building, for purposes of determining the lease classification and allocating its contractual rental payments to the lease components. The fair value of the underlying asset and lease components also impact the evaluation and

accounting for assets held for sale and sale-leaseback transactions. The fair value assessments may materially impact the Company's financial position related to certain Design Galleries or distribution center facilities which typically have greater fair values.

The determination of fair value requires subjectivity and estimates, including the use of multiple valuation techniques and uncertain inputs, such as market price per square foot and assumed capitalization rates or the replacement cost of the assets, where applicable. Where real estate valuation expertise is required the Company obtains independent third-party appraisals to determine the fair value of the underlying asset and lease components. While determining fair value requires a variety of input assumptions and judgment, management believes its estimates of fair market value are reasonable.

Construction Related Activities

The Company is often involved in the construction of leased stores for its newer Design Galleries. Prior to construction commencement, the Company evaluates whether or not it, as lessee, controls the asset being constructed and, depending on the extent to which it is involved, the Company may be the "deemed owner" of the leased asset for accounting purposes during the construction period under a build-to-suit arrangement.

If the Company is not the "deemed owner" for accounting purposes during the construction period, such lease is classified as either an operating or finance lease upon lease commencement. During the construction period and prior to lease commencement, any capital amounts contributed by the Company toward the construction of the leased asset (excluding normal leasehold improvements, which are recorded within property and equipment—net) are recorded as "Landlord assets under construction" within other non-current assets on the consolidated balance sheets (refer to Note 4—*Prepaid Expense and Other Assets*). Upon completion of the construction project, and upon lease commencement, the Company reclassifies amounts of the construction project determined to be the landlord asset to lease right-of-use assets on the consolidated balance sheets based on the lease classification determined at lease commencement. The construction costs determined not to be part of the leased asset are classified as property and equipment—net on the consolidated balance sheets.

If the Company is the "deemed owner" for accounting purposes, upon commencement of the construction project it is required to capitalize (i) costs incurred by the Company and (ii) the cash and non-cash assets contributed by the landlord for construction as property and equipment on its consolidated balance sheets as build-to-suit assets, with an offsetting financing obligation under build-to-suit lease transactions. The contributions by the landlord toward construction, including the building, existing site improvements at construction commencement and any amounts paid by the landlord to those responsible for construction, are included as property and equipment additions due to build-to-suit lease transactions within the non-cash section of the consolidated statements of cash flows. Over the lease term, these non-cash additions to property and equipment do not impact the Company's cash outflows, nor do they impact net income on the consolidated statements of operations.

Upon completion of the construction project, the Company performs a sale-leaseback analysis to determine if it can derecognize the build-to-suit asset and corresponding financing obligation. If the asset and liability cannot be derecognized, the Company accounts for the agreement as a debt-like arrangement.

If the Company is involved in a debt-like arrangement for a non-real estate asset under construction for which the Company plans to lease such asset upon construction completion and makes deposits during the construction period, the Company recognizes the related deposits as "Deposits on asset under construction" within other non-current assets on the consolidated balance sheets (refer to Note 4—*Prepaid Expense and Other Assets*). In the event the Company executes promissory notes related to the deposits, such promissory notes are recorded as "Promissory notes on asset under construction" within other current liabilities on the consolidated balance sheets (refer to Note 7—*Accounts Payable, Accrued Expenses and Other Current Liabilities*). The Company recognizes the constructive disbursements and receipts of such debt-like arrangements on a gross basis

on the consolidated statements of cash flows within cash flows from investing activities and cash flows from financing activities, respectively.

Sale-Leaseback Activities

The Company occasionally enters into sale-leaseback transactions to finance certain property acquisitions and capital expenditures, pursuant to which the Company sells the property to a third party and agrees to lease the property back for a certain period of time. To determine whether the transfer of the property should be accounted for as a sale, the Company evaluates whether it has transferred control to the third party in accordance with the guidance set forth in ASC Topic 606.

If the transfer of the asset is a sale at market terms, the Company recognizes the transaction price for the sale based on the cash proceeds received, derecognizes the carrying amount of the underlying asset and recognizes a gain or loss in the consolidated statements of operations for any difference between the carrying value of the asset and the transaction price. The Company then accounts for the leaseback in accordance with its lease accounting policy.

If the transfer of the asset is determined not to be a sale, the Company accounts for the transaction as a financing arrangement. The Company continues to present the asset within property and equipment—net on the consolidated balance sheets and recognizes a non-current obligation on the consolidated balance sheets for the transaction price, with the financial liability subsequently measured in accordance with other applicable GAAP.

Intangible Assets

Intangible assets reflect the value assigned to tradenames, trademarks and domain names. The Company does not amortize its intangible assets as the Company defines the life of these assets as indefinite.

Impairment

Goodwill

The Company evaluates goodwill annually to determine whether it is impaired or whenever events occur or circumstances change that would indicate that the fair value of a reporting unit is less than its carrying amount. Conditions that may indicate impairment include, but are not limited to, a significant adverse change in customer demand or business climate that could affect the value of an asset; general economic conditions, such as increasing Treasury rates or unexpected changes in gross domestic product growth; a change in the Company's market share; budget-to-actual performance and consistency of operating margins and capital expenditures; a product recall or an adverse action or assessment by a regulator; or changes in management or key personnel.

The Company performs its annual goodwill impairment testing in the fourth fiscal quarter by comparing the fair value of a reporting unit with its carrying amount, limited to the total amount of goodwill of the reporting unit. The Company will recognize an impairment charge for the amount by which the carrying amount exceeds the reporting unit's fair value.

The Company determines fair values using the discounted cash flow approach ("income approach") or the market multiple valuation approach ("market approach"), when available and appropriate, or a combination of both. The Company assesses the valuation methodology based upon the relevance and availability of the data at the time it performs the valuation. If multiple valuation methodologies are used, the results are weighted appropriately.

Under the income approach, fair value is determined based on the present value of estimated future cash flows, discounted at an appropriate risk-adjusted rate. The Company uses its internal forecasts to estimate future

cash flows and includes an estimate of long-term future growth rates based on its most recent views of the long-term outlook for each respective reporting unit. Actual results may differ from those assumed in the Company's forecasts. The Company derives its discount rates using a capital asset pricing model and analyzing published rates for industries relevant to its reporting units to estimate the cost of equity financing. The Company uses discount rates that are commensurate with the risks and uncertainty inherent in the respective businesses and in its internally developed forecasts.

Valuations using the market approach are derived from metrics of publicly traded companies or historically completed transactions of comparable businesses. The selection of comparable businesses is based on the markets in which the reporting units operate giving consideration to risk profiles, size, geography, and diversity of products and services. A market approach is limited to reporting units for which there are publicly traded companies that have the characteristics similar to the Company's businesses.

Estimating the fair value of reporting units requires the use of estimates and significant judgments that are based on a number of factors including actual operating results. It is reasonably possible that the judgments and estimates described above could change in future periods.

A reporting unit is an operating segment, or a business unit one level below that operating segment for which discrete financial information is prepared and regularly reviewed by the Chief Operating Decision Maker ("CODM"), which is the Company's Chief Executive Officer. The Company has deemed RH Segment and Waterworks to be the reporting units for which goodwill is independently tested, as these operating segments are the lowest level for which discrete financial information is prepared and regularly reviewed by the CODM.

RH Segment Reporting Unit

During fiscal 2019, fiscal 2018 and fiscal 2017, the Company reviewed the RH Segment reporting unit goodwill for impairment by assessing qualitative factors to determine whether it was more likely than not that the fair value of the reporting unit was less than its carrying amount. Based on the qualitative tests performed in each fiscal year, the Company determined that it was not more likely than not that the fair value of the reporting unit was less than its carrying amount for fiscal 2019, fiscal 2018 and fiscal 2017, and therefore the Company did not recognize goodwill impairment with respect to the RH Segment in any such fiscal year.

Waterworks Reporting Unit

During the fourth fiscal quarters of 2018 and 2017, the Company conducted its annual strategic planning process. Based upon the outcome of this process in each fiscal year, management identified indicators that there could be an impairment of the Waterworks reporting unit. These indicators included (i) an updated long-range financial plan provided by the Waterworks segment management that indicated a reduction of revenues and EBITDA as compared to prior long-range financial plans, (ii) a review of the strategic initiatives of the Waterworks segment and (iii) the Waterworks segment not achieving revenue and operating income objectives compared to plans.

In determining the Waterworks reporting unit estimated fair value using the income approach in both fiscal 2018 and fiscal 2017, the Company projected future cash flows based on management's estimates and long-term plans and applied a discount rate based on a weighted-average cost of capital. This analysis required the Company to make judgments about revenues, expenses, fixed asset and working capital requirements, the impact of updated tax legislation and other subjective inputs. In determining the Waterworks reporting unit estimated fair value using the market approach, the Company considered assumptions that it believes market participants would use in valuing the Waterworks reporting unit, based on EBITDA multiples and including the application of a control premium. For purposes of this analysis, in both fiscal years, the Company weighted the results 80% towards the income approach and 20% towards the market approach.

Based on the estimated fair value of the Waterworks reporting unit as of the assessment date of each of its fiscal 2018 and fiscal 2017 analysis, the Company recorded a \$17.4 million and \$33.7 million non-cash impairment in the fourth quarter of fiscal 2018 and fiscal 2017, respectively, to reduce the carrying value of goodwill in the Waterworks reporting unit. The impairment is recorded in goodwill and tradename impairment on the consolidated statements of operations and the Waterworks reporting unit goodwill was fully impaired as of February 2, 2019.

Tradenames, Trademarks and Domain Names

The Company annually evaluates whether tradenames, trademarks and domain names continue to have an indefinite life. Tradenames, trademarks and domain names are reviewed for impairment annually in the fourth quarter and may be reviewed more frequently if indicators of impairment are present. Conditions that may indicate impairment include, but are not limited to, a significant adverse change in customer demand or business climate that could affect the value of an asset, a product recall or an adverse action or assessment by a regulator.

The Company qualitatively assesses indefinite-lived intangible asset impairment to determine whether it is more likely than not that the fair value of the asset is less than its carrying amount. If tradenames, trademarks and domain names are not qualitatively assessed or if such intangible assets are qualitatively assessed and it is determined it is not more likely than not that the asset's fair value is greater than its carrying amount, an impairment review is performed by comparing the carrying value to the estimated fair value, determined using a discounted cash flow methodology, which requires management judgments that may significantly affect the ending asset valuation. Factors used in the valuation of intangible assets with indefinite lives include, but are not limited to, management's plans for future operations, brand initiatives, recent results of operations and projected future cash flows.

In the event the Company quantitatively assesses a reporting unit's indefinite-lived intangible asset for impairment, the Company performs an impairment test which utilizes the discounted cash flow methodology under the relief-from-royalty method. Under the relief-from-royalty method, significant assumptions include the forecasted future revenues and the estimated royalty rate, expressed as a percentage of revenues.

RH Segment Reporting Unit

During fiscal 2019, fiscal 2018 and fiscal 2017, the Company qualitatively assessed the indefinite-lived intangible assets of the RH Segment reporting unit for impairment and determined it was more likely than not that the fair value of the assets were greater than their carrying amounts. Based on the qualitative tests performed in each fiscal year, the Company did not perform quantitative impairment tests in any year. The Company did not recognize any impairment with respect to intangible assets for the RH Segment reporting unit in fiscal 2019, fiscal 2018 and fiscal 2017.

Waterworks Reporting Unit

In connection with the goodwill impairment test performed for the Waterworks reporting unit in fiscal 2017, described above, the Company performed an impairment test on the tradenames allocated to the reporting unit which utilized the discounted cash flow methodology under the relief-from-royalty method. Under the relief-from-royalty method, the Company's significant assumptions include the forecasted future revenues and the estimated royalty rate, expressed as a percentage of revenues. Based on the quantitative impairment test performed, which resulted in fair value of the tradename in excess of book value by approximately 26%, the Company concluded that the tradename allocated to the Waterworks reporting unit was not impaired as of February 3, 2018 and did not recognize any impairment with respect to the tradename for the Waterworks reporting unit in fiscal 2017.

At the end of each of the first three fiscal quarters of 2018, the Company determined that there were no events or circumstances that indicated any impairment for the Waterworks reporting unit tradename. During the fourth fiscal quarter of 2018, management updated the fiscal 2019 budget and financial projections beyond fiscal 2019 for the Waterworks reporting unit. There were certain factors that caused the key financial inputs for the

tradename valuation model to significantly decrease from the previous inputs, the most significant of which was a reduction of future forecasted net revenues resulting from an expected shift in product mix, challenges in continuing to grow the showrooms business and supply chain constraints.

These factors arising during the fourth fiscal quarter of 2018 had a significant and negative impact on the estimated future cash flows of the Waterworks reporting unit. In connection with the goodwill impairment test performed for the Waterworks reporting unit in fiscal 2018, described above, the Company performed an impairment test on the tradename allocated to the reporting unit which utilized the discounted cash flow methodology under the relief-from-royalty method. Under the relief-from-royalty method, the Company's significant assumptions include the forecasted future revenues and the estimated royalty rate, expressed as a percentage of revenues. Based on the quantitative impairment test performed and the result of changes in forecasted revenues and the valuation assumption around future royalty rates, the Company concluded that the Waterworks reporting unit tradename was impaired as of February 2, 2019. As a result, the Company recognized a \$14.6 million non-cash impairment with respect to the tradename for the Waterworks reporting unit in fiscal 2018, which was recorded in goodwill and tradename impairment on the consolidated statements of operations.

The Company performed its annual impairment procedures on the tradename allocated to the Waterworks reporting unit which utilized the discounted cash flow methodology under the relief-from-royalty method. Under the relief-from-royalty method, the Company's significant assumptions include the forecasted future revenues and the estimated royalty rate, expressed as a percentage of revenues. Based on the quantitative impairment test performed, the Company concluded that the Waterworks reporting unit tradename was not impaired as of February 1, 2020. The Company did not recognize any impairment for the Waterworks reporting unit tradename in fiscal 2019, and the Waterworks tradename balance was \$37.5 million as of February 1, 2020.

Long-Lived Assets

Long-lived assets, such as property and equipment and lease right-of-use assets, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Conditions that may indicate impairment include, but are not limited to, a significant adverse change in customer demand or business climate that could affect the value of an asset, change in intended use of an asset, a product recall or an adverse action or assessment by a regulator. If the sum of the estimated undiscounted future cash flows over the remaining life of the primary asset is less than the carrying value, the Company recognizes a loss equal to the difference between the carrying value and the fair value, usually determined by the estimated discounted cash flow analysis of the asset or asset group. The asset group is defined as the lowest level for which identifiable cash flows are available and largely independent of the cash flows of other groups of assets, which for the stores is the individual gallery level.

Since there is typically no active market for the Company's long-lived assets, the Company estimates fair values based on the expected future cash flows of the asset or asset group, using a discount rate commensurate with the related risk. The estimate of fair value requires management judgments that may significantly affect the ending asset valuation. Future cash flows are estimated based on gallery-level historical results, current trends, and operating and cash flow projections. The Company's estimates are subject to uncertainty and may be affected by a number of factors outside its control, including general economic conditions and the competitive environment. While the Company believes its estimates and judgments about future cash flows are reasonable, future impairment charges may be required if the expected cash flow estimates, as projected, do not occur or if events change requiring the Company to revise its estimates.

The Company did not record impairment for long-lived tangible assets at the individual gallery level in fiscal 2019, fiscal 2018 or fiscal 2017. Due to certain distribution center closures and business line integrations in fiscal 2019, fiscal 2018 and fiscal 2017, the Company recorded impairment for certain corporate assets and other long-lived assets as discussed below under "Distribution Center Closures" and "RH Contemporary Art Impairment," as well as in Note 9—*Leases*. No additional impairment has been recorded for corporate assets and other long-lived assets in fiscal 2019, fiscal 2018 and fiscal 2017.

Distribution Center Closures

During the third quarter of fiscal 2018, the Company initiated and executed a plan to close its distribution center located in Essex, MD. As a result of the distribution center closure, the Company incurred restructuring related costs in the RH Segment in fiscal 2018, including a lease impairment charge of \$2.2 million and a loss on disposal of capitalized property and equipment of \$0.2 million, as well as costs for employee termination benefits of \$0.2 million. The impact to selling, general and administrative expenses on the consolidated statements of operations was \$2.6 million, which represents the total charges incurred with this distribution center closure. The Company did not incur any charges in fiscal 2019 and does not expect to incur additional charges in the future associated with this distribution center closure.

During the third quarter of fiscal 2017, the Company initiated a plan to close two of its distribution centers, one located in Mira Loma, CA and one located in Dallas, TX. The Mira Loma distribution center closure was finalized in November 2017 and the Dallas distribution center closure was finalized in January 2018, both of which occurred in the fourth quarter of fiscal 2017. As a result of the distribution center closures, the Company incurred restructuring related costs in the RH Segment in fiscal 2017, including estimated loss on disposal of capitalized property and equipment of \$4.4 million, as well as costs for employee termination benefits of \$0.9 million. The total expense of \$5.3 million was included in selling, general and administrative expenses on the consolidated statements of operations.

During the first quarter of fiscal 2018, the Company recognized a \$0.8 million reversal of an estimated loss on disposal of asset due to negotiations of the sales price being finalized. The Company did not incur any charges in fiscal 2019 and does not expect to incur additional charges in the future associated with these distribution center closures.

RH Contemporary Art Impairment

In fiscal 2016, the Company initiated and executed a plan to integrate the RH Contemporary Art (“RHCA”) product line into the broader RH platform and no longer operates RHCA as a separate division. The Company recorded additional operating lease right-of-use asset impairment associated with RHCA of \$4.6 million, \$3.4 million and \$4.4 million during fiscal 2019, fiscal 2018 and fiscal 2017, respectively. These impairment charges, which are recorded in the RH Segment, resulted from an update to both the timing and the amount of future estimated lease related cash inflows based on present market conditions, which is included in selling, general and administrative expenses on the consolidated statements of operations.

Debt Issuance Costs

Debt issuance costs related to debt, excluding the asset based credit facility, are recorded as a contra-liability and are presented net against the respective debt balance on the consolidated balance sheets. Debt issuance costs are amortized utilizing the effective interest method over the expected life of the respective debt. Such amortization is included in interest expense—net on the consolidated statements of operations.

Deferred financing fees related to the asset based credit facility are included in non-current assets on the consolidated balance sheets. Deferred financing fees related to the asset based credit facility are amortized utilizing the straight-line method. Such amortization is included in interest expense—net on the consolidated statements of operations.

Revenue Recognition

The Company recognizes revenues and the related cost of goods sold when a customer obtains control of the merchandise, which is when the customer has the ability to direct the use of and obtain the benefits from the merchandise. Revenue recognized for merchandise delivered via the home-delivery channel is recognized upon

delivery. Revenues recognized for merchandise delivered via all other delivery channels are recognized upon shipment. Revenues from “cash-and-carry” store sales are recognized at the point of sale in the store. Discounts or other accommodations provided to customers are accounted for as a reduction of sales.

The Company recognizes shipping and handling fees as activities to fulfill the promise to transfer the merchandise to customers. The Company applies this policy consistently across all of its distribution channels. In instances where revenue is recognized for the related merchandise upon delivery to customers, the related costs of shipping and handling activities are accrued for in the same period. In instances where revenue is recognized for the related merchandise prior to delivery to customers (i.e., revenue recognized upon shipment), the related costs of shipping and handling activities are accrued for in the same period. Costs of shipping and handling are included in cost of goods sold.

Sales tax collected is not recognized as revenue but is included in accounts payable and accrued expenses on the consolidated balance sheets as it is ultimately remitted to governmental authorities.

The Company reserves for projected merchandise returns. Merchandise returns are often resalable merchandise and are refunded by issuing the same payment tender of the original purchase. Merchandise exchanges of the same product and price are not considered merchandise returns and, therefore, are excluded when calculating the sales returns reserve.

The Company’s customers may return purchased items for a refund. The Company provides an allowance for sales returns based on historical return rates, which is presented on a gross basis. The allowance for sales returns is presented within other current liabilities and the estimated value of the right of return asset for merchandise is presented within prepaid expense and other assets on the consolidated balance sheets.

A summary of the allowance for sales returns is as follows (*in thousands*):

	Year Ended		
	February 1, 2020	February 2, 2019	February 3, 2018
Balance at beginning of fiscal year	\$ 19,821	\$ 10,565	\$ 10,077
Impact of Topic 606 adoption	—	5,862	—
Provision for sales returns	107,811	112,218	108,134
Actual sales returns	<u>(108,426)</u>	<u>(108,824)</u>	<u>(107,646)</u>
Balance at end of fiscal year	<u>\$ 19,206</u>	<u>\$ 19,821</u>	<u>\$ 10,565</u>

Deferred Revenue and Customer Deposits

The Company defers revenue associated with merchandise delivered via the home-delivery channel. In instances where the Company recognizes revenue when the merchandise is delivered to customers, it is included as deferred revenue on the consolidated balance sheets while in-transit. Deferred revenue also includes the unrecognized portion of the annual RH Members Program fee. New membership fees are recorded as deferred revenue when collected from customers and recognized as revenue based on expected product revenues over the annual membership period, based on historical trends of sales to members. Membership renewal fees are recorded as deferred revenue when collected from customers and are recognized as revenue on a straight-line basis over the membership period, or one year.

Customer deposits represent payments made by customers on custom orders. At the time of purchase the Company collects deposits for all custom orders equivalent to 50% of the customer purchase price. Custom order deposits are recognized as revenue when the customer obtains control of the merchandise.

The Company expects that substantially all of the deferred revenue, customer deposits and deferred membership fees as of February 1, 2020 will be recognized within the next six months as the performance obligations are satisfied.

Gift Cards and Merchandise Credits

The Company sells gift cards and issues merchandise credits to its customers in its stores and through its websites and product catalogs. Such gift cards and merchandise credits do not have expiration dates. The Company defers revenue when cash payments are received in advance of performance for unsatisfied obligations related to its gift cards and merchandise credits. During fiscal 2019 and fiscal 2018, the Company recognized \$19.8 million and \$21.6 million, respectively, of revenue related to previous deferrals related to its gift cards and merchandise credits. Customer liabilities related to gift cards and merchandise credits was \$16.6 million and \$17.2 million as of February 1, 2020 and February 2, 2019, respectively.

The Company recognizes breakage associated with gift cards and merchandise credits proportional to actual gift card redemptions. Breakage of \$1.6 million and \$1.5 million was recorded in net revenues in fiscal 2019 and fiscal 2018, respectively. Breakage resulted in a reduction of selling, general and administrative expenses of \$3.0 million in fiscal 2017.

The Company expects that approximately 70% of the remaining gift card and merchandise credit liabilities will be recognized when the gift cards are redeemed by customers.

Self Insurance

The Company maintains insurance coverage for significant exposures, as well as those risks that, by law, must be insured. In the case of the Company's health care coverage for employees, the Company has a managed self insurance program related to claims filed. Expenses related to this self insured program are computed on an actuarial basis, based on claims experience, regulatory requirements, an estimate of claims incurred but not yet reported ("IBNR") and other relevant factors. The projections involved in this process are subject to uncertainty related to the timing and amount of claims filed, levels of IBNR, fluctuations in health care costs and changes to regulatory requirements. The Company had liabilities of \$2.2 million and \$2.0 million related to health care coverage as of February 1, 2020 and February 2, 2019, respectively.

The Company carries workers' compensation insurance subject to a deductible amount for which the Company is responsible on each claim. The Company had liabilities of \$4.7 and \$3.3 million related to workers' compensation claims, primarily for claims that do not meet the per-incident deductible, as of February 1, 2020 and February 2, 2019, respectively.

Stock-Based Compensation

The Company recognizes the fair value of stock-based compensation in the consolidated financial statements as compensation expense over the requisite service period. For service-only awards, compensation expense is recognized on a straight-line basis, net of forfeitures, over the requisite service period for the fair value of awards that actually vest. Fair value for restricted stock units is valued using the closing price of the Company's stock on the date of grant. The fair value of each option award granted under the Company's award plan is estimated on the date of grant using a Black-Scholes Merton option pricing model ("OPM") which requires the input of assumptions regarding the expected term, expected volatility, dividend yield and risk-free interest rate. The Company elected to calculate the expected term of the option awards using the "simplified method." This election was made based on the lack of sufficient historical exercise data to provide a reasonable basis upon which to estimate expected term. Under the "simplified" calculation method, the expected term is calculated as an average of the vesting period and the contractual life of the options.

Cost of Goods Sold

Cost of goods sold includes, but is not limited to, the direct cost of purchased merchandise, inventory shrinkage, inventory reserves and write-downs, inbound freight, all freight costs to get merchandise to the Company's stores, design and buying costs, occupancy costs related to store operations and supply chain, such as rent, property tax and common area maintenance, depreciation and amortization and all logistics costs associated with shipping product to customers.

Selling, General and Administrative Expenses

Selling, general and administrative expenses include all operating costs not included in cost of goods sold. These expenses include payroll and payroll related expenses, store expenses other than occupancy, and expenses related to many of the Company's operations at its corporate headquarters, including utilities, depreciation and amortization, credit card fees and marketing expense, which primarily includes catalog production, mailing and print advertising costs. All store pre-opening costs are included in selling, general and administrative expenses and are expensed as incurred.

Net Income (Loss) Per Share

Basic net income (loss) per share is computed as net income (loss) divided by the weighted-average number of common shares outstanding for the period. Diluted net income per share is computed as net income divided by the weighted-average number of common shares outstanding for the period, common share equivalents under equity plans using the treasury-stock method and the calculated common share equivalents in excess of the respective conversion rates related to each of the convertible senior notes. Diluted net loss per share is computed as net loss divided by the weighted-average number of common shares outstanding for the period. Potential dilutive securities are excluded from the computation of diluted net income (loss) per share if their effect is anti-dilutive.

Treasury Stock

The Company records its purchases of treasury stock at cost as a separate component of stockholders' equity (deficit). Upon retirement of treasury stock, the Company allocates the excess of the purchase price over par value to additional paid-in capital subject to certain limitations with any remaining purchase price allocated to retained earnings (accumulated deficit).

Income Taxes

The Company accounts for income taxes under an asset and liability approach that requires the recognition of deferred tax assets and liabilities for the expected future tax consequences of events that have been recognized in the Company's consolidated financial statements or tax returns. In estimating future tax consequences, the Company generally takes into account all expected future events then known to it, other than changes in the tax law or rates which have not yet been enacted and which are not permitted to be considered. Accordingly, the Company may record a valuation allowance to reduce its net deferred tax assets to the amount that is more-likely-than-not to be realized. The determination as to whether a deferred tax asset will be realized is made on a jurisdictional basis and is based upon management's best estimate of the recoverability of the Company's net deferred tax assets. Future taxable income and ongoing prudent and feasible tax planning are considered in determining the amount of the valuation allowance, and the amount of the allowance is subject to adjustment in the future. Specifically, in the event the Company were to determine that it is not more-likely-than-not able to realize its net deferred tax assets in the future, an adjustment to the valuation allowance would decrease income in the period such determination is made. This allowance does not alter the Company's ability to utilize the underlying tax net operating loss and credit carryforwards in the future, the utilization of which is limited to achieving future taxable income.

The accounting standard for uncertainty in income taxes prescribes a recognition threshold that a tax position is required to meet before being recognized in the financial statements and provides guidance on derecognition, measurement, classification, interest and penalties, accounting in interim periods, disclosure and transition issues. Differences between tax positions taken in a tax return and amounts recognized in the financial statements generally result in an increase in liability for income taxes payable or a reduction of an income tax refund receivable, or a reduction in a deferred tax asset or an increase in a deferred tax liability, or both. The Company recognizes interest and penalties related to unrecognized tax benefits in tax expense.

Comprehensive Income

Comprehensive income is comprised of net income and other gains and losses affecting equity that are excluded from net income. The components of other comprehensive income consist of net gains (losses) on foreign currency translation and net unrealized holding gains (losses) on available-for-sale investments, both of which are presented net of tax.

Foreign Currency Translation

Local currencies are generally considered the functional currencies outside the United States. Assets and liabilities denominated in non-U.S. currencies are translated at the rate of exchange prevailing on the date of the consolidated balance sheets and revenues and expenses are translated at average rates of exchange for the period. The related translation gains (losses) are reflected in the accumulated other comprehensive income section on the consolidated statements of stockholders' equity (deficit). Foreign currency gains (losses) resulting from foreign currency transactions are included in selling, general and administrative expenses on the consolidated statements of operations and are not material for all periods presented.

Recently Issued Accounting Standards

Revenue from Contracts with Customers

In May 2014, the Financial Accounting Standards Board ("FASB") and International Accounting Standards Board issued their converged accounting standards update on revenue recognition, *Accounting Standards Update 2014-09—Revenue from Contracts with Customers (Topic 606)*. This guidance outlines a single comprehensive model for companies to use in accounting for revenue arising from contracts with customers and supersedes most current revenue recognition guidance, including industry-specific guidance. The core principle of the revenue model is that revenue is recognized when a customer obtains control of a good or service. A customer obtains control when it has the ability to direct the use of and obtain the benefits from the good or service. Under the new guidance, transfer of control is no longer the same as transfer of risks and rewards as indicated in the prior guidance.

Adoption and Accounting Policy

The Company adopted Topic 606, on February 4, 2018, using the modified retrospective transition method and recorded a decrease to opening retained earnings of \$21.0 million, inclusive of the tax impact. Results reported within the Company's condensed consolidated financial statements for reporting periods beginning February 4, 2018 are presented under Topic 606 while prior periods are not adjusted and continue to be reported in accordance with the Company's historic accounting under ASC 605—Revenue Recognition (Topic 605).

Under Topic 606, changes were made to the recognition timing or classification of revenues and expenses for the following:

Description	Policy under Topic 605	Policy under Topic 606
Advertising expenses	Costs associated with Source Books were capitalized and amortized over their expected period of future benefit. Expense was amortized based upon the ratio of actual revenues to the total of actual and estimated future revenues on an individual Source Book basis, generally over a twelve-month period after they were mailed.	Costs associated with Source Books are expensed upon the delivery of the Source Books to the carrier. In the case of multiple printings of a Source Book, the creative costs will be expensed in full upon the initial delivery of Source Books to the carrier.
Gift card breakage	Recognized gift card breakage (amounts not expected to be redeemed) within selling, general and administrative expenses.	Recognize gift card breakage within net revenues proportional to actual gift card redemptions.
Membership revenue	Annual fees for new memberships in the RH Members Program and renewals were recorded as deferred revenue when collected from customers and recognized as revenue on a straight-line basis over the twelve month membership period.	Annual fees for new memberships in the RH Members Program are recorded as deferred revenue when collected from customers and recognized as revenue based on expected product revenues over the annual membership period, using historical trends of sales to members. RH Members Program renewal fees are recorded as deferred revenue when collected from customers and will continue to be recognized as revenue on a straight-line basis over the twelve month membership period.
Revenue recognition	Revenue for merchandise that is not delivered via the home-delivery channel was recognized upon delivery.	Revenue for merchandise that is not delivered via the home-delivery channel will be recognized upon shipment.
Allowance for sales returns	Recognized an allowance for sales returns as a net liability within other current liabilities.	Recognize an allowance for sales returns on a gross basis as a liability within other current liabilities and a right of return asset for merchandise within prepaid expense and other current assets.

Adoption Impact on Fiscal 2019 and Fiscal 2018 Results

The following tables summarize the impact of adopting Topic 606 on the Company's consolidated statement of income (*in thousands*):

	Year Ended					
	February 1, 2020			February 2, 2019		
	As Reported	Adjustments	Balances without Adoption of Topic 606	As Adjusted and Revised ⁽¹⁾	Adjustments	Balances without Adoption of Topic 606
Net revenues	\$2,647,437	\$ (2,030)	\$2,645,407	\$2,505,653	\$(9,868)	\$2,495,785
Cost of goods sold	1,552,426	861	1,553,287	1,520,076	(3,485)	1,516,591
Gross profit	1,095,011	(2,891)	1,092,120	985,577	(6,383)	979,194
Selling, general and administrative expenses	732,180	(10,742)	721,438	723,841	(2,616)	721,225
Income from operations	362,831	7,851	370,682	261,736	(3,767)	257,969
Other expenses						
Interest expense—net	87,177	—	87,177	67,769	—	67,769
Goodwill and tradename impairment	—	—	—	32,086	—	32,086
Loss on extinguishment of debt	6,472	—	6,472	917	—	917
Total other expenses	93,649	—	93,649	100,772	—	100,772
Income before income taxes	269,182	7,851	277,033	160,964	(3,767)	157,197
Income tax expense	48,807	1,336	50,143	25,233	(3,945)	21,288
Net income	\$ 220,375	\$ 6,515	\$ 226,890	\$ 135,731	\$ 178	\$ 135,909

(1) Reflects the modified retrospective application of the new lease accounting standard (Accounting Standards Update 2016-02—*Leases*). Refer to “Leases” below.

The following table summarizes the impact of adopting Topic 606 on certain line items of the Company's consolidated balance sheet (*in thousands*):

	As of February 1, 2020			As of February 2, 2019		
	As Reported	Adjustments	Balances without Adoption of Topic 606	As Adjusted and Revised ⁽¹⁾	Adjustments	Balances without Adoption of Topic 606
Prepaid expense and other current assets	\$ 61,619	\$ 30,980	\$ 92,599	\$ 104,198	\$33,587	\$ 137,785
Deferred tax assets	45,005	(6,561)	38,444	35,603	(6,561)	29,042
Accounts payable and accrued expenses	330,309	(570)	329,739	320,497	(686)	319,811
Deferred revenue and customer deposits	162,433	7,894	170,327	152,595	9,304	161,899
Other current liabilities	140,714	(10,634)	130,080	109,456	(2,806)	106,650
Accumulated deficit	(409,253)	27,729	(381,524)	(392,537)	21,214	(371,323)

(1) Reflects the modified retrospective application of the new lease accounting standard (Accounting Standards Update 2016-02—*Leases*). Refer to “Leases” below.

Leases

In February 2016, the Financial Accounting Standards Board (“FASB”) issued *Accounting Standards Update 2016-02—Leases*, which requires a lessee to distinguish all leases as operating leases or finance leases and recognize all leases on the balance sheet as a right-of-use asset with a corresponding lease liability representing the present value of lease payments. The standard also requires a lessee to recognize a single lease cost for operating leases, calculated so that the cost of the lease is allocated over the lease term, generally on a straight-line basis. The lease cost for finance leases includes both principal and interest components, and is higher than the corresponding cash payment at the beginning of the lease term and declines over the lease term as the liability is reduced. In July 2018, the FASB issued *Accounting Standards Update 2018-10—Codification Improvements to Topic 842 (Leases)*, and *Accounting Standards Update 2018-11—Leases (Topic 842)—Targeted Improvements*, which (i) narrows amendments to clarify how to apply certain aspects of the new lease standard, (ii) provides entities with an additional transition method to adopt the new standard, and (iii) provides lessors with a practical expedient for separating components of a contract. In March 2019, the FASB also issued *Accounting Standards Update 2019-01—Leases (Topic 842)—Codification Improvements*. These Accounting Standards Updates are collectively referred to as the “ASUs.”

The Company adopted the ASUs as of February 3, 2019 using a modified retrospective approach. Under this adoption method, the results of prior comparative periods are presented with an adjustment to opening retained earnings of the earliest comparative period presented. In addition, the Company elected to adopt the package of transition practical expedients, which permitted the Company not to reassess its prior conclusions regarding lease identification, lease classification and initial direct costs. The Company adopted the policy election to not separate lease and non-lease components for certain asset classes (such as real estate leases), as well as the short-term lease policy election offered under the ASUs whereby the Company does not recognize right of use assets and lease liabilities for leases with terms of 12 months or less. The Company did not apply the hindsight practical expedient upon adoption.

As a result of the adoption of the ASUs, the Company recorded an increase to the fiscal 2017 (earliest comparative period) opening retained earnings balance of \$4.0 million, inclusive of the tax impact.

The following table presents the impact of adopting the ASUs, as well as the correction of an immaterial error as discussed in “Revision” above, on the Company’s consolidated balance sheet (*in thousands*):

	February 2, 2019		
	<u>As Reported</u>	<u>Adjustments and Other⁽¹⁾</u>	<u>As Adjusted and Revised</u>
ASSETS			
Current assets:			
Cash and cash equivalents	\$ 5,803	\$ —	\$ 5,803
Accounts receivable—net	40,224	—	40,224
Merchandise inventories	531,947	—	531,947
Asset held for sale	—	21,795 ⁽²⁾	21,795
Prepaid expense and other current assets	104,719	(521) ⁽³⁾	104,198
Total current assets	682,693	21,274	703,967
Property and equipment—net	863,562	89,395 ⁽⁴⁾	952,957
Operating lease right-of-use assets	—	440,504 ⁽⁵⁾	440,504
Goodwill	124,379	—	124,379
Tradenames, trademarks and domain names	86,022	—	86,022
Deferred tax assets	30,033	5,570 ⁽⁶⁾	35,603
Other non-current assets	19,345	60,241 ⁽⁷⁾	79,586
Total assets	<u>\$1,806,034</u>	<u>\$ 616,984</u>	<u>\$2,423,018</u>
LIABILITIES AND STOCKHOLDERS’ DEFICIT			
Current liabilities:			
Accounts payable and accrued expenses	\$ 320,441	\$ 56 ⁽⁸⁾	\$ 320,497
Deferred revenue and customer deposits	152,595	—	152,595
Convertible senior notes due 2019—net	343,789	—	343,789
Operating lease liabilities	—	66,249 ⁽⁵⁾	66,249
Other current liabilities	101,347	8,109 ⁽¹⁾⁽⁹⁾	109,456
Total current liabilities	918,172	74,414	992,586
Asset based credit facility	57,500	—	57,500
Convertible senior notes due 2020—net	271,157	—	271,157
Convertible senior notes due 2023—net	249,151	—	249,151
Financing obligations under build-to-suit lease transactions	228,928	(228,928) ⁽¹⁰⁾	—
Deferred rent and lease incentives	53,742	(53,742) ⁽¹⁰⁾	—
Non-current operating lease liabilities	—	437,557 ⁽⁵⁾	437,557
Non-current finance lease liabilities	—	421,245 ⁽⁹⁾	421,245
Other non-current obligations	50,346	(17,834) ⁽¹⁾⁽¹¹⁾	32,512
Total liabilities	<u>1,828,996</u>	<u>632,712</u>	<u>2,461,708</u>
Stockholders’ deficit:			
Preferred stock	—	—	—
Common stock	2	—	2
Additional paid-in capital	356,422	—	356,422
Accumulated other comprehensive loss	(2,333)	(1)	(2,334)
Accumulated deficit	(376,810)	(15,727) ⁽¹⁾⁽¹²⁾	(392,537)
Treasury stock	(243)	—	(243)
Total stockholders’ deficit	<u>(22,962)</u>	<u>(15,728)</u>	<u>(38,690)</u>
Total liabilities and stockholders’ deficit	<u>\$1,806,034</u>	<u>\$ 616,984</u>	<u>\$2,423,018</u>

-
- (1) During the adoption process of the ASUs, the Company identified a lease agreement that was incorrectly accounted for as an impaired lease under ASC 420—*Exit or Disposal Cost Obligations* in fiscal 2017 and the first quarter of fiscal 2018. Refer to “Revision” above.
 - (2) Represents recognition of asset held for sale under a sale-leaseback transaction.
 - (3) Represents reclassification of prepaid rent to operating lease liabilities and other current liabilities (for finance leases).
 - (4) Represents (i) recognition of finance lease right-of-use assets, partially offset by (ii) derecognition of non-Company owned properties that were capitalized under previously existing build-to-suit accounting policies, (iii) reclassification of construction in progress assets determined to be landlord assets to other non-current assets and (iv) reclassification of initial direct costs related to operating leases to operating lease right-of-use assets.
 - (5) Represents recognition of operating lease right-of-use assets and corresponding current and non-current lease liabilities. The operating lease right-of-use asset also includes the reclassification of deferred rent and unamortized lease incentives related to operating leases and the reclassification of initial direct costs from property and equipment—net.
 - (6) Represents recognition of net deferred tax assets related to the adoption of the ASUs.
 - (7) Primarily represents reclassification from property and equipment—net of construction in progress assets determined to be landlord assets for which the lease has not yet commenced.
 - (8) Represents a reclassification of an accrual for real estate taxes.
 - (9) Represents recognition of the current and non-current finance lease liabilities. The other current liabilities line item also includes the reclassification of current obligations associated with leases previously reported as capital leases to finance lease liabilities.
 - (10) Represents (i) derecognition of liabilities related to non-Company owned properties that were consolidated under previously existing build-to-suit accounting policies and (ii) reclassification of deferred rent and unamortized lease incentives to operating lease right-of-use assets upon adoption of the ASUs.
 - (11) Represents (i) derecognition of the net lease loss liabilities as such balances were reclassified to operating lease right-of-use assets and operating current and non-current liabilities and (ii) the reclassification of non-current obligations associated with leases previously reported as capital leases to finance lease liabilities.
 - (12) Represents a decrease to the consolidated net income for fiscal 2017 and fiscal 2018, as well as an increase of \$4.0 million to beginning fiscal 2017 retained earnings related to the adoption of the ASUs.

Cloud Computing

In August 2018, the FASB issued *Accounting Standards Update 2018-15—Intangibles—Goodwill and Other—Internal-Use Software (Subtopic 350-40): Customer’s Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement that is a Service Contract*, which amends *Accounting Standards Update 2015-05—Customers Accounting for Fees in a Cloud Computing Agreement*. The amendments in this ASU more closely align the requirements for capitalizing implementation costs incurred in a hosting arrangement that is a service contract with the requirements for capitalizing implementation costs incurred to develop or obtain internal-use software (and hosting arrangements that include an internal use software license). The ASU is effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. Early adoption is permitted.

The Company will adopt the new accounting standard in the first quarter of fiscal 2020 using the prospective method. The related assets will be recorded within other non-current assets on the Company’s consolidated balance sheets, and the amortization of assets placed in service will be recorded in cost of goods sold or selling, general and administrative expenses on the consolidated statements of operations on a straight-line basis over the term of the hosting arrangement, which includes reasonably certain renewal periods. The Company is in process of finalizing the adoption of the new accounting standard which is not expected to materially impact the Company’s financial position or results of operations.

Current Expected Credit Losses

In June 2016, the FASB issued *Accounting Standards Update 2016-13—Financial Instruments—Credit Losses: Measurement of Credit Losses on Financial Instruments*. The ASU amends the impairment model to utilize an expected loss methodology in place of the currently used incurred loss methodology to result in more timely recognition of losses. The guidance in this ASU applies to financial assets measured at amortized cost basis, such as receivables that result from revenue transactions. The ASU is effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. The Company is in process of assessing the impact of the new accounting standard.

Income Taxes

In December 2019, the FASB issued *Accounting Standards Update 2019-12—Income Taxes (Topic 740): Simplifying the Accounting for Income Taxes*. The ASU impacts various topic areas within ASC 740, including accounting for taxes under hybrid tax regimes, accounting for increases in goodwill, allocation of tax amounts to separate company financial statements within a group that files a consolidated tax return, intra period tax allocation, interim period accounting, and accounting for ownership changes in investments, among other minor codification improvements. The guidance in this ASU becomes effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2020. The Company is currently evaluating the effects that the adoption of this new accounting standard will have on its consolidated financial statements.

NOTE 4—PREPAID EXPENSE AND OTHER ASSETS

Prepaid expense and other current assets consist of the following (*in thousands*):

	February 1, 2020	February 2, 2019
Prepaid expense and other current assets	\$30,678	\$ 15,439
Capitalized catalog costs	13,740	16,178
Vendor deposits	11,258	11,836
Right of return asset for merchandise	5,746	5,883
Federal and state tax receivable	197	4,862
Insurance recovery receivable ⁽¹⁾	—	50,000
Total prepaid expense and other current assets . . .	<u>\$61,619</u>	<u>\$104,198</u>

(1) Refer to Note 18—*Commitments and Contingencies*.

Other non-current assets consist of the following (*in thousands*):

	February 1, 2020	February 2, 2019
Landlord assets under construction	\$138,315	\$63,159
Deposits on asset under construction	60,000	—
Promissory note receivable, including interest	5,354	5,104
Other deposits	5,157	5,068
Deferred financing fees	2,602	3,415
Other non-current assets	3,417	2,840
Total other non-current assets	<u>\$214,845</u>	<u>\$79,586</u>

NOTE 5—PROPERTY AND EQUIPMENT

Property and equipment consists of the following (*in thousands*):

	February 1, 2020	February 2, 2019
Finance lease right-of-use assets ⁽¹⁾	\$ 734,425	\$ 702,379
Leasehold improvements ⁽²⁾	318,313	311,416
Computer software	138,328	143,776
Furniture, fixtures and equipment	79,575	76,194
Machinery, equipment and aircraft	66,228	54,207
Building and building improvements	33,370	2,750
Land	6,061	7,110
Built-to-suit property	2,882	—
Total property and equipment	1,379,182	1,297,832
Less—accumulated depreciation and amortization ⁽³⁾ . .	(411,583)	(344,875)
Total property and equipment—net	<u>\$ 967,599</u>	<u>\$ 952,957</u>

(1) Refer to “Lease Accounting” within Note 3—*Significant Accounting Policies* and Note 9—*Leases*.

(2) Leasehold improvements include construction in progress of \$16.0 million and \$14.7 million as of February 1, 2020 and February 2, 2019, respectively.

(3) Includes accumulated amortization related to finance lease right-of-use assets of \$92.3 million and \$55.5 million as of February 1, 2020 and February 2, 2019, respectively. Refer to Note 9—*Leases*.

The Company recorded depreciation and amortization of property and equipment, excluding amortization for finance lease right-of-use assets, of \$63.7 million, \$62.6 million and \$63.7 million in fiscal 2019, fiscal 2018 and fiscal 2017, respectively.

NOTE 6—GOODWILL, TRADENAMES, TRADEMARKS AND DOMAIN NAMES

The following sets forth the fiscal 2019 goodwill, tradenames, trademarks and domain names activity for the RH Segment and Waterworks (*in thousands*):

	February 2, 2019	Foreign Currency Translation	February 1, 2020
RH Segment			
Goodwill	\$124,379	\$ (12)	\$124,367
Tradenames, trademarks and domain names . .	48,563	—	48,563
Waterworks			
Tradename ⁽¹⁾	37,459	—	37,459

(1) Presented net of an impairment charge of \$14.6 million recorded in fiscal 2018.

The following sets forth the fiscal 2018 goodwill, tradenames, trademarks and domain names activity for the RH Segment and Waterworks (*in thousands*):

	<u>February 3, 2018</u>	<u>Impairment ⁽¹⁾</u>	<u>Foreign Currency Translation</u>	<u>February 2, 2019</u>
RH Segment				
Goodwill	\$124,448	\$ —	\$ (69)	\$124,379
Tradenames, trademarks and domain names	48,563	—	—	48,563
Waterworks				
Goodwill ⁽²⁾	17,445	(17,445)	—	—
Tradename ⁽³⁾	52,100	(14,641)	—	37,459

- (1) Refer to “Impairment” within Note 3—*Significant Accounting Policies*.
- (2) Waterworks reporting unit goodwill of \$51.1 million recognized upon acquisition in fiscal 2016 was fully impaired as of February 2, 2019, with \$17.4 million and \$33.7 million impairment recorded in fiscal 2018 and fiscal 2017, respectively.
- (3) Presented net of an impairment charge of \$14.6 million recorded in fiscal 2018.

NOTE 7—ACCOUNTS PAYABLE, ACCRUED EXPENSES AND OTHER CURRENT LIABILITIES

Accounts payable and accrued expenses consist of the following (*in thousands*):

	<u>February 1, 2020</u>	<u>February 2, 2019</u>
Accounts payable	\$180,714	\$183,039
Accrued compensation	64,659	64,192
Accrued freight and duty	25,170	20,787
Accrued sales taxes	19,618	18,354
Accrued occupancy	12,067	10,839
Accrued catalog costs	8,267	10,276
Accrued professional fees	4,381	2,050
Other accrued expenses	15,433	10,960
Total accounts payable and accrued expenses	<u>\$330,309</u>	<u>\$320,497</u>

Other current liabilities consist of the following (*in thousands*):

	<u>February 1, 2020</u>	<u>February 2, 2019</u>
Promissory notes on asset under construction	\$ 53,000	\$ —
Current portion of debt	22,009	892
Allowance for sales returns	19,206	19,821
Unredeemed gift card and merchandise credit liability	16,625	17,192
Federal and state taxes payable	13,591	719
Finance lease liabilities	9,188	9,184
Product recall reserve	2,055	7,767
Other current liabilities	5,040	3,881
Provision for legal settlement ⁽¹⁾	—	50,000
Total other current liabilities	<u>\$140,714</u>	<u>\$109,456</u>

- (1) Refer to Note 18—*Commitments and Contingencies*.

NOTE 8—OTHER NON-CURRENT OBLIGATIONS

Other non-current obligations consist of the following (*in thousands*):

	February 1, 2020	February 2, 2019
Notes payable for share repurchases	\$18,741	\$18,741
Rollover units and profit interests ⁽¹⁾	3,064	2,637
Unrecognized tax benefits	3,020	2,992
Deferred contract incentive ⁽²⁾	595	2,976
Other non-current obligations	3,100	5,166
Total other non-current obligations	<u>\$28,520</u>	<u>\$32,512</u>

- (1) Represents rollover units and profit interests associated with the acquisition of Waterworks. Refer to Note 16—*Stock-Based Compensation*.
- (2) Represents the non-current portion of an incentive payment received in relation to a 5-year service agreement, which will be amortized over the term of the agreement.

NOTE 9—LEASES

Lease costs—net consist of the following (*in thousands*):

	Year Ended		
	February 1, 2020	February 2, 2019	February 3, 2018
Operating lease cost ⁽¹⁾⁽²⁾	\$ 86,448	\$ 87,742	\$ 95,499
Finance lease costs			
Amortization of leased assets ⁽¹⁾	36,991	28,848	19,542
Interest on lease liabilities ⁽³⁾	22,608	16,785	11,154
Variable lease costs ⁽⁴⁾	23,471	21,889	23,280
Sublease income ⁽⁵⁾	(9,609)	(7,794)	(1,003)
Total lease costs—net	<u>\$159,909</u>	<u>\$147,470</u>	<u>\$148,472</u>

- (1) Operating lease costs and amortization of finance lease right-of-use assets are included in cost of goods sold or selling, general and administrative expenses on the consolidated statements of operations based on the Company's policy. Refer to Note 3—*Significant Accounting Policies*.
- (2) Includes short-term operating lease costs which are not material.
- (3) Included in interest expense—net on the consolidated statements of operations.
- (4) Represents variable lease payments under operating and finance lease agreements, primarily associated with contingent rent based on a percentage of retail sales over contractual levels of \$14.6 million, \$13.0 million and \$13.8 million and charges associated with common area maintenance of \$8.9 million, \$8.9 million, and \$9.5 million in fiscal 2019, fiscal 2018, and fiscal 2017, respectively. Other variable costs, such as single lease cost related to variable lease payments based on an index or rate that were not included in the measurement of the initial lease liability and right-of-use asset, were not material in fiscal 2019, fiscal 2018, and fiscal 2017.
- (5) Included in selling, general and administrative expenses on the consolidated statements of operations.

Lease right-of-use assets and lease liabilities consist of the following (*in thousands*):

		<u>February 1, 2020</u>	<u>February 2, 2019</u>
Balance Sheet Classification			
Assets			
Operating leases	Operating lease right-of-use assets	\$ 410,904	\$ 440,504
Finance leases ⁽¹⁾⁽²⁾	Property and equipment—net	642,117	646,875
	Total lease right-of-use assets	<u>\$1,053,021</u>	<u>\$1,087,379</u>
Liabilities			
<i>Current</i> ⁽³⁾			
Operating leases	Operating lease liabilities	\$ 58,924	\$ 66,249
Finance leases	Other current liabilities	9,188	9,184
	Total lease liabilities—current	68,112	75,433
<i>Non-current</i>			
Operating leases	Non-current operating lease liabilities	409,930	437,557
Finance leases	Non-current finance lease liabilities	442,988	421,245
	Total lease liabilities—non-current	852,918	858,802
	Total lease liabilities	<u>\$ 921,030</u>	<u>\$ 934,235</u>

- (1) Finance lease right-of-use assets include capitalized amounts related to the Company's completed construction activities to design and build leased assets, which are reclassified from other non-current assets upon lease commencement.
- (2) Finance lease right-of-use assets are recorded net of accumulated amortization of \$92.3 million and \$55.5 million as of February 1, 2020 and February 2, 2019, respectively.
- (3) Current portion of lease liabilities represents the reduction of the related lease liability over the next 12 months.

The maturities of lease liabilities are as follows as of February 1, 2020 (*in thousands*):

<u>Fiscal year</u>	<u>Operating Leases</u>	<u>Finance Leases</u>	<u>Total</u>
2020	\$ 75,634	\$ 32,138	\$ 107,772
2021	69,343	35,323	104,666
2022	60,711	35,747	96,458
2023	56,266	36,170	92,436
2024	52,424	36,660	89,084
Thereafter	246,482	568,856	815,338
Total lease payments ⁽¹⁾	<u>560,860</u>	<u>744,894</u>	<u>1,305,754</u>
Less—imputed interest ⁽²⁾	<u>(92,006)</u>	<u>(292,718)</u>	<u>(384,724)</u>
Present value of lease liabilities ⁽³⁾	<u>\$468,854</u>	<u>\$ 452,176</u>	<u>\$ 921,030</u>

- (1) Total lease payments include future obligations for renewal options that are reasonably certain to be exercised and are included in the measurement of the lease liability. Total lease payments exclude \$360.9 million of legally binding payments under the noncancellable term for leases signed but not yet commenced as of February 1, 2020.
- (2) Calculated using the incremental borrowing rate for each lease at lease commencement.
- (3) Excludes future commitments under short-term lease agreements of \$0.9 million as of February 1, 2020.

Supplemental information related to leases consists of the following:

	<u>February 1, 2020</u>	<u>February 2, 2019</u>
Weighted-average remaining lease term (years)		
Operating leases	8.9	9.2
Finance leases	18.6	19.6
Weighted-average discount rate		
Operating leases	3.82%	3.78%
Finance leases	5.25%	5.28%

Other information related to leases consists of the following (*in thousands*):

	<u>Year Ended</u>		
	<u>February 1, 2020</u>	<u>February 2, 2019</u>	<u>February 3, 2018</u>
Cash paid for amounts included in the measurement of lease liabilities			
Operating cash flows from operating leases	\$ (95,329)	\$ (91,965)	\$ (95,279)
Operating cash flows from finance leases	(25,260)	(16,785)	(11,154)
Financing cash flows from finance leases	(9,682)	(6,885)	(6,105)
Total cash outflows from leases	<u>\$(130,271)</u>	<u>\$(115,635)</u>	<u>\$(112,538)</u>
Lease right-of-use assets obtained in exchange for lease obligations—net of lease terminations (non-cash)			
Finance leases	\$ 34,063	\$ 174,977	\$ 26,770
Operating leases	42,122	33,790	33,710

Asset Held for Sale and Sale-Leaseback Transaction

During the fourth quarter of fiscal 2018, the Company committed to a plan to sell the Yountville Design Gallery, which resulted in a reclassification of such Gallery from property and equipment—net to assets held for sale on the consolidated balance sheets as of February 2, 2019. The Company performed an assessment and determined that based on management’s best estimate of the fair value of such Gallery as of February 2, 2019, it had an impairment of \$8.5 million in fiscal 2018 in the RH Segment. In October 2019, the Company executed a sale-leaseback transaction for the Yountville Design Gallery for sales proceeds of \$23.5 million, which qualified for sale-leaseback accounting in accordance with ASC 842. Concurrently with the sale, the Company entered into an operating leaseback arrangement with an initial lease term of 15 years and renewal options for up to an additional 30 years. The Company recognized a gain related to the execution of the sale transaction of \$1.2 million in fiscal 2019, which was recorded in selling, general and administrative expenses on the consolidated statements of operations.

NOTE 10—CONVERTIBLE SENIOR NOTES

\$350 million 0.00% Convertible Senior Notes due 2024

In September 2019, the Company issued in a private offering \$350 million principal amount of 0.00% convertible senior notes due 2024 (the “2024 Notes”). The 2024 Notes are governed by the terms of an indenture between the Company and U.S. Bank National Association, as the Trustee. The 2024 Notes will mature on September 15, 2024, unless earlier purchased by the Company or converted. The 2024 Notes will not bear interest, except that the 2024 Notes will be subject to “special interest” in certain limited circumstances in the event of the failure of the Company to perform certain of its obligations under the indenture governing the 2024 Notes. The 2024 Notes are unsecured obligations and do not contain any financial covenants or restrictions on the payments of dividends, the incurrence of indebtedness or the issuance or repurchase of securities by the

Company or any of its subsidiaries. Certain events are also considered “events of default” under the 2024 Notes, which may result in the acceleration of the maturity of the 2024 Notes, as described in the indenture governing the 2024 Notes. Events of default under the indenture for the 2024 Notes include, among other things, the occurrence of an event of default by us as defined under any mortgage, indenture or instrument under which there may be issued, or by which there may be secured or evidenced, any indebtedness of the Company or any of its significant subsidiaries for money borrowed, if that event of default (i) constitutes the failure to pay when due indebtedness in the aggregate principal amount in excess of \$20 million and (ii) such event of default continues for a period of 30 days after written notice is delivered to the Company by the Trustee or to the Company and the Trustee by the holders of at least 25% of the aggregate principal amount of the 2024 Notes then outstanding.

The initial conversion rate applicable to the 2024 Notes is 4.7304 shares of common stock per \$1,000 principal amount of 2024 Notes, or a total of approximately 1.656 million shares for the total \$350 million principal amount. This initial conversion rate is equivalent to an initial conversion price of approximately \$211.40 per share, which represents a 25% premium to the \$169.12 closing share price on the day the 2024 Notes were priced. The conversion rate will be subject to adjustment upon the occurrence of certain specified events, but will not be adjusted for any accrued and unpaid special interest. In addition, upon the occurrence of a “make-whole fundamental change” as defined in the indenture governing the 2024 Notes, the Company will, in certain circumstances, increase the conversion rate by a number of additional shares for a holder that elects to convert its 2024 Notes in connection with such make-whole fundamental change.

Prior to June 15, 2024, the 2024 Notes are convertible only under the following circumstances: (1) during any calendar quarter commencing after December 31, 2019, if, for at least 20 trading days (whether or not consecutive) during the 30 consecutive trading day period ending on the last trading day of the immediately preceding calendar quarter, the last reported sale price of the Company’s common stock on such trading day is greater than or equal to 130% of the applicable conversion price on such trading day; (2) during the five consecutive business day period after any ten consecutive trading day period in which, for each day of that period, the trading price per \$1,000 principal amount of 2024 Notes for such trading day was less than 98% of the product of the last reported sale price of the Company’s common stock and the applicable conversion rate on such trading day; or (3) upon the occurrence of specified corporate transactions. As of February 1, 2020, none of these conditions have occurred and, as a result, the 2024 Notes were not convertible as of February 1, 2020. On and after June 15, 2024, until the close of business on the second scheduled trading day immediately preceding the maturity date, holders may convert all or a portion of their 2024 Notes at any time, regardless of the foregoing circumstances. Upon conversion, the 2024 Notes will be settled, at the Company’s election, in cash, shares of the Company’s common stock, or a combination of cash and shares of the Company’s common stock. If the Company has not delivered a notice of its election of settlement method prior to the final conversion period it will be deemed to have elected combination settlement with a dollar amount per note to be received upon conversion of \$1,000.

The Company may not redeem the 2024 Notes; however, upon the occurrence of a fundamental change (as defined in the indenture governing the 2024 Notes), holders may require the Company to purchase all or a portion of their 2024 Notes for cash at a price equal to 100% of the principal amount of the 2024 Notes to be purchased plus any accrued and unpaid special interest to, but excluding, the fundamental change purchase date.

Under GAAP, certain convertible debt instruments that may be settled in cash on conversion are required to be separately accounted for as liability and equity components of the instrument in a manner that reflects the issuer’s non-convertible debt borrowing rate. Accordingly, in accounting for the issuance of the 2024 Notes, the Company separated the 2024 Notes into liability and equity components. The carrying amount of the liability component was calculated by measuring the fair value of a similar liability that does not have an associated convertible feature. The carrying amount of the equity component, which is recognized as a debt discount, represents the difference between the proceeds from the issuance of the 2024 Notes and the fair value of the liability component of the 2024 Notes. The excess of the principal amount of the liability component over its carrying amount (“debt discount”) will be amortized to interest expense using an effective interest rate of 5.74%

over the expected life of the 2024 Notes. The equity component is not remeasured as long as it continues to meet the conditions for equity classification.

Debt issuance costs related to the 2024 Notes were comprised of discounts upon original issuance of \$3.5 million and third party offering costs of \$1.3 million. In accounting for the debt issuance costs related to the issuance of the 2024 Notes, the Company allocated the total amount incurred to the liability and equity components based on their relative values. Debt issuance costs attributable to the liability component are amortized to interest expense using the effective interest method over the expected life of the 2024 Notes, and debt issuance costs attributable to the equity component are netted with the equity component in stockholders' equity (deficit).

Discounts and third party offering costs attributable to the liability component are recorded as a contra-liability and are presented net against the convertible senior notes due 2024 balance on the consolidated balance sheets. During fiscal 2019 the Company recorded \$0.2 million related to the amortization of debt issuance costs related to the 2024 Notes.

The carrying value of the 2024 Notes, excluding the discounts upon original issuance and third party offering costs, is as follows (*in thousands*):

	<u>February 1, 2020</u>
Liability component	
Principal	\$350,000
Less: Debt discount	<u>(81,634)</u>
Net carrying amount	<u>\$268,366</u>
Equity component ⁽¹⁾	<u>\$ 87,252</u>

(1) Included in additional paid-in capital on the consolidated balance sheets.

The Company recorded interest expense of \$5.6 million for the amortization of the debt discount related to the 2024 Notes during fiscal 2019.

2024 Notes—Convertible Bond Hedge and Warrant Transactions

In connection with the offering of the 2024 Notes and exercise of the overallotment option in September 2019, the Company entered into convertible note hedge transactions whereby the Company has the option to purchase a total of approximately 1.656 million shares of its common stock at a price of approximately \$211.40 per share. The total cost of the convertible note hedge transactions was approximately \$91.4 million. In addition, the Company sold warrants whereby the holders of the warrants have the option to purchase a total of approximately 1.656 million shares of the Company's common stock at a price of \$338.24 per share, which represents a 100% premium to the \$169.12 closing share price on the day the 2024 Notes were priced. The warrants contain certain adjustment mechanisms whereby the total number of shares to be purchased under such warrants may be increased up to a cap of approximately 3.3 million shares of common stock (which cap may also be subject to adjustment). The Company received approximately \$50.2 million in cash proceeds from the sale of these warrants. Taken together, the purchase of the convertible note hedges and sale of the warrants are intended to offset any actual earnings dilution from the conversion of the 2024 Notes until the Company's common stock is above approximately \$338.24 per share. As these transactions meet certain accounting criteria, the convertible note hedges and warrants are recorded in stockholders' equity, are not accounted for as derivatives and are not remeasured each reporting period. The net costs incurred in connection with the convertible note hedge and warrant transactions were recorded as a reduction to additional paid-in capital on the consolidated balance sheets.

The Company recorded a deferred tax liability of \$21.7 million in connection with the debt discount associated with the 2024 Notes and recorded a deferred tax asset of \$22.7 million in connection with the

convertible note hedge transactions. The deferred tax liability and deferred tax asset are recorded in deferred tax assets on the consolidated balance sheets.

\$335 million 0.00% Convertible Senior Notes due 2023

In June 2018, the Company issued in a private offering \$300 million principal amount of 0.00% convertible senior notes due 2023 and issued an additional \$35 million principal amount in connection with the overallotment option granted to the initial purchasers as part of the offering (collectively, the “2023 Notes”). The 2023 Notes are governed by the terms of an indenture between the Company and U.S. Bank National Association, as the Trustee. The 2023 Notes will mature on June 15, 2023, unless earlier purchased by the Company or converted. The 2023 Notes will not bear interest, except that the 2023 Notes will be subject to “special interest” in certain limited circumstances in the event of the failure of the Company to perform certain of its obligations under the indenture governing the 2023 Notes. The 2023 Notes are unsecured obligations and do not contain any financial covenants or restrictions on the payments of dividends, the incurrence of indebtedness or the issuance or repurchase of securities by the Company or any of its subsidiaries. Certain events are also considered “events of default” under the 2023 Notes, which may result in the acceleration of the maturity of the 2023 Notes, as described in the indenture governing the 2023 Notes. Events of default under the indenture for the 2023 Notes include, among other things, the occurrence of an event of default by us as defined under any mortgage, indenture or instrument under which there may be issued, or by which there may be secured or evidenced, any indebtedness of the Company or any of its significant subsidiaries for money borrowed, if that event of default (i) constitutes the failure to pay when due indebtedness in the aggregate principal amount in excess of \$20 million and (ii) such event of default continues for a period of 30 days after written notice is delivered to the Company by the Trustee or to the Company and the Trustee by the holders of at least 25% of the aggregate principal amount of the 2023 Notes then outstanding.

The initial conversion rate applicable to the 2023 Notes is 5.1640 shares of common stock per \$1,000 principal amount of 2023 Notes, which is equivalent to an initial conversion price of approximately \$193.65 per share. The conversion rate will be subject to adjustment upon the occurrence of certain specified events, but will not be adjusted for any accrued and unpaid special interest. In addition, upon the occurrence of a “make-whole fundamental change” as defined in the indenture governing the 2023 Notes, the Company will, in certain circumstances, increase the conversion rate by a number of additional shares for a holder that elects to convert its 2023 Notes in connection with such make-whole fundamental change.

Prior to March 15, 2023, the 2023 Notes are convertible only under the following circumstances: (1) during any calendar quarter commencing after September 30, 2018, if, for at least 20 trading days (whether or not consecutive) during the 30 consecutive trading day period ending on the last trading day of the immediately preceding calendar quarter, the last reported sale price of the Company’s common stock on such trading day is greater than or equal to 130% of the applicable conversion price on such trading day; (2) during the five consecutive business day period after any ten consecutive trading day period in which, for each day of that period, the trading price per \$1,000 principal amount of 2023 Notes for such trading day was less than 98% of the product of the last reported sale price of the Company’s common stock and the applicable conversion rate on such trading day; or (3) upon the occurrence of specified corporate transactions. As of February 1, 2020, none of these conditions have occurred and, as a result, the 2023 Notes were not convertible as of February 1, 2020. On and after March 15, 2023, until the close of business on the second scheduled trading day immediately preceding the maturity date, holders may convert all or a portion of their 2023 Notes at any time, regardless of the foregoing circumstances. Upon conversion, the 2023 Notes will be settled, at the Company’s election, in cash, shares of the Company’s common stock, or a combination of cash and shares of the Company’s common stock. If the Company has not delivered a notice of its election of settlement method prior to the final conversion period it will be deemed to have elected combination settlement with a dollar amount per note to be received upon conversion of \$1,000.

The Company may not redeem the 2023 Notes; however, upon the occurrence of a fundamental change (as defined in the indenture governing the 2023 Notes), holders may require the Company to purchase all or a

portion of their 2023 Notes for cash at a price equal to 100% of the principal amount of the 2023 Notes to be purchased plus any accrued and unpaid special interest to, but excluding, the fundamental change purchase date.

Under GAAP, certain convertible debt instruments that may be settled in cash on conversion are required to be separately accounted for as liability and equity components of the instrument in a manner that reflects the issuer’s non-convertible debt borrowing rate. Accordingly, in accounting for the issuance of the 2023 Notes, the Company separated the 2023 Notes into liability and equity components. The carrying amount of the liability component was calculated by measuring the fair value of a similar liability that does not have an associated convertible feature. The carrying amount of the equity component, which is recognized as a debt discount, represents the difference between the proceeds from the issuance of the 2023 Notes and the fair value of the liability component of the 2023 Notes. The excess of the principal amount of the liability component over its carrying amount (“debt discount”) will be amortized to interest expense using an effective interest rate of 6.35% over the expected life of the 2023 Notes. The equity component is not remeasured as long as it continues to meet the conditions for equity classification.

Debt issuance costs related to the 2023 Notes were comprised of discounts upon original issuance of \$1.7 million and third party offering costs of \$4.6 million. In accounting for the debt issuance costs related to the issuance of the 2023 Notes, the Company allocated the total amount incurred to the liability and equity components based on their relative values. Debt issuance costs attributable to the liability component are amortized to interest expense using the effective interest method over the expected life of the 2023 Notes, and debt issuance costs attributable to the equity component are netted with the equity component in stockholders’ equity (deficit).

Discounts and third party offering costs attributable to the liability component are recorded as a contra-liability and are presented net against the convertible senior notes due 2023 balance on the consolidated balance sheets. The Company recorded \$0.9 million and \$0.5 million related to the amortization of debt issuance costs in fiscal 2019 and fiscal 2018, respectively, related to the 2023 Notes.

The carrying values of the 2023 Notes, excluding the discounts upon original issuance and third party offering costs, are as follows (*in thousands*):

	<u>February 1, 2020</u>	<u>February 2, 2019</u>
Liability component		
Principal	\$ 335,000	\$ 335,000
Less: Debt discount	<u>(64,729)</u>	<u>(81,311)</u>
Net carrying amount	<u>\$ 270,271</u>	<u>\$ 253,689</u>
Equity component ⁽¹⁾	<u>\$ 90,990</u>	<u>\$ 90,990</u>

(1) Included in additional paid-in capital on the consolidated balance sheets.

The Company recorded interest expense of \$16.5 million and \$9.7 million for the amortization of the debt discount related to the 2023 Notes during fiscal 2019 and fiscal 2018, respectively.

2023 Notes—Convertible Bond Hedge and Warrant Transactions

In connection with the offering of the 2023 Notes and exercise of the overallotment option in June 2018, the Company entered into convertible note hedge transactions whereby the Company has the option to purchase a total of approximately 1.730 million shares of its common stock at a price of approximately \$193.65 per share. The total cost of the convertible note hedge transactions was approximately \$91.9 million. In addition, the Company sold warrants whereby the holders of the warrants have the option to purchase a total of approximately 1.730 million shares of the Company’s common stock at a price of \$309.84 per share. The warrants contain

certain adjustment mechanisms whereby the total number of shares to be purchased under such warrants may be increased up to a cap of approximately 3.5 million shares of common stock (which cap may also be subject to adjustment). The Company received approximately \$51.0 million in cash proceeds from the sale of these warrants. Taken together, the purchase of the convertible note hedges and sale of the warrants are intended to offset any actual earnings dilution from the conversion of the 2023 Notes until the Company's common stock is above approximately \$309.84 per share. As these transactions meet certain accounting criteria, the convertible note hedges and warrants are recorded in stockholders' equity (deficit), are not accounted for as derivatives and are not remeasured each reporting period. The net costs incurred in connection with the convertible note hedge and warrant transactions were recorded as a reduction to additional paid-in capital on the consolidated balance sheets.

The Company recorded a deferred tax liability of \$22.3 million in connection with the debt discount associated with the 2023 Notes and recorded a deferred tax asset of \$22.5 million in connection with the convertible note hedge transactions. The deferred tax liability and deferred tax asset are recorded in deferred tax assets on the consolidated balance sheets.

\$300 million 0.00% Convertible Senior Notes due 2020

In June 2015, the Company issued in a private offering \$250 million principal amount of 0.00% convertible senior notes due 2020 and, in July 2015, the Company issued an additional \$50 million principal amount pursuant to the exercise of the over-allotment option granted to the initial purchasers as part of its June 2015 offering (collectively, the "2020 Notes"). The 2020 Notes are governed by the terms of an indenture between the Company and U.S. Bank National Association, as the Trustee. The 2020 Notes will mature on July 15, 2020, unless earlier purchased by the Company or converted. The 2020 Notes will not bear interest, except that the 2020 Notes will be subject to "special interest" in certain limited circumstances in the event of the failure of the Company to perform certain of its obligations under the indenture governing the 2020 Notes. The 2020 Notes are unsecured obligations and do not contain any financial covenants or restrictions on the payments of dividends, the incurrence of indebtedness or the issuance or repurchase of securities by the Company or any of its subsidiaries. Certain events are also considered "events of default" under the 2020 Notes, which may result in the acceleration of the maturity of the 2020 Notes, as described in the indenture governing the 2020 Notes. Events of default under the indenture for the 2020 Notes include, among other things, the occurrence of an event of default by us as defined under any mortgage, indenture or instrument under which there may be issued, or by which there may be secured or evidenced, any indebtedness of the Company or any of its significant subsidiaries for money borrowed, if that event of default (i) constitutes the failure to pay when due indebtedness in the aggregate principal amount in excess of \$20 million and (ii) such event of default continues for a period of 30 days after written notice is delivered to the Company by the Trustee or to the Company and the Trustee by the holders of at least 25% of the aggregate principal amount of the 2020 Notes then outstanding. The 2020 Notes are guaranteed by the Company's primary operating subsidiary, Restoration Hardware, Inc., as Guarantor. The guarantee is the unsecured obligation of the Guarantor and is subordinated to the Guarantor's obligations from time to time with respect to its Credit Agreement and ranks equal in right of payment with respect to Guarantor's other obligations.

The initial conversion rate applicable to the 2020 Notes is 8.4656 shares of common stock per \$1,000 principal amount of 2020 Notes, which is equivalent to an initial conversion price of approximately \$118.13 per share. To the extent the stock price is less than \$118.13 per share, the Company is required to settle the par value in cash, subject to the cash settlement averaging period under the indenture. To the extent the stock price is greater than \$118.13 per share, the Company may settle the par value at the Company's election, in cash, shares of the Company's common stock, or a combination of cash and shares of the Company's common stock. The conversion rate will be subject to adjustment upon the occurrence of certain specified events, but will not be adjusted for any accrued and unpaid special interest. In addition, upon the occurrence of a "make-whole fundamental change" as defined in the indenture governing the 2020 Notes, the Company will, in certain circumstances, increase the conversion rate by a number of additional shares for a holder that elects to convert its 2020 Notes in connection with such make-whole fundamental change.

Prior to March 15, 2020, the 2020 Notes are convertible only under the following circumstances: (1) during any calendar quarter commencing after September 30, 2015, if, for at least 20 trading days (whether or not consecutive) during the 30 consecutive trading day period ending on the last trading day of the immediately preceding calendar quarter, the last reported sale price of the Company's common stock on such trading day is greater than or equal to 130% of the applicable conversion price on such trading day; (2) during the five consecutive business day period after any ten consecutive trading day period in which, for each day of that period, the trading price per \$1,000 principal amount of 2020 Notes for such trading day was less than 98% of the product of the last reported sale price of the Company's common stock and the applicable conversion rate on such trading day; or (3) upon the occurrence of specified corporate transactions. The first condition was satisfied during the calendar quarter ended December 31, 2019 and, accordingly, holders may convert their 2020 Notes during the calendar quarter ending March 31, 2020. Regardless of the foregoing circumstances, on and after March 15, 2020, until the close of business on the second scheduled trading day immediately preceding the maturity date, holders may convert all or a portion of their 2020 Notes at any time. Upon conversion, the 2020 Notes will be settled, at the Company's election, in cash, shares of the Company's common stock, or a combination of cash and shares of the Company's common stock to the extent the Company's stock price is greater than \$118.13 per share. If the Company has not delivered a notice of its election of settlement method prior to the final conversion period it will be deemed to have elected combination settlement with a dollar amount per note to be received upon conversion of \$1,000. We expect to repay the \$300 million outstanding principal amount of the convertible notes in cash, whether in connection with a conversion of such notes or repayment at maturity in July 2020.

The Company may not redeem the 2020 Notes; however, upon the occurrence of a fundamental change (as defined in the indenture governing the 2020 Notes), holders may require the Company to purchase all or a portion of their 2020 Notes for cash at a price equal to 100% of the principal amount of the 2020 Notes to be purchased plus any accrued and unpaid special interest to, but excluding, the fundamental change purchase date.

Under GAAP, certain convertible debt instruments that may be settled in cash on conversion are required to be separately accounted for as liability and equity components of the instrument in a manner that reflects the issuer's non-convertible debt borrowing rate. Accordingly, in accounting for the issuance of the 2020 Notes, the Company separated the 2020 Notes into liability and equity components. The carrying amount of the liability component was calculated by measuring the fair value of a similar liability that does not have an associated convertible feature. The carrying amount of the equity component, which is recognized as a debt discount, represents the difference between the proceeds from the issuance of the 2020 Notes and the fair value of the liability component of the 2020 Notes. The debt discount will be amortized to interest expense using an effective interest rate of 6.47% over the expected life of the 2020 Notes. The equity component is not remeasured as long as it continues to meet the conditions for equity classification.

Debt issuance costs related to the 2020 Notes were comprised of discounts upon original issuance of \$3.8 million and third party offering costs of \$2.3 million. In accounting for the debt issuance costs related to the issuance of the 2020 Notes, the Company allocated the total amount incurred to the liability and equity components based on their relative values. Debt issuance costs attributable to the liability component are amortized to interest expense using the effective interest method over the expected life of the 2020 Notes, and debt issuance costs attributable to the equity component are netted with the equity component in stockholders' equity (deficit).

Discounts and third party offering costs attributable to the liability component are recorded as a contra-liability and are presented net against the convertible senior notes due 2020 balance on the consolidated balance sheets. The Company recorded \$1.2 million, \$1.1 million and \$1.0 million related to the amortization of debt issuance costs in fiscal 2019, fiscal 2018 and fiscal 2017, respectively, related to the 2020 Notes.

The carrying values of the 2020 Notes, excluding the discounts upon original issuance and third party offering costs, are as follows (*in thousands*):

	<u>February 1, 2020</u>	<u>February 2, 2019</u>
Liability component		
Principal	\$ 300,000	\$ 300,000
Less: Debt discount	(8,890)	(27,081)
Net carrying amount	<u>\$ 291,110</u>	<u>\$ 272,919</u>
Equity component ⁽¹⁾	<u>\$ 84,003</u>	<u>\$ 84,003</u>

(1) Included in additional paid-in capital on the consolidated balance sheets.

The Company recorded interest expense of \$18.2 million, \$17.1 million and \$16.0 million for the amortization of the debt discount related to the 2020 Notes during fiscal 2019, fiscal 2018 and fiscal 2017, respectively.

2020 Notes—Convertible Bond Hedge and Warrant Transactions

In connection with the offering of the 2020 Notes in June 2015 and the exercise in full of the over-allotment option in July 2015, the Company entered into convertible note hedge transactions whereby the Company has the option to purchase a total of approximately 2.540 million shares of its common stock at a price of approximately \$118.13 per share. The total cost of the convertible note hedge transactions was approximately \$68.3 million. In addition, the Company sold warrants whereby the holders of the warrants have the option to purchase a total of approximately 2.540 million shares of the Company’s common stock at a price of \$189.00 per share. The warrants contain certain adjustment mechanisms whereby the total number of shares to be purchased under such warrants may be increased up to a cap of approximately 5.1 million shares of common stock (which cap may also be subject to adjustment). The Company received approximately \$30.4 million in cash proceeds from the sale of these warrants. Taken together, the purchase of the convertible note hedges and sale of the warrants are intended to offset any actual earnings dilution from the conversion of the 2020 Notes until the Company’s common stock is above approximately \$189.00 per share. As these transactions meet certain accounting criteria, the convertible note hedges and warrants are recorded in stockholders’ equity (deficit), are not accounted for as derivatives and are not remeasured each reporting period. The net costs incurred in connection with the convertible note hedge and warrant transactions were recorded as a reduction to additional paid-in capital on the consolidated balance sheets.

The Company recorded a deferred tax liability of \$32.8 million in connection with the debt discount associated with the 2020 Notes and recorded a deferred tax asset of \$26.6 million in connection with the convertible note hedge transactions. The deferred tax liability and deferred tax asset are recorded in non-current deferred tax assets on the consolidated balance sheets.

The provision for income taxes in fiscal 2017 included \$1.1 million of income tax benefit as a result of the Tax Act for the provisional re-measurement of the deferred tax asset and liability related to the 2020 Notes for the reduction in the U.S. corporate income tax rate from 35% to 21%.

\$350 million 0.00% Convertible Senior Notes due 2019

In June 2014, the Company issued \$350 million principal amount of 0.00% convertible senior notes due 2019 (the “2019 Notes”) in a private offering. The 2019 Notes were governed by the terms of an indenture between the Company and U.S. Bank National Association, as the Trustee. The 2019 Notes did not bear interest, except that the 2019 Notes were subject to “special interest” in certain limited circumstances in the event of the failure of the Company to perform certain of its obligations under the indenture governing the 2019 Notes. The 2019 Notes were unsecured obligations and did not contain any financial covenants or restrictions on the payments of dividends, the incurrence of indebtedness or the issuance or repurchase of securities by the Company or any of its subsidiaries. Certain events were also considered “events of default” under the 2019

Notes, which could result in the acceleration of the maturity of the 2019 Notes, as described in the indenture governing the 2019 Notes. The 2019 Notes matured on June 15, 2019.

The initial conversion rate applicable to the 2019 Notes was 8.6143 shares of common stock per \$1,000 principal amount of 2019 Notes, which was equivalent to an initial conversion price of approximately \$116.09 per share. The conversion rate was subject to adjustment upon the occurrence of certain specified events, but was not adjusted for any accrued and unpaid special interest. In addition, upon the occurrence of a “make-whole fundamental change” as defined in the indenture governing the 2019 Notes, the Company would, in certain circumstances, increase the conversion rate by a number of additional shares for a holder that elected to convert its 2019 Notes in connection with such make-whole fundamental change.

Under GAAP, certain convertible debt instruments that may be settled in cash on conversion are required to be separately accounted for as liability and equity components of the instrument in a manner that reflects the issuer’s non-convertible debt borrowing rate. Accordingly, in accounting for the issuance of the 2019 Notes, the Company separated the 2019 Notes into liability and equity components. The carrying amount of the liability component was calculated by measuring the fair value of a similar liability that does not have an associated convertible feature. The carrying amount of the equity component, which is recognized as a debt discount, represents the difference between the proceeds from the issuance of the 2019 Notes and the fair value of the liability component of the 2019 Notes. The debt discount was amortized to interest expense using an effective interest rate of 4.51% over the expected life of the 2019 Notes. The equity component was not remeasured as long as it continued to meet the conditions for equity classification.

Debt issuance costs related to the 2019 Notes were comprised of discounts and commissions payable to the initial purchasers of \$4.4 million and third party offering costs of \$1.0 million. In accounting for the debt issuance costs related to the issuance of the 2019 Notes, the Company allocated the total amount incurred to the liability and equity components based on their relative values. Debt issuance costs attributable to the liability component were amortized to interest expense using the effective interest method over the expected life of the 2019 Notes, and debt issuance costs attributable to the equity component were netted with the equity component in stockholders’ equity (deficit).

Discounts, commissions payable to the initial purchasers and third party offering costs attributable to the liability component were recorded as a contra-liability and were presented net against the convertible senior notes due 2019 balance on the consolidated balance sheets. The Company recorded \$0.4 million, \$0.9 million and \$0.9 million related to the amortization of debt issuance costs in fiscal 2019, fiscal 2018 and fiscal 2017, respectively, related to the 2019 Notes.

In June 2019, upon the maturity of the 2019 Notes, \$350.0 million in aggregate principal amount of the 2019 Notes were settled for \$349.0 million in cash and 42 shares of common stock. As a result, the Company recognized a gain on extinguishment of debt of \$1.0 million during fiscal 2019.

As of February 1, 2020, the 2019 Notes are no longer outstanding. As of February 2, 2019, the carrying value of the 2019 Notes, excluding the discounts and commissions payable to the initial purchasers and third party offering costs, was as follows (*in thousands*):

	February 2, 2019
Liability component	
Principal	\$ 350,000
Less: Debt discount	(5,854)
Net carrying amount	<u>\$ 344,146</u>
Equity component ⁽¹⁾	<u>\$ 70,482</u>

(1) Included in additional paid-in capital on the consolidated balance sheets.

The Company recorded interest expense of \$5.9 million, \$15.1 million and \$14.5 million for the amortization of the debt discount related to the 2019 Notes in fiscal 2019, fiscal 2018 and fiscal 2017, respectively.

2019 Notes—Convertible Bond Hedge and Warrant Transactions

In connection with the offering of the 2019 Notes, the Company entered into convertible note hedge transactions whereby the Company had the option to purchase a total of approximately 3.015 million shares of its common stock at a price of approximately \$116.09 per share. The total cost of the convertible note hedge transactions was approximately \$73.3 million. The convertible note hedge terminated upon the maturity date of the 2019 Notes. In addition, the Company sold warrants whereby the holders of the warrants had the option to purchase a total of approximately 3.015 million shares of the Company’s common stock at a price of \$171.98 per share. The Company received \$40.4 million in cash proceeds from the sale of these warrants. Taken together, the purchase of the convertible note hedges and sale of the warrants were intended to offset any actual dilution from the conversion of the 2019 Notes and to effectively increase the overall conversion price from \$116.09 per share to \$171.98 per share. As these transactions met certain accounting criteria, the convertible note hedges and warrants were recorded in stockholders’ equity (deficit), were not accounted for as derivatives and were not remeasured each reporting period. The net costs incurred in connection with the convertible note hedge and warrant transactions were recorded as a reduction to additional paid-in capital on the consolidated balance sheets.

During fiscal 2019, the Company delivered approximately 167,100 shares upon exercise of the warrants under the terms of the warrant agreements. The warrants expired on December 6, 2019.

The Company recorded a deferred tax liability of \$27.5 million in connection with the debt discount associated with the 2019 Notes and recorded a deferred tax asset of \$28.6 million in connection with the convertible note hedge transactions. The provision for income taxes in fiscal 2017 included \$0.1 million of income tax expense as a result of the Tax Act for the provisional re-measurement of the deferred tax asset and liability related to the 2019 Notes for the reduction in the U.S. corporate income tax rate from 35% to 21%. The deferred tax liability and deferred tax assets were included in non-current deferred tax assets on the consolidated balance sheets. There is no deferred tax asset or liability remaining as of February 1, 2020 due to the maturity of the 2019 Notes.

NOTE 11—CREDIT FACILITIES

The outstanding balances under the Company’s credit facilities were as follows (*in thousands*):

	February 1, 2020			February 2, 2019		
	Outstanding Amount	Unamortized Debt Issuance Costs	Net Carrying Amount	Outstanding Amount	Unamortized Debt Issuance Costs	Net Carrying Amount
Asset based credit facility ⁽¹⁾ . . .	\$ —	\$ —	\$ —	\$57,500	\$ —	\$57,500
Equipment promissory notes ⁽²⁾	53,372	(310)	53,062	—	—	—
Total credit facilities	<u>\$53,372</u>	<u>\$(310)</u>	<u>\$53,062</u>	<u>\$57,500</u>	<u>\$ —</u>	<u>\$57,500</u>

(1) Deferred financing fees associated with the asset based credit facility as of February 1, 2020 and February 2, 2019 were \$2.6 million and \$3.4 million, respectively, and are included in other non-current assets on the consolidated balance sheets. The deferred financing fees are amortized on a straight line basis over the life of the revolving line of credit, which has a maturity date of June 28, 2022.

(2) Represents total equipment security notes secured by certain of the Company’s property and equipment, of which \$22.0 million outstanding was included in other current liabilities. The remaining \$31.4 million outstanding, included in other non-current obligations on the consolidated balance sheets, has principal payments due of \$23.0 million, \$7.9 million and \$0.5 million in fiscal 2021, fiscal 2022 and fiscal 2023, respectively.

Asset Based Credit Facility & Term Loan Facilities

In August 2011, Restoration Hardware, Inc., along with its Canadian subsidiary, Restoration Hardware Canada, Inc., entered into a credit agreement with Bank of America, N.A., as administrative agent, and certain other lenders (the “Original Credit Agreement”).

On June 28, 2017, Restoration Hardware, Inc. entered into an eleventh amended and restated credit agreement (the “Credit Agreement”) among Restoration Hardware, Inc., Restoration Hardware Canada, Inc., various subsidiaries of RH named therein as borrowers or guarantors, the lenders party thereto and Bank of America, N.A. as administrative agent and collateral agent (“First Lien Administrative Agent”), which amended and restated the Original Credit Agreement. The Credit Agreement has a revolving line of credit with initial availability of up to \$600.0 million, of which \$10.0 million is available to Restoration Hardware Canada, Inc., and includes a \$200.0 million accordion feature under which the revolving line of credit may be expanded by agreement of the parties from \$600.0 million to up to \$800.0 million if and to the extent the lenders, whether existing lenders or new lenders, agree to increase their credit commitments. In addition, the Credit Agreement established an \$80.0 million last in, last out (“LILO”) term loan facility. The maturity date of the Credit Agreement is June 28, 2022.

In June 2018, the Company repaid the LILO term loan in full. As a result of the repayment, the Company incurred a \$0.5 million loss on extinguishment of debt in fiscal 2018, which represents the acceleration of amortization of debt issuance costs. The Company did not incur any prepayment penalties upon the early extinguishment of the LILO term loan.

On June 12, 2018, Restoration Hardware, Inc. entered into a First Amendment (the “First Amendment”) to the Credit Agreement. The First Amendment (a) changed the Credit Agreement’s definition of “Eligible In-Transit Inventory” to clarify the requirements to be fulfilled by the borrowers with respect to such in-transit inventory, and (b) clarified that no Default or Event of Default was caused by any prior non-compliance with such requirements with respect to in-transit inventory. Eligible In-Transit Inventory consists of inventory being shipped from vendor locations outside of the United States. Qualifying in-transit inventory is included within the Company’s borrowing base for eligible collateral for purposes of determining the amount of borrowing available to borrowers under the Credit Agreement.

On November 23, 2018, Restoration Hardware, Inc. entered into a Consent and Second Amendment (the “Second Amendment”) to the Credit Agreement. The Second Amendment included certain clarifying changes to among other things: (a) address the processing of payments from insurance proceeds in connection with casualty or other insured losses with respect to property or assets of a Loan Party, and (b) add an additional category of permitted restricted payment to allow the lead borrower to make annual restricted payments of up to \$3 million per fiscal year to cover payments of certain administrative and other obligations of RH in the ordinary course of business.

On April 4, 2019, Restoration Hardware, Inc., entered into a third amendment to the Credit Agreement (the “Third Amendment”). The Third Amendment, among other things, (a) established a \$120.0 million first in, last out (“FILO”) term loan facility, which amount was fully borrowed as of April 4, 2019 and which incurs interest at a rate that is 1.25% greater than the interest rate applicable to the revolving loans provided for under the Credit Agreement at any time, (b) provided for additional permitted indebtedness, as defined in the Credit Agreement, that the loan parties can incur, and (c) modified the borrowing availability under the Credit Agreement in certain circumstances.

The Company repaid the full amount of the FILO term loan as of February 1, 2020. As a result of the repayment, the Company incurred a \$0.8 million loss on extinguishment of debt in fiscal 2019, which represents the acceleration of amortization of debt issuance costs. The Company did not incur any prepayment penalties upon the early extinguishment of the FILO term loan.

On May 31, 2019, Restoration Hardware, Inc. entered into a fourth amendment to the Credit Agreement (the “Fourth Amendment”). The Fourth Amendment, among other things, amended the Credit Agreement to (a) extend the time to deliver monthly financial statements to the lenders for the fiscal months ending February 2019 and March 2019 until June 19, 2019, (b) remove the requirement to deliver monthly financial statements to the lenders for the last fiscal month of any fiscal quarter, and (c) waive any default or event of default under the Credit Agreement relating to the delivery of monthly financial statements or other information to lenders for the fiscal months ending February 2019 and March 2019.

The availability of credit at any given time under the Credit Agreement is limited by reference to a borrowing base formula based upon numerous factors, including the value of eligible inventory and eligible accounts receivable. As a result of the borrowing base formula, actual borrowing availability under the revolving line of credit could be less than the stated amount of the revolving line of credit (as reduced by the actual borrowings and outstanding letters of credit under the revolving line of credit). All obligations under the Credit Agreement are secured by substantially all of the assets, including accounts receivable, inventory, intangible assets, property, equipment, goods and fixtures of Restoration Hardware, Inc., Restoration Hardware Canada, Inc., RH US, LLC, Waterworks Operating Co., LLC and Waterworks IP Co., LLC.

Borrowings under the revolving line of credit are subject to interest, at the borrowers’ option, at either the bank’s reference rate or London Inter-bank Offered Rate (“LIBOR”) (or, in the case of the revolving line of credit, the Bank of America “BA” Rate or the Canadian Prime Rate, as such terms are defined in the Credit Agreement, for Canadian borrowings denominated in Canadian dollars or the United States Index Rate or LIBOR for Canadian borrowings denominated in United States dollars) plus an applicable margin rate, in each case.

The Credit Agreement contains various restrictive covenants, including, among others, limitations on the ability to incur liens, make loans or other investments, incur additional debt, issue additional equity, merge or consolidate with or into another person, sell assets, pay dividends or make other distributions, or enter into transactions with affiliates, along with other restrictions and limitations typical to credit agreements of this type and size. The Credit Agreement also contains various affirmative covenants, including the obligation to deliver notice to the First Lien Administrative Agent following the Company’s obtaining knowledge of any matter that has resulted or could reasonably be expected to result in a “Material Adverse Effect” (as defined in the Credit Agreement).

In addition, under the Credit Agreement, the Company is required to meet specified financial ratios in order to undertake certain actions, and the Company may be required to maintain certain levels of excess availability or meet a specified consolidated fixed-charge coverage ratio (“FCCR”). Subject to certain exceptions, the trigger for the FCCR occurs if the domestic availability under the revolving line of credit is less than the greater of (i) \$40.0 million and (ii) 10% of the lesser of (x) the domestic revolving commitments under the Credit Agreement and (y) the domestic revolving borrowing base. If the availability under the Credit Agreement is less than the foregoing amount, then Restoration Hardware, Inc. is required subject to certain exceptions to maintain an FCCR of at least one to one. As of February 1, 2020, Restoration Hardware, Inc. was in compliance with all applicable financial covenants of the Credit Agreement.

The Credit Agreement requires a daily sweep of all cash receipts and collections to prepay the loans under the agreement while (i) an event of default exists or (ii) the availability under the revolving line of credit for extensions of credit is less than the greater of (A) \$40.0 million and (B) 10% of the sum of (a) the lesser of (x) the aggregate revolving commitments under the Credit Agreement and (y) the aggregate revolving borrowing base, plus (b) the lesser of (x) the then outstanding amount of the LILO term loan or (y) the LILO term loan borrowing base.

The Credit Agreement includes customary events of default, in certain cases subject to customary periods to cure. The occurrence of an event of default, following the applicable cure period, would permit the lenders to, among other things, terminate any existing commitments under the Credit Agreement and declare the unpaid

principal, accrued and unpaid interest and all other amounts payable under the Credit Agreement to be immediately due and payable.

As of February 1, 2020, the Company had no outstanding borrowings under the revolving credit facility portion of the Credit Agreement. The availability of credit at any given time under the Credit Agreement is limited by reference to a borrowing base formula based upon numerous factors, including the value of eligible inventory and eligible accounts receivable. As a result of the borrowing base formula, actual borrowing availability under the revolving line of credit could be less than the stated amount of the revolving line of credit (as reduced by the actual borrowings and outstanding letters of credit under the revolving line of credit). Under the terms of such provisions, the amount under the revolving line of credit borrowing base that could be available pursuant to the Credit Agreement as of February 1, 2020 was \$321.7 million, net of \$13.2 million in outstanding letters of credit.

Second Lien Credit Agreement

On April 10, 2019, Restoration Hardware, Inc., entered into a credit agreement, dated as of April 9, 2019 and effective as of April 10, 2019 (the “Second Lien Credit Agreement”), among (i) Restoration Hardware, Inc., as lead borrower, (ii) the guarantors party thereto, (iii) the lenders party thereto, each of whom were managed or advised by either Benefit Street Partners L.L.C. and its affiliated investment managers or Apollo Capital Management, L.P. and its affiliated investment managers, and (iv) BSP Agency, LLC, as administrative agent and collateral agent (the “Second Lien Administrative Agent”) with respect to a second lien term loan in an aggregate principal amount equal to \$200.0 million with a maturity date of April 9, 2024 (the “Second Lien Term Loan”). The second lien term loan of \$200.0 million in principal was repaid in full on September 20, 2019. As a result of the repayment, the Company incurred a \$6.7 million loss on extinguishment of debt, which includes a prepayment penalty of \$4.0 million and acceleration of amortization of debt issuance costs of \$2.7 million.

The Second Lien Term Loan bore interest at an annual rate generally based on LIBOR plus 6.50%. This rate was a floating rate that reset periodically based upon changes in LIBOR rates during the life of the Second Lien Term Loan. At the date of the initial borrowing, the rate was set at one-month LIBOR plus 6.50%.

Intercreditor Agreement

On April 10, 2019, in connection with the Second Lien Credit Agreement, Restoration Hardware, Inc. entered into an Intercreditor Agreement (the “Intercreditor Agreement”), dated as of April 9, 2019 and effective as of April 10, 2019, with the First Lien Administrative Agent and the Second Lien Administrative Agent. The Intercreditor Agreement established various customary inter-lender terms, including, without limitation, with respect to priority of liens, permitted actions by each party, application of proceeds, exercise of remedies in case of default, releases of liens and certain limitations on the amendment of the Credit Agreement and the Second Lien Credit Agreement without the consent of the other party. The Intercreditor Agreement is no longer in effect after repayment of the Second Lien Term Loan on September 20, 2019.

Equipment Loan Facility

On September 5, 2017, Restoration Hardware, Inc. entered into a Master Loan and Security Agreement with Banc of America Leasing & Capital, LLC (“BAL”) pursuant to which BAL and the Company agreed that BAL would finance certain equipment of the Company from time to time, with each such equipment financing to be evidenced by an equipment security note setting forth the terms for each particular equipment loan. Each equipment loan is secured by a purchase money security interest in the financed equipment. As of February 1, 2020, the Company had \$53.4 million in aggregate amounts outstanding under the equipment security notes at a weighted-average interest rate of 4.56%. The maturity dates of the equipment security notes vary, but generally have a maturity of three or four years. The Company is required to make monthly installment payments under the equipment security notes.

NOTE 12—FAIR VALUE MEASUREMENTS

Certain financial assets and liabilities are required to be carried at fair value. Fair value is the price that would be received to sell an asset, or paid to transfer a liability, in an orderly transaction between market participants at the measurement date. In determining the fair value, the Company utilizes market data or assumptions that it believes market participants would use in pricing the asset or liability, which would maximize the use of observable inputs and minimize the use of unobservable inputs to the extent possible, including assumptions about risk and the risks inherent in the inputs of the valuation technique.

The degree of judgment used in measuring the fair value of financial instruments generally correlates to the level of pricing observability. Pricing observability is impacted by a number of factors, including the type of financial instrument, whether the financial instrument is new to the market and not yet established and the characteristics specific to the transaction. Financial instruments with readily available active quoted prices for which fair value can be measured generally will have a higher degree of pricing observability and a lesser degree of judgment used in measuring fair value. Conversely, financial instruments rarely traded or not quoted will generally have less, or no, pricing observability and a higher degree of judgment used in measuring fair value.

The Company's financial assets and liabilities measured and reported at fair value are classified and disclosed in one of the following categories:

- Level 1—Quoted prices are available in active markets for identical investments as of the reporting date.
- Level 2—Pricing inputs are other than quoted prices in active markets, which are either directly or indirectly observable as of the reporting date, and fair value is determined through the use of models or other valuation methodologies.
- Level 3—Pricing inputs are unobservable for the investment and include situations where there is little, if any, market activity for the investment. The inputs used in the determination of fair value require significant management judgment or estimation.

A financial instrument's categorization within the fair value hierarchy is based upon the lowest level of input that is significant to the fair value measurement.

Fair Value Measurements—Recurring

Amounts reported as cash and equivalents, receivables, and accounts payable and accrued expenses approximate fair value due to the short-term nature of activity within these accounts. The estimated fair value of the asset based credit facility approximates cost as the interest rate associated with the facility is variable and resets frequently. The estimated fair value and carrying value of the 2019 Notes, 2020 Notes, 2023 Notes and 2024 Notes were as follows (*in thousands*):

	February 1, 2020		February 2, 2019	
	Fair Value	Carrying Value ⁽¹⁾	Fair Value	Carrying Value ⁽¹⁾
Convertible senior notes due 2019 ⁽²⁾	\$ —	\$ —	\$334,756	\$344,146
Convertible senior notes due 2020	295,573	291,110	260,258	272,919
Convertible senior notes due 2023	272,623	270,271	230,684	253,689
Convertible senior notes due 2024	255,849	268,366	—	—

(1) Carrying value represents the principal amount less the equity component of the 2019 Notes, 2020 Notes, 2023 Notes and 2024 Notes classified in stockholders' equity (deficit), and does not exclude the discounts upon original issuance, discounts and commissions payable to the initial purchasers and third party offering costs, as applicable.

(2) The 2019 Notes matured on June 15, 2019.

The fair value of each of the 2019 Notes, 2020 Notes, 2023 Notes and 2024 Notes was determined based on inputs that are observable in the market or that could be derived from, or corroborated with, observable market data, including the trading price of the Company’s convertible notes, when available, the Company’s stock price and interest rates based on similar debt issued by parties with credit ratings similar to the Company (Level 2).

Fair Value Measurements—Non-Recurring

The fair value of the Waterworks reporting unit and tradename as of February 2, 2019 was determined based on unobservable (Level 3) inputs and valuation techniques, as discussed in “Impairment” within Note 3—*Significant Accounting Policies*. The fair value of the asset held for sale as of February 2, 2019 was determined based on an appraisal prepared using unobservable (Level 3) inputs and valuation techniques.

NOTE 13—INCOME TAXES

The United States enacted the Tax Cuts and Jobs Act (the “Tax Act”) on December 22, 2017, which had a significant impact to the Company’s provision for income taxes as of and for the years ended February 2, 2019 and February 3, 2018. The Tax Act included a number of changes to existing U.S. tax laws that impact the Company, including the reduction of the U.S. corporate income tax rate from 35% to 21% for tax years beginning after December 31, 2017.

Reduction of the U.S. Corporate Income Tax Rate

The Company measures deferred tax assets and liabilities using enacted tax rates that will apply in the years in which the temporary differences are expected to be recovered or paid. Accordingly, the Company’s deferred tax assets and liabilities were re-measured to reflect the reduction in the U.S. corporate income tax rate from 35% to 21%, resulting in a provisional \$6.1 million increase in income tax expense for the year ended February 3, 2018 and a corresponding provisional \$6.1 million decrease in net deferred tax assets as of February 3, 2018. The Company completed the accounting for re-measurement of its deferred tax assets and liabilities as of February 2, 2019, and recorded \$0.5 million to income tax expense and a corresponding \$0.5 million decrease in net deferred tax assets as of February 2, 2019. The cumulative impact to the Company’s provision for income tax expense in fiscal 2017 and fiscal 2018 for the re-measurement of the Company’s deferred tax assets and liabilities as result of the Tax Act was \$6.6 million.

Transition Tax on Foreign Earnings

The Company recognized a provisional income tax expense of \$1.0 million for the year ended February 3, 2018 related to the one-time transition tax on indefinitely reinvested foreign earnings. The Company completed its computation of transition tax liability in 2018 and did not recognize additional income tax expense or benefit for the year ended February 2, 2019. The cumulative impact to the Company’s provision for income tax expense for the one-time transition tax on indefinitely reinvested foreign earnings as result of the Tax Act was \$1.0 million.

The following is a summary of the income before income taxes (*in thousands*):

	Year Ended		
	February 1, 2020	February 2, 2019	February 3, 2018
Domestic	\$267,538	\$157,827	\$21,241
Foreign	1,644	3,137	1,292
Total income before income taxes	<u>\$269,182</u>	<u>\$160,964</u>	<u>\$22,533</u>

The following is a summary of the income tax expense (benefit) (*in thousands*):

	Year Ended		
	February 1, 2020	February 2, 2019	February 3, 2018
Current			
Federal	\$45,985	\$24,012	\$18,593
State	10,806	6,275	2,761
Foreign	403	1,270	933
Total current tax expense	<u>57,194</u>	<u>31,557</u>	<u>22,287</u>
Deferred			
Federal	(7,173)	(4,428)	3,692
State	(1,477)	(2,049)	(844)
Foreign	263	153	(3)
Total deferred tax expense (benefit)	<u>(8,387)</u>	<u>(6,324)</u>	<u>2,845</u>
Total income tax expense	<u>\$48,807</u>	<u>\$25,233</u>	<u>\$25,132</u>

A reconciliation of the federal statutory tax rate to the Company's effective tax rate is as follows:

	Year Ended		
	February 1, 2020	February 2, 2019	February 3, 2018
Provision at federal statutory tax rate	21.0%	21.0%	33.7%
State income taxes—net of federal tax impact	2.5	1.7	4.7
Tax rate adjustments	0.2	0.1	(0.8)
Meals and entertainment	0.1	0.3	1.9
Aircraft expenses	0.1	0.1	4.8
Stock compensation—excess benefits	(6.6)	(9.9)	(27.9)
Goodwill impairment	—	1.8	23.9
Non-deductible stock-based compensation	—	—	35.7
Federal statutory tax rate change	—	—	27.4
Foreign income inclusion—transition tax	—	—	4.4
Net adjustments to tax accruals and other	—	—	1.9
Valuation allowance	—	0.3	1.5
Donation of appreciated property	—	—	(0.2)
Foreign income	—	—	(1.3)
Other permanent items	0.8	0.3	1.8
Effective tax rate	<u>18.1%</u>	<u>15.7%</u>	<u>111.5%</u>

Significant components of the Company's deferred tax assets and liabilities are as follows (*in thousands*):

	<u>February 1, 2020</u>	<u>February 2, 2019</u>
Non-current deferred tax assets (liabilities)		
Lease liabilities	\$ 249,243	\$ 253,826
Stock-based compensation	22,400	22,721
Accrued expenses	21,362	16,657
Merchandise inventories	8,028	14,735
Deferred lease credits	6,395	1,188
Deferred revenue	2,235	—
Net operating loss carryforwards	1,763	1,654
Convertible senior notes	717	—
Other	1,846	2,591
	<u>313,989</u>	<u>313,372</u>
Valuation allowance	(1,007)	(1,623)
	<u>\$ 312,982</u>	<u>\$ 311,749</u>
Property and equipment	\$ (137,448)	\$ (137,240)
Lease right-of-use assets	(110,075)	(118,549)
Tradename, trademarks and intangibles	(13,026)	(12,386)
Prepaid expense and other	(4,882)	(4,209)
State benefit	(2,546)	(2,556)
Convertible senior notes	—	(1,054)
Deferred revenue	—	(152)
	<u>(267,977)</u>	<u>(276,146)</u>
Total net non-current deferred tax assets . .	<u>\$ 45,005</u>	<u>\$ 35,603</u>

A reconciliation of the valuation allowance is as follows (*in thousands*):

	<u>Year Ended</u>	
	<u>February 1, 2020</u>	<u>February 2, 2019</u>
Balance at beginning of fiscal year	\$1,623	\$1,190
Net changes in deferred tax assets and liabilities	(616)	433
Balance at end of fiscal year	<u>\$1,007</u>	<u>\$1,623</u>

The Company has recorded deferred tax assets and liabilities based upon estimates of their realizable value, such estimates are based upon likely future tax consequences. In assessing the need for a valuation allowance, the Company considers both positive and negative evidence related to the likelihood of realization of the deferred tax assets. If, based on the weight of available evidence, it is more likely than not that the deferred tax assets will not be realized, the Company records a valuation allowance.

As of February 1, 2020 and February 2, 2019, the Company had \$1.0 million and \$1.6 million, respectively, in valuation allowances against deferred tax assets in certain state and foreign jurisdictions due to historical losses.

As of February 1, 2020, the Company had state net operating loss carryovers of \$6.5 million and foreign net operating loss carryovers of \$8.2 million. The state net operating loss carryovers will begin to expire in 2022, and the foreign net operating loss carryovers will begin to expire in 2023. Internal Revenue Code Section 382 and

similar state rules place a limitation on the amount of taxable income which can be offset by net operating loss carryforwards after a change in ownership (generally greater than 50% change in ownership). The Company cannot give any assurances that it will not undergo an ownership change in the future resulting in further limitations on utilization of net operating losses.

A reconciliation of the exposures related to unrecognized tax benefits is as follows (*in thousands*):

	Year Ended		
	February 1, 2020	February 2, 2019	February 3, 2018
Balance at beginning of fiscal year	\$8,459	\$8,152	\$2,190
Gross increases (decreases)—prior period tax positions	(2)	239	5,491
Gross increases (decreases)—current period tax positions	438	375	471
Reductions based on the lapse of the applicable statutes of limitations	(381)	(307)	—
Balance at end of fiscal year	<u>\$8,514</u>	<u>\$8,459</u>	<u>\$8,152</u>

As of February 1, 2020, the Company has \$8.5 million of unrecognized tax benefits, of which \$7.8 million would reduce income tax expense and the effective tax rate, if recognized. The remaining unrecognized tax benefits would offset other deferred tax assets, if recognized. In October 2017, the Company filed an amended federal tax return claiming a \$5.4 million refund, however, no income tax benefit was recorded during fiscal 2019, fiscal 2018 or fiscal 2017 given the technical nature and amount of the refund claim. An income tax benefit related to this refund claim could be recorded in a future period upon settlement with the respective taxing authority. As of February 1, 2020, the Company has \$6.3 million of exposures related to unrecognized tax benefits that are expected to decrease in the next 12 months.

The Company accounts for interest and penalties related to exposures as a component of income tax expense. The Company had interest accruals of \$0.5 million associated with exposures as of both February 1, 2020 and February 2, 2019, respectively.

The Company is subject to taxation in the United States and various states and foreign jurisdictions. As of February 1, 2020, the Company is subject to examination by the tax authorities for fiscal 2015 through fiscal 2018. With few exceptions, as of February 1, 2020, the Company is no longer subject to U.S. federal, state, local, or foreign examinations by tax authorities for years before fiscal 2015.

NOTE 14—NET INCOME (LOSS) PER SHARE

The weighted-average shares used for net income (loss) per share are as follows:

	Year Ended		
	February 1, 2020	February 2, 2019	February 3, 2018
Weighted-average shares—basic	19,082,303	21,613,678	27,053,616
Effect of dilutive stock-based awards	4,554,682	4,567,303	—
Effect of dilutive convertible senior notes ⁽¹⁾	662,049	352,244	—
Weighted-average shares—diluted	<u>24,299,034</u>	<u>26,533,225</u>	<u>27,053,616</u>

(1) The 2019 Notes, 2020 Notes, 2023 Notes and 2024 Notes have an impact on the Company's dilutive share count beginning at stock prices of \$116.09 per share, \$118.13 per share, \$193.65 per share and \$211.40 per

share, respectively. The 2019 Notes matured on June 15, 2019 and did not have an impact of the Company's dilutive share count post-maturity.

The following number of options and restricted stock units were excluded from the calculation of diluted net income (loss) per share because their inclusion would have been anti-dilutive:

	Year Ended		
	February 1, 2020	February 2, 2019	February 3, 2018
Options	360,496	351,145	2,895,471
Restricted stock units	—	2,625	229,308
Total anti-dilutive stock-based awards	<u>360,496</u>	<u>353,770</u>	<u>3,124,779</u>

NOTE 15—SHARE REPURCHASES AND SHARE RETIREMENTS

\$950 Million Share Repurchase Program

On October 10, 2018, the Company's Board of Directors authorized a share repurchase program of up to \$700.0 million. In fiscal 2018, the Company repurchased approximately 2.0 million shares of its common stock under this share repurchase program at an average price of \$122.10 per share, for an aggregate repurchase amount of approximately \$250.0 million. Subsequent to the repurchases under this share repurchase program in fiscal 2018, the initial \$700.0 million authorization amount was replenished by the Board of Directors on March 25, 2019 (as replenished, the \$950 million Repurchase Program"). In fiscal 2019, the Company repurchased approximately 2.2 million shares of its common stock under the \$950 million Repurchase Program at an average price of \$115.36 per share, for an aggregate repurchase amount of approximately \$250.0 million. As of February 1, 2020, there was \$450.0 million remaining for future share repurchases under this program.

\$700 Million Share Repurchase Program

On May 2, 2017, the Company's Board of Directors authorized a share repurchase program of up to \$700 million (the "\$700 Million Repurchase Program"). Under the \$700 Million Repurchase Program, the Company repurchased approximately 12.4 million shares of its common stock at an average price of \$56.60 per share, for an aggregate repurchase amount of approximately \$700 million in fiscal 2017. As the \$700 Million Repurchase Program was completed during fiscal 2017, there will be no repurchases in future periods under this repurchase authorization.

\$300 Million Share Repurchase Program

On February 21, 2017, the Company's Board of Directors authorized a share repurchase program of up to \$300 million (the "\$300 Million Repurchase Program"). Under the \$300 Million Repurchase Program, the Company repurchased approximately 7.8 million shares of its common stock at an average price of \$38.24 per share, for an aggregate repurchase amount of approximately \$300 million in fiscal 2017. As the \$300 Million Repurchase Program was completed during fiscal 2017, there will be no repurchases in future periods under this repurchase authorization.

Share Repurchases Under Equity Plans

As of February 1, 2020 and February 2, 2019, the aggregate unpaid principal amount of the notes payable for share repurchases was \$18.7 million and \$19.6 million, respectively. As of February 1, 2020, \$18.7 million was included in other non-current obligations on the consolidated balance sheets. As of February 2, 2019, \$0.9 million and \$18.7 million were included in other current liabilities and other non-current obligations on the consolidated balance sheets, respectively. The Company recorded interest expense on the outstanding notes of \$0.9 million, \$1.0 million and \$1.0 million in fiscal 2019, fiscal 2018 and fiscal 2017, respectively.

Of the \$18.7 million and \$19.6 million notes payable for share repurchases outstanding as of February 1, 2020 and February 2, 2019, respectively, \$15.5 million was due to a current board member of the Company.

Share Retirements

In fiscal 2019, the Company retired 2,170,154 shares of its common stock related to shares it had repurchased under the \$950 Million Repurchase Program. As a result of this retirement, the Company reclassified a total of \$250.3 million from treasury stock, of which \$13.2 million was allocated to additional paid-in capital and \$237.1 million was allocated to retained earnings (accumulated deficit) on the consolidated balance sheets and consolidated statements of shareholders' equity (deficit) as of February 1, 2020.

In fiscal 2018, the Company retired 22,267,711 shares of its common stock related to shares it had repurchased under the \$300 Million Repurchase Program, \$700 Million Repurchase Program and \$950 Million Repurchase Program. As a result of this retirement, the Company reclassified a total of \$1,250.3 million from treasury stock, of which \$591.5 million was allocated to additional paid-in capital and \$658.8 million was allocated to retained earnings (accumulated deficit) on the consolidated balance sheets and consolidated statements of shareholders' equity (deficit) as of February 2, 2019.

In fiscal 2017, the Company retired 294,888 shares of its common stock related to shares it had repurchased under the Company's equity plans. As a result of this retirement, the Company reclassified a total of \$19.5 million from treasury stock, all of which was allocated to additional paid-in capital on the consolidated balance sheets and consolidated statements of shareholders' equity (deficit) as of February 3, 2018.

There was no impact on the consolidated statements of operations or cash flows related to these share retirement activities.

NOTE 16—STOCK-BASED COMPENSATION

The Company estimates the value of equity grants based upon an OPM and recognizes this estimated value as compensation expense over the vesting periods. The Company recognizes expense associated with performance-based awards when it becomes probable that the performance condition will be met. Once it becomes probable that an award will vest, the Company recognizes compensation expense equal to the number of shares which are probable to vest multiplied by the fair value of the related shares measured at the grant date.

Stock-based compensation expense is included in selling, general and administrative expenses on the consolidated statements of operations. The Company recorded stock-based compensation expense of \$21.8 million, \$24.0 million and \$50.7 million in fiscal 2019, fiscal 2018 and fiscal 2017, respectively. No stock-based compensation cost has been capitalized in the accompanying consolidated financial statements.

2012 Stock Incentive Plan and 2012 Stock Option Plan

The Restoration Hardware 2012 Stock Incentive Plan (the "Stock Incentive Plan") was adopted on November 1, 2012. The Stock Incentive Plan provides for the grant of incentive stock options to the Company's employees, non-qualified stock options, stock appreciation rights, restricted stock, restricted stock units, dividend equivalent rights, cash-based awards and any combination thereof to the Company's employees, directors and consultants and the Company's parent and subsidiary corporations' employees, directors and consultants.

The Restoration Hardware 2012 Stock Option Plan (the "Option Plan") was adopted on November 1, 2012 and on such date 6,829,041 fully vested options were granted under this plan to certain of the Company's employees and advisors. Aside from these options granted on November 1, 2012, no other awards will be granted under the Option Plan.

As of February 2, 2019, there were a total of 1,419,552 shares issuable under the Stock Incentive Plan. On February 4, 2019, an additional 409,556 shares became issuable under the Stock Incentive Plan in accordance with the Stock Incentive Plan evergreen provision, increasing the total number of shares issuable under the Stock Incentive Plan to 1,829,108. Awards under the plans reduce the number of shares available for future issuance. Cancellations and forfeitures of awards previously granted under the Stock Incentive Plan increase the number of shares available for future issuance. Cancellations and forfeitures of awards previously granted under the Option Plan are immediately retired and are no longer available for future issuance.

The number of shares available for future issuance under the Stock Incentive Plan as of February 1, 2020 was 1,630,107. Shares issued as a result of award exercises under the Stock Incentive Plan and Option Plan will be funded with the issuance of new shares. On February 3, 2020, an additional 384,734 shares became issuable under the Stock Incentive Plan in accordance with the Stock Incentive Plan evergreen provision.

2012 Stock Incentive Plan and 2012 Stock Option Plan—Stock Options

A summary of stock option activity under the Stock Incentive Plan and the Option Plan is as follows:

	<u>Options</u>	<u>Weighted-Average Exercise Price</u>
Outstanding—February 2, 2019	7,499,416	\$ 54.37
Granted	534,050	110.17
Exercised	(643,090)	42.20
Cancelled	<u>(255,641)</u>	90.88
Outstanding—February 1, 2020	<u>7,134,735</u>	\$ 58.34

The fair value of stock options issued was estimated on the date of grant using the following assumptions:

	<u>Year Ended</u>		
	<u>February 1, 2020</u>	<u>February 2, 2019</u>	<u>February 3, 2018</u>
Expected volatility	55.7%	54.7%	48.3%
Expected life (years)	7.1	6.7	9.3
Risk-free interest rate	2.3%	2.9%	2.2%
Dividend yield	—	—	—

A summary of additional information about stock options is as follows:

	<u>Year Ended</u>		
	<u>February 1, 2020</u>	<u>February 2, 2019</u>	<u>February 3, 2018</u>
Weighted-average fair value per share of stock options granted	\$ 63.35	\$ 69.60	\$ 24.24
Aggregate intrinsic value of stock options exercised (in thousands) . .	82,718	77,311	27,362
Fair value of stock options vested (in thousands)	11,816	13,915	38,402

Information about stock options outstanding, vested or expected to vest, and exercisable as of February 1, 2020 is as follows:

Range of Exercise Prices	Options Outstanding			Options Exercisable	
	Number of Options	Weighted-Average Remaining Contractual Life (in years)	Weighted-Average Exercise Price	Number of Options	Weighted-Average Exercise Price
\$25.39 - \$45.82	1,011,010	6.08	\$ 35.59	431,410	\$ 34.70
\$46.50 - \$46.50	2,876,826	2.75	46.50	2,876,826	46.50
\$47.53 - \$61.30	1,294,395	6.64	52.47	1,270,635	52.38
\$68.30 - \$90.92	1,160,604	3.68	77.21	1,101,689	76.67
\$91.67 - \$212.77	781,900	8.79	110.66	53,150	107.11
\$241.97 - \$241.97	10,000	9.84	241.97	—	—
Total	<u>7,134,735</u>	4.75	\$ 58.34	<u>5,733,710</u>	\$ 53.27
Vested or expected to vest	<u>6,819,795</u>		\$ 56.93		

The aggregate intrinsic value of options outstanding, options vested or expected to vest, and options exercisable as of February 1, 2020 was \$1,073.5 million, \$1,035.6 million, and \$891.5 million, respectively. Stock options exercisable as of February 1, 2020 had a weighted-average remaining contractual life of 4.10 years.

The Company recorded stock-based compensation expense for stock options of \$14.0 million, \$13.6 million and \$37.5 million in fiscal 2019, fiscal 2018 and fiscal 2017, respectively. The fiscal 2017 expense of \$37.5 million includes the \$23.9 million of expense associated with the option grant to Mr. Friedman in May 2017. Refer to *Chairman and Chief Executive Officer Option Grant* below. As of February 1, 2020, the total unrecognized compensation expense related to unvested options was \$35.5 million, which is expected to be recognized on a straight-line basis over a weighted-average period of 3.13 years.

2012 Stock Incentive Plan—Restricted Stock Awards

The Company grants restricted stock awards, which include restricted stock and restricted stock units, to its employees and members of its Board of Directors. A summary of restricted stock award activity is as follows:

	Awards	Weighted-Average Grant Date Fair Value	Intrinsic Value
Outstanding—February 2, 2019	415,469	\$ 52.40	
Granted	7,014	129.21	
Released	(176,508)	59.61	
Cancelled	(25,990)	53.05	
Outstanding—February 1, 2020	<u>219,985</u>	\$ 49.00	\$45,921,869

A summary of additional information about restricted stock awards is as follows:

	Year Ended		
	February 1, 2020	February 2, 2019	February 3, 2018
Weighted-average fair value per share of awards granted	\$129.21	\$111.38	\$ 55.31
Grant date fair value of awards released (in thousands)	10,522	11,477	16,839

The Company recorded stock-based compensation expense for restricted stock awards of \$7.3 million, \$10.0 million and \$12.8 million in fiscal 2019, fiscal 2018 and fiscal 2017, respectively. As of February 1, 2020, the total unrecognized compensation expense related to unvested restricted stock awards was \$5.5 million, which is expected to be recognized on a straight-line basis over a weighted-average period of 1.47 years.

Chairman and Chief Executive Officer Option Grant

On May 2, 2017, the Company's Board of Directors granted Mr. Friedman an option to purchase 1,000,000 shares of the Company's common stock with an exercise price equal to \$50 per share.

The option contains dual-condition restrictions consisting of both time-based service restrictions over four years and performance-based restrictions linked to achieving the Company's common stock price objectives of \$100, \$125 and \$150 per share. The option is fully vested on the date of grant but the shares underlying the option remain subject to transfer restrictions to the extent the performance-based and time-based requirements have not been met. The option resulted in a non-cash stock compensation charge of \$23.9 million in fiscal 2017, which is included in the \$37.5 million stock-based compensation expense for stock options recorded in fiscal 2017 discussed above.

Time-Based Restrictions

The time-based restrictions are measured over an initial four year service period from the date of the award and these restrictions will lapse at the end of each of these first four years at a rate of 250,000 shares per year if (i) Mr. Friedman remains employed at the end of such year, and (ii) the stock price goals have been achieved in such year as described further below.

Performance-Based Restrictions

The stock price objectives are measured each year and are set at prices for the Company's common stock of \$100, \$125 and \$150 per share. If all three stock price objectives are met in the first performance year, restrictions will lapse as to 250,000 shares in aggregate at the end of such year, with 83,333 shares tied to a \$100 price per share, 83,333 shares tied to a \$125 price per share and 83,334 shares tied to a \$150 price per share.

The same price performance tests are applied in the second year of performance such that restrictions will lapse for an additional 250,000 shares at the end of the second year and then again as to an additional 250,000 shares at the end of each of the third and fourth years so long as Mr. Friedman remains employed at the end of each year.

To the extent that any of the price performance objectives is not reached within one of these first four performance years, the stock price objective can be achieved in any subsequent year until the 8th anniversary of the date of grant.

Rollover Units

In connection with the acquisition of Waterworks, \$1.5 million rollover units in the Waterworks subsidiary (the "Rollover Units") were recorded as part of the transaction. The Rollover Units are subject to the terms of the Waterworks LLC agreement, including redemption rights at an amount equal to the greater of (i) the \$1.5 million remitted as consideration in the business combination or (ii) an amount based on the percentage interest represented in the overall valuation of the Waterworks subsidiary (the "Appreciation Rights"). The Appreciation Rights are measured at fair value and are subject to fair value measurements during the expected life of the Rollover Units, with changes to fair value recorded in the consolidated statements of operations. The fair value of the Appreciation Rights is determined based on an OPM. The Company did not record any expense related to the Appreciation Rights during fiscal 2019, fiscal 2018 or fiscal 2017. As of both February 1, 2020 and February 2, 2019, the liability associated with the Rollover Units and related Appreciation Rights was \$1.5 million, which is included in other non-current obligations on the consolidated balance sheets.

Profit Interests

In connection with the acquisition of Waterworks, profit interests units in the Waterworks subsidiary (the “Profit Interests”) were issued to certain Waterworks associates. The Profit Interests are measured at their grant date fair value and expensed on a straight-line basis over their expected life, or five years. The Profit Interests are subject to fair value measurements during their expected life, with changes to fair value recorded in the consolidated statements of operations. The fair value of the Profit Interests is determined based on an OPM. The Company recorded \$0.5 million, \$0.4 million and \$0.4 million related to the Profit Interests in fiscal 2019, fiscal 2018 and fiscal 2017, respectively, which is included in selling, general and administrative expenses on the consolidated statements of operations. As of February 1, 2020 and February 2, 2019, the liability associated with the Profit Interests was \$1.6 million and \$1.1 million, respectively, which is included in other non-current obligations on the consolidated balance sheets.

NOTE 17—EMPLOYEE BENEFIT PLANS

The Company has a 401(k) plan for its employees who meet certain service and age requirements. Participants may contribute up to 50% of their salaries limited to the maximum allowed by the Internal Revenue Service regulations. The Company, at its discretion, may contribute funds to the 401(k) plan. The Company made no contributions to the 401(k) plan during fiscal 2019, fiscal 2018, or fiscal 2017.

NOTE 18—COMMITMENTS AND CONTINGENCIES

Commitments

The Company had no material off balance sheet commitments as of February 1, 2020.

Contingencies

The Company is involved in lawsuits, claims and proceedings incident to the ordinary course of its business. These disputes are increasing in number as the business expands and the Company grows larger. Litigation is inherently unpredictable. As a result, the outcome of matters in which the Company is involved could result in unexpected expenses and liability that could adversely affect the Company’s operations. In addition, any claims against the Company, whether meritorious or not, could be time consuming, result in costly litigation, require significant amounts of management time and result in the diversion of significant operational resources.

The Company reviews the need for any loss contingency reserves and establishes reserves when, in the opinion of management, it is probable that a matter would result in liability, and the amount of loss, if any, can be reasonably estimated. Generally, in view of the inherent difficulty of predicting the outcome of those matters, particularly in cases in which claimants seek substantial or indeterminate damages, it is not possible to determine whether a liability has been incurred or to reasonably estimate the ultimate or minimum amount of that liability until the case is close to resolution, in which case no reserve is established until that time. When and to the extent that the Company does establish a reserve, there can be no assurance that any such recorded liability for estimated losses will be for the appropriate amount, and actual losses could be higher or lower than what the Company accrues from time to time. The Company believes that the ultimate resolution of its current matters will not have a material adverse effect on its consolidated financial statements.

Securities Class Action

On February 2, 2017, City of Miami General Employees’ & Sanitation Employees’ Retirement Trust filed a class action complaint in the United States District Court, Northern District of California, against the Company, Gary Friedman, and Karen Boone. On March 16, 2017, Peter J. Errichiello, Jr. filed a similar class action complaint in the same forum and against the same parties. On April 26, 2017, the court consolidated the two actions. The consolidated action is captioned *In re RH, Inc. Securities Litigation*. An amended consolidated

complaint was filed in June 2017 asserting claims under sections 10(b) and 20(a) of the Securities Exchange Act of 1934, as amended (the “Exchange Act”). The complaint asserts claims purportedly on behalf of a class of purchasers of Company common stock from March 26, 2015 to June 8, 2016. The alleged misstatements relate to statements regarding the roll out of the RH Modern product line and the Company’s inventory levels. The complaint seeks class certification, monetary damages, and other appropriate relief, including an award of costs and attorneys’ fees. On March 21, 2019, the Company and the individual defendants in the case entered into a binding memorandum of understanding to settle the case. The settlement amount is \$50 million, which was funded entirely by the Company’s insurance carriers. On May 6, 2019, the plaintiffs filed a motion for preliminary approval of the proposed settlement together with a settlement agreement executed by both parties. The settlement agreement was subject to customary conditions including court approval following notice to the Company’s shareholders, and a hearing at which time the court will consider the fairness, reasonableness and adequacy of the settlement. On June 21, 2019, the court issued an order preliminarily approving the settlement. The court granted final approval of the settlement on October 25, 2019.

As a result of signing the settlement agreement in fiscal 2018, the Company recorded a provision for legal settlement and unpaid legal fees for \$50 million within other current liabilities on the consolidated balance sheets as of February 2, 2019. Additionally, the Company recorded a litigation insurance recovery receivable of \$50 million as of February 2, 2019 within prepaid expense and other current assets on the consolidated balance sheets, which represented the estimated insurance claims proceeds from the Company’s insurance carriers.

As a result of the court approval and adjudication of the claims in fiscal 2019, as well as the Company’s insurance carriers funding the settlement amount, the Company has derecognized the provision for legal settlement and unpaid legal fees within other current liabilities and the associated litigation insurance recovery receivable on the consolidated balance sheets as of February 1, 2020, which settlement resolved all of the claims that were or could have been brought in the action.

Shareholder Derivative Lawsuit

On April 24, 2018, purported Company shareholder David Magnani filed a purported shareholder derivative suit in the United States District Court, Northern District of California, captioned Magnani v. Friedman et al. (No. 18-cv-02452). On June 29, 2018, Hosrof Izmirliyan filed a similar purported shareholder derivative complaint in the same forum, captioned Izmirliyan v. Friedman et al. (No. 18-cv-03930). On July 29, 2018, the court consolidated both derivative actions, and the consolidated action is captioned In re RH Shareholder Derivative Litigation. On August 24, 2018, plaintiffs filed an amended complaint that names RH as a nominal defendant and Gary Friedman, Karen Boone, Carlos Alberini, Keith Belling, Eri Chaya, Mark Demilio, Katie Mitic, Ali Rowghani and Leonard Schlesinger as defendants. The allegations substantially track those in the securities class action described above. Plaintiffs bring claims against all individual defendants under Section 14(a) of the Exchange Act, as well as claims for breach of fiduciary duty, unjust enrichment, and waste of corporate assets. The plaintiffs also allege insider trading and misappropriation of information claims against two of the individual defendants. The amended complaint seeks monetary damages, corporate governance changes, restitution, and an award of costs and attorneys’ fees. The Company believes that plaintiffs lack standing to bring this derivative action. On September 28, 2018, the Company filed a motion to stay proceedings and a motion to dismiss the consolidated complaint. On January 23, 2019, the court granted the motion to stay the case pending resolution of the securities class action discussed above. On March 19, 2020, the parties reached an agreement in principle to settle the litigation, which agreement is subject to the finalization of a stipulation of settlement, and certain conditions, including approval by the Company’s board of directors, and approval by the Court. The settlement involves certain non-monetary terms as well as payment of the plaintiffs’ attorneys’ legal fees, which payment is expected to be funded by the Company’s insurance carriers.

NOTE 19—SEGMENT REPORTING

The Company defines reportable and operating segments on the same basis that it uses to evaluate performance internally by the CODM. The Company has determined that the Chief Executive Officer is its CODM.

The Company has two operating segments: RH Segment and Waterworks. The two operating segments include all sales channels accessed by the Company's customers, including sales through catalogs, websites, stores, and the commercial channel.

The Company's two operating segments are strategic business units that offer products for the home furnishings customer. While RH Segment and Waterworks have a shared management team and customer base, the Company has determined that their results cannot be aggregated as they do not share similar economic characteristics, as well as due to other quantitative factors.

The Company uses operating income to evaluate segment profitability. Operating income is defined as net income before interest expense—net, goodwill and tradename impairment, loss on extinguishment of debt—net and income tax expense.

Segment Information

The following table presents the statements of operations metrics reviewed by the CODM to evaluate performance internally or as required under ASC 280—*Segment Reporting (in thousands)*:

	Year Ended								
	February 1, 2020			February 2, 2019			February 3, 2018		
	RH Segment	Waterworks	Total	RH Segment	Waterworks	Total	RH Segment	Waterworks	Total
Net revenues	\$ 2,514,296	\$133,141	\$2,647,437	\$2,375,472	\$130,181	\$2,505,653	\$2,319,332	\$120,842	\$2,440,174
Gross profit	1,038,722	56,289	1,095,011	933,805	51,772	985,577	791,730	47,568	839,298
Depreciation and amortization . .	96,148	4,591	100,739	86,719	4,653	91,372	78,772	4,404	83,176

The following table presents the balance sheet metrics as required under ASC 280—*Segment Reporting (in thousands)*:

	February 1, 2020			February 2, 2019		
	RH Segment	Waterworks	Total	RH Segment	Waterworks	Total
Goodwill ⁽¹⁾	\$ 124,367	\$ —	\$ 124,367	\$ 124,379	\$ —	\$ 124,379
Tradenames, trademarks and domain names ⁽²⁾	48,563	37,459	86,022	48,563	37,459	86,022
Total assets	2,301,823	143,871	2,445,694	2,273,951	149,067	2,423,018

- (1) The Waterworks reporting unit goodwill of \$51.1 million recognized upon acquisition in fiscal 2016 was fully impaired as of February 2, 2019, with \$17.4 million and \$33.7 million impairment recorded in fiscal 2018 and fiscal 2017, respectively.
- (2) The Waterworks reporting unit tradename is presented net of an impairment charge of \$14.6 million recorded in fiscal 2018.

The Company uses segment operating income to evaluate segment performance and allocate resources. Segment operating income excludes (i) asset impairments and lease losses, (ii) severance costs associated with a reorganizations, (iii) product recall accruals and adjustments—net, (iv) asset held for sale gain (loss), (v) favorable legal settlements, net of legal expenses, (vi) disposals of inventory and property and equipment,

lease related charges, inventory transfer costs and other costs and adjustments associated with distribution center closures, (vii) non-cash amortization of the inventory fair value adjustment recorded in connection with the acquisition of Waterworks, (viii) a non-cash compensation charge related to a fully vested option grant made to Mr. Friedman in May 2017, (ix) the release of the remaining reserve for potential claims regarding anti-dumping duties which the Company believes have lapsed and (x) the gain on sale of building and land for one of the Company's previously owned retail galleries. These items are excluded from segment operating income in order to provide better transparency of segment operating results. Accordingly, these items are not presented by segment because they are excluded from the segment profitability measure that the CODM and management reviews.

The following table presents segment operating income and income before income taxes (*in thousands*):

	Year Ended		
	February 1, 2020	February 2, 2019	February 3, 2018
Operating income:			
RH Segment	\$ 375,315	\$ 288,106	\$ 161,111
Waterworks	3,780	(922)	(1,615)
Asset impairments and lease losses	(21,899)	(7,218)	(4,417)
Reorganization related costs	(1,075)	(9,977)	(949)
Recall accrual	3,988	(1,619)	(7,707)
Asset held for sale gain (loss)	1,529	(8,497)	—
Legal settlements	1,193	5,289	—
Distribution center closures	—	(3,046)	(7,230)
Impact of inventory step-up	—	(380)	(2,527)
Executive non-cash compensation	—	—	(23,872)
Anti-dumping exposure	—	—	2,202
Gain on sale of building and land	—	—	2,119
Income from operations	362,831	261,736	117,115
Interest expense—net	87,177	67,769	56,002
Goodwill and tradename impairment	—	32,086	33,700
Loss on extinguishment of debt—net	6,472	917	4,880
Income before income taxes	<u>\$ 269,182</u>	<u>\$ 160,964</u>	<u>\$ 22,533</u>

The Company classifies its sales into furniture and non-furniture product lines. Furniture includes both indoor and outdoor furniture. Non-furniture includes lighting, textiles, fittings, fixtures, surfaces, accessories and home décor. Net revenues in each category were as follows (*in thousands*):

	Year Ended		
	February 1, 2020	February 2, 2019	February 3, 2018
Furniture	\$ 1,794,317	\$ 1,625,553	\$ 1,543,404
Non-furniture	853,120	880,100	896,770
Total net revenues	<u>\$ 2,647,437</u>	<u>\$ 2,505,653</u>	<u>\$ 2,440,174</u>

The Company is domiciled in the United States and primarily operates its retail and outlet stores in the United States. As of February 1, 2020, the Company operates 4 retail and 2 outlet stores in Canada and 1 retail store in the U.K. Revenues from Canadian and U.K. operations, and the long-lived assets in Canada and the U.K., are not material to the Company. Canada and U.K. geographic revenues are based upon revenues recognized at the retail store locations in the respective country.

No single customer accounted for more than 10% of the Company's revenues in fiscal 2019, fiscal 2018 or fiscal 2017.

NOTE 20—SUBSEQUENT EVENT

In March 2020, the World Health Organization declared the outbreak of COVID-19 as a pandemic, which continues to spread throughout the United States and globally. The COVID-19 health crisis poses significant and widespread risks to the Company's business as well as to the business environment and the markets in which the Company operates. In response to the public health crisis posed by COVID-19, effective from March 17, 2020, the Company temporarily closed its retail locations for an indeterminate period of time. Although the Company continues to serve its customers virtually through its Gallery representatives and designers, as well as its online websites, the Company's business operations are being substantially affected by applicable regulatory restrictions including stay-at-home requirements applicable in California where its corporate headquarters is located. The Company's decision to reopen retail locations will be affected by a number of factors including applicable regulatory restrictions and there is substantial uncertainty regarding the manner and timing in which the Company can return some or all of its business to more normal business operations. The Company may face longer term closure requirements and other operational restrictions with respect to some or all of its physical locations for prolonged periods of time due to, among other factors, evolving and increasingly stringent federal, state and local restrictions including shelter-in-place orders. Even once the Company is able to reopen closed physical locations, changes in consumer behavior and health concerns may continue to impact consumer demand for the Company's products and customer traffic at its Galleries, restaurants and outlets and may make it more difficult to staff its business operations. As a result of these developments, the Company expects an unfavorable impact on its sales, results of operations and cash flows in fiscal 2020.

The Company has already experienced significant disruption to its business as a result of the rapid development of COVID-19 and the corresponding reduction in sales associated with its retail location closures. The Company may face longer term closure requirements with respect to some or all of its physical locations for prolonged periods of time due to, among other factors, evolving and increasingly stringent federal, state and local restrictions and shelter-in-place orders. Even once the Company is able to reopen its physical locations, changes in consumer behavior and health concerns may continue to impact customer traffic at the Company's retail locations and may make it more difficult to staff these locations. Additionally, customer purchasing patterns are influenced by economic factors including the health of the stock market and the Company has correlated previous downturns in the stock market with a reduction in consumer demands for its products. Accordingly, adverse conditions and events have occurred that will impact the Company's operations and liquidity.

The Company has relied on cash flows from operations, net cash proceeds from the issuance of the convertible senior notes, as well as borrowings under credit facilities as primary sources of liquidity. The current events and economic conditions are significant in relation to the Company's ability to fund its business operations, as well as debt repayments when due, such as the \$300 million convertible senior notes maturing in July 2020 and payments under equipment promissory notes. The Company expects to repay the \$300 million outstanding principal amount of the convertible notes in cash, whether in connection with a conversion of such notes or repayment at maturity in July 2020.

In response to the impact of COVID-19, the Company is implementing a number of measures to minimize cash outlays, including managing workforce costs, delaying planned capital expenditures, deferring new business introductions, adjusting the timing and circulation of Source Books and minimizing discretionary expenses. The Company plans to utilize its asset based credit facility, and the Company may pursue other sources of capital that may include other forms of external financing, in order to increase its cash position and preserve financial flexibility in response to the uncertainty in the United States and global markets resulting from COVID-19. Refer to Note 10—*Convertible Senior Notes* and Note 11—*Credit Facilities* for further information on the terms and conditions of the Company's outstanding debt agreements. The Company had outstanding borrowings under the Credit Agreement of \$35.0 million as of March 27, 2020 and the amount under the revolving line of credit borrowing base that could be available pursuant to the Credit Agreement was \$307.9 million, net of \$13.2 million in outstanding letters of credit. The Company believes that these actions mitigate risks arising from COVID-19

and will be sufficient to repay the Company's debt obligations as they become due, meet working capital requirements and fulfill other capital needs for more than the next 12 months.

NOTE 21—SELECTED QUARTERLY FINANCIAL DATA (UNAUDITED)

Quarterly financial data for fiscal 2019 and fiscal 2018 are set forth below (*in thousands, except share and per share amounts*):

<u>Fiscal 2019</u>	Three Months Ended			
	<u>May 4, 2019</u>	<u>August 3, 2019</u>	<u>November 2, 2019</u>	<u>February 1, 2020</u>
Net revenues	\$ 598,421	\$ 706,514	\$ 677,526	\$ 664,976
Gross profit	232,814	294,958	284,166	283,073
Net income	35,722	63,757	52,463	68,433
Weighted-average shares used in computing basic net income per share	19,976,858	18,465,876	18,765,769	19,120,709
Basic net income per share	\$ 1.79	\$ 3.45	\$ 2.80	\$ 3.58
Weighted-average shares used in computing diluted net income per share	24,933,987	22,324,112	24,170,172	25,767,864
Diluted net income per share	\$ 1.43	\$ 2.86	\$ 2.17	\$ 2.66

<u>Fiscal 2018</u>	Three Months Ended			
	<u>May 5, 2018</u>	<u>August 4, 2018</u>	<u>November 3, 2018</u>	<u>February 2, 2019</u>
Net revenues	\$ 557,406	\$ 640,798	\$ 636,558	\$ 670,891
Gross profit	209,333	268,344	250,021	257,879
Net income	25,461	62,906	20,114	27,250
Weighted-average shares used in computing basic net income per share	21,545,025	21,925,702	22,082,141	20,901,841
Basic net income per share	\$ 1.18	\$ 2.87	\$ 0.91	\$ 1.30
Weighted-average shares used in computing diluted net income per share	25,230,228	27,496,561	27,703,319	25,702,791
Diluted net income per share	\$ 1.01	\$ 2.29	\$ 0.73	\$ 1.06

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

None.

Item 9A. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended) as of the end of the period covered by this annual report. Based on that evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that as of the end of the period covered by this report our disclosure controls and procedures were effective to provide reasonable assurance that information required to be disclosed by us in reports that we file or submit under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and include controls and procedures designed to ensure that the information required to be disclosed by us in such reports is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosures.

Management's Report on Internal Control over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as defined in Exchange Act Rule 13a-15(f). Management conducted an assessment of our internal control over financial reporting as of February 1, 2020 based on the framework established by the Committee of Sponsoring Organizations of the Treadway Commission in *Internal Control—Integrated Framework* (2013). Based on the assessment, management concluded that our internal control over financial reporting was effective as of February 1, 2020. The effectiveness of the Company's internal control over financial reporting as of February 1, 2020 has been audited by PricewaterhouseCoopers LLP, an independent registered public accounting firm, as stated in their report which is included herein.

Changes in Internal Control over Financial Reporting

There were no changes in our internal control over financial reporting that occurred during our most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Limitations on Effectiveness of Controls and Procedures and Internal Control over Financial Reporting

In designing and evaluating the disclosure controls and procedures and internal control over financial reporting, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives. In addition, the design of disclosure controls and procedures and internal control over financial reporting must reflect the fact that there are resource constraints and that management is required to apply judgment in evaluating the benefits of possible controls and procedures relative to their costs.

Item 9B. Other Information

None.

PART III

Item 10. Directors, Executive Officers and Corporate Governance

The information required by this item will be contained in our definitive Proxy Statement for the 2020 Annual Meeting of Stockholders (the “Proxy Statement”) and is incorporated herein by reference.

Item 11. Executive Compensation

The information required by this item will be contained in our Proxy Statement and is incorporated herein by reference.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

The information required by this item will be contained in our Proxy Statement and is incorporated herein by reference.

Item 13. Certain Relationships and Related Transactions and Director Independence

The information required by this item will be contained in our Proxy Statement and is incorporated herein by reference.

Item 14. Principal Accountant Fees and Services

The information required by this item will be contained in our Proxy Statement and is incorporated herein by reference.

PART IV

Item 15. Exhibits and Financial Statement Schedules

(a) The following documents are filed as part of this Annual Report on Form 10-K:

1. Consolidated Financial Statements

The following financial statements are included in Part II, Item 8 of this Annual Report on Form 10-K:

- Report of Independent Registered Public Accounting Firm on Consolidated Financial Statements
- Consolidated Balance Sheets as of February 1, 2020 and February 2, 2019
- Consolidated Statements of Operations for the fiscal years ended February 1, 2020, February 2, 2019 and February 3, 2018
- Consolidated Statements of Comprehensive Income (Loss) for the fiscal years ended February 1, 2020, February 2, 2019 and February 3, 2018
- Consolidated Statements of Stockholders' Equity (Deficit) for the fiscal years ended February 1, 2020, February 2, 2019 and February 3, 2018
- Consolidated Statements of Cash Flows for the fiscal years ended February 1, 2020, February 2, 2019 and February 3, 2018
- Notes to the Consolidated Financial Statements

2. Financial Statement Schedules

Separate financial statement schedules have been omitted either because they are not applicable or because the required information is included in the consolidated financial statements or notes described in Item 15(a)(1) above.

3. Exhibits

The Exhibits listed in the Index to Exhibits, which appears immediately before the signature page and is incorporated herein by reference, are filed or incorporated by reference as part of this Annual Report on Form 10-K.

Item 16. Form 10-K Summary

The Company has elected not to include summary information.

EXHIBIT INDEX

Exhibit Number	Exhibit Description	Form	Incorporated by Reference		Exhibit Number	Filed Herewith
			File Number	Date of First Filing		
3.1	Restated Certificate of Incorporation of RH.	10-K	001-35720	March 29, 2017	3.1	
3.2	Amended and Restated Bylaws of RH.	8-K	001-35720	March 3, 2017	3.1	
4.1	Description of Securities of Registrant.					X
4.2	Form of RH Common Stock Certificate.	10-K	001-35720	March 29, 2017	4.1	
4.3	Indenture dated June 24, 2014, between Restoration Hardware Holdings, Inc. and U.S. Bank National Association, as Trustee, including form of 0.00% Convertible Senior Note due 2019.	8-K	001-35720	June 24, 2014	4.1	
4.4	Indenture dated June 23, 2015, between Restoration Hardware Holdings, Inc., the Guarantor and U.S. Bank National Association, as Trustee, including form of 0.00% Convertible Senior Note due 2020.	8-K	001-35720	June 24, 2015	4.1	
4.5	Indenture dated June 18, 2018, between RH and U.S. Bank National Association, as Trustee, including form of 0.00% Convertible Senior Note due 2023.	8-K	001-35720	June 19, 2018	4.1	
4.6	First Supplemental Indenture dated as of August 31, 2018, between RH and U.S. Bank National Association, as Trustee, relating to the 0.00% Convertible Senior Note due 2023.	10-Q	001-35720	September 5, 2018	4.2	
4.7	Indenture dated September 17, 2019, between RH and U.S. Bank National Association, as Trustee, including form of 0.00% Convertible Senior Note due 2024.	8-K	001-35720	September 18, 2019	4.1	

<u>Exhibit Number</u>	<u>Exhibit Description</u>	<u>Form</u>	<u>Incorporated by Reference</u>		<u>Exhibit Number</u>	<u>Filed Herewith</u>
			<u>File Number</u>	<u>Date of First Filing</u>		
10.1	Form of Indemnification Agreement entered into by and between Restoration Hardware Holdings, Inc. and each of its directors.	S-1/A	333-176767	October 23, 2012	10.4	
10.2*	Executive Employment Agreement, dated as of July 2, 2013, by and between Restoration Hardware, Inc. and Gary Friedman.	8-K	001-35720	July 3, 2013	10.1	
10.3*	2012 Equity Replacement Plan and related documents.	S-8	333-184716	November 2, 2012	4.2	
10.4*	2012 Stock Incentive Plan and related documents.	S-8	333-184716	November 2, 2012	4.3	
10.5*	2012 Stock Option Plan and related documents.	S-8	333-184716	November 2, 2012	4.4	
10.6*	Form of 2012 Stock Incentive Plan and 2012 Stock Option Plan related documents, as amended and restated.	10-Q	001-35720	December 17, 2013	10.2	
10.7*	Form of Notice of Restricted Stock Unit Award and Restricted Stock Unit Agreement under 2012 Stock Incentive Plan.	10-K	001-35720	March 31, 2014	10.17	
10.8*	Notice of Stock Option Award and Stock Option Award Agreement by and between RH and Gary Friedman.	8-K	001-35720	May 3, 2017	10.1	
10.9*	Cash Incentive Bonus Plan.	10-Q	001-35720	September 9, 2017	10.2	
10.10*	Form of Compensation Protection Agreement for Section 16 Presidents.	10-K	001-35720	March 29, 2018	10.11	
10.11	Form of Base Convertible Bond Hedge Confirmation, dated June 18, 2015, between Restoration Hardware Holdings, Inc. and each of the Counterparties.	8-K	001-35720	June 24, 2015	10.1	
10.12	Form of Base Warrant Confirmation, dated June 18, 2015, between Restoration Hardware Holdings, Inc. and each of the Counterparties.	8-K	001-35720	June 24, 2015	10.2	

<u>Exhibit Number</u>	<u>Exhibit Description</u>	<u>Form</u>	<u>Incorporated by Reference</u>		<u>Exhibit Number</u>	<u>Filed Herewith</u>
			<u>File Number</u>	<u>Date of First Filing</u>		
10.13	Form of Base Convertible Bond Hedge Confirmation, dated June 13, 2018, between RH and each of the counterparties thereto.	8-K	001-35720	June 19, 2018	10.1	
10.14	Form of Base Warrant Confirmation, dated June 13, 2018, between RH and each of the counterparties thereto.	8-K	001-35720	June 19, 2018	10.2	
10.15	Form of Base Convertible Bond Hedge Confirmation, dated September 12, 2019, between RH and each of the Counterparties.	8-K	001-35720	September 18, 2019	10.1	
10.16	Form of Base Warrant Confirmation, dated September 12, 2019, between RH and each of the Counterparties.	8-K	001-35720	September 18, 2019	10.2	
10.17	Form of Additional Convertible Bond Hedge Confirmation, dated September 13, 2019, between RH and each of the Counterparties.	8-K	001-35720	September 18, 2019	10.3	
10.18	Form of Additional Warrant Confirmation, dated September 13, 2019, between RH and each of the Counterparties.	8-K	001-35720	September 18, 2019	10.4	
10.19	Amended and Restated Aircraft Time Sharing Agreement entered into on March 29, 2016 by and between Restoration Hardware, Inc. and Gary G. Friedman.	10-K	001-35720	March 30, 2016	10.13	
10.20	Eleventh Amended and Restated Credit Agreement dated as of June 28, 2017 among Restoration Hardware, Inc., as lead borrower, various other subsidiaries of RH named therein as borrowers, the guarantors party thereto, the lenders party thereto and Bank of America, N.A. as administrative agent and collateral agent.	8-K	001-35720	July 3, 2017	10.1	

<u>Exhibit Number</u>	<u>Exhibit Description</u>	<u>Form</u>	<u>Incorporated by Reference</u>		<u>Exhibit Number</u>	<u>Filed Herewith</u>
			<u>File Number</u>	<u>Date of First Filing</u>		
10.21	First Amendment to Eleventh Amended and Restated Credit Agreement, dated June 12, 2018, among Restoration Hardware, Inc., as lead borrower, various other subsidiaries of RH named therein as borrowers, the guarantors party thereto, the lenders party thereto and Bank of America, N.A., as administrative agent and collateral agent.	10-Q	001-35720	June 12, 2018	10.1	
10.22	Consent and Second Amendment to Eleventh Amended and Restated Credit Agreement, dated November 23, 2018, among Restoration Hardware, Inc., as lead borrower, various other subsidiaries of RH named therein as borrowers, the guarantors party thereto, the lenders party thereto and Bank of America, N.A. as administrative agent and collateral agent.	8-K	001-35720	November 23, 2018	10.1	
10.23	Third Amendment to Eleventh Amended and Restated Credit Agreement, dated April 4, 2019, among Restoration Hardware, Inc., as lead borrower, various other subsidiaries of RH named therein as borrowers, the guarantors party thereto, the lenders party thereto and Bank of America, N.A. as administrative agent and collateral agent.	8-K	001-35720	April 5, 2019	10.1	

<u>Exhibit Number</u>	<u>Exhibit Description</u>	<u>Form</u>	<u>Incorporated by Reference</u>		<u>Exhibit Number</u>	<u>Filed Herewith</u>
			<u>File Number</u>	<u>Date of First Filing</u>		
10.24	Credit Agreement, dated as of July 7, 2017, among Restoration Hardware, Inc., as lead borrower, various other subsidiaries of RH named therein as borrowers, the guarantors party thereto, the lenders party thereto and Wilmington Trust, National Association as administrative agent and collateral agent.	8-K	001-35720	July 13, 2017	10.1	
10.25	Credit Agreement, dated as of April 9, 2019 and effective as of April 10, 2019, among Restoration Hardware, Inc., as lead borrower, various other subsidiaries of RH named therein as borrowers, the guarantors party thereto, the lenders party thereto and BSP Agency, LLC, as administrative agent and collateral agent.	8-K	001-35720	April 16, 2019	10.1	
10.26	Intercreditor Agreement, dated as of April 9, 2019 and effective as of April 10, 2019, among Restoration Hardware, Inc., Bank of America, N.A. and BSP Agency, LLC.	8-K	001-35720	April 16, 2019	10.2	
21.1	Subsidiary List	—	—	—	—	X
23.1	Consent of PricewaterhouseCoopers LLP	—	—	—	—	X
24.1	Power of Attorney (included on signature page)	—	—	—	—	X
31.1	Certification of Chief Executive Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended.	—	—	—	—	X
31.2	Certification of Chief Financial Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended.	—	—	—	—	X
32.1	Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.	—	—	—	—	X

Exhibit Number	Exhibit Description	Form	Incorporated by Reference		Exhibit Number	Filed Herewith
			File Number	Date of First Filing		
32.2	Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.	—	—	—	—	X
101.INS	XBRL Instance Document—the instance document does not appear in the Interactive Data File because its XBRL tags are embedded within the Inline XBRL document.	—	—	—	—	X
101.SCH	Inline XBRL Taxonomy Extension Schema Document	—	—	—	—	X
101.CAL	Inline XBRL Taxonomy Extension Calculation Linkbase Document	—	—	—	—	X
101.DEF	Inline XBRL Extension Definition	—	—	—	—	X
101.LAB	Inline XBRL Taxonomy Extension Label Linkbase Document	—	—	—	—	X
101.PRE	Inline XBRL Taxonomy Extension Presentation Linkbase Document	—	—	—	—	X
104	Cover Page Interactive Data File—the cover page interactive data file does not appear in the Interactive Data File because its XBRL tags are embedded within the Inline XBRL document.	—	—	—	—	X

* Indicates management contract or compensatory plan or arrangement.

