

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, 2014

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

**RESTORATION HARDWARE HOLDINGS, INC.**

(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, Suite J  
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)

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 and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted 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 and post such files). Yes  No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

Large accelerated filer  Accelerated filer

Non-accelerated filer  (Do not check if a smaller reporting company) Smaller reporting company

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 3, 2013, 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 \$1,696,344,000. 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 21, 2014, 38,887,454 shares of registrant's common stock were outstanding.

**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the registrant's Proxy Statement for its 2013 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, 2014.

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## 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,” “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. 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 as a result of new information, future events or otherwise, except as otherwise required by law.

## PART I

### Item 1. Business

#### Overview

Restoration Hardware Holdings, Inc. (“RH” or the “Company”) is a leading luxury retailer in the home furnishings marketplace. Our collections of timeless, updated classics and reproductions 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, tableware and children’s furnishings. Our ability to innovate, curate and integrate products, categories, services and businesses with a completely authentic and distinctive point of view, then rapidly scale them across our fully integrated multi-channel infrastructure is a powerful platform for continued long-term growth. We evolved our brand to become RH, positioning our Company to curate a lifestyle beyond the four walls of the home. Our unique product development, go-to-market and supply chain capabilities, together with our significant scale, enable us to offer a compelling combination of design, quality and value that we believe is unparalleled in the marketplace.

Our business is fully integrated across our multiple channels of distribution, consisting of our stores, catalogs and websites. As of February 1, 2014, we operated a total of 70 retail stores, consisting of 62 Galleries, 5 Full Line Design Galleries and 3 Baby & Child Galleries, as well as 17 outlet stores throughout the United States and Canada. In fiscal 2013, we distributed approximately 12.3 million Source Books, and our websites logged approximately 22.2 million unique visits.

We have achieved strong growth in sales and profitability, as illustrated by the following:

- Net revenues increased 30% to \$1.6 billion in fiscal 2013, on top of a 25% increase in fiscal 2012 and a 24% increase in fiscal 2011.
- The fourth quarter of fiscal 2013 marked our 16<sup>th</sup> consecutive quarter of double-digit net revenue growth.
- Our net income increased to \$18.2 million in fiscal 2013 from a net loss of \$12.8 million in fiscal 2012.
- Our adjusted net income increased 83% to \$69.1 million in fiscal 2013 from fiscal 2012.

#### Growth Strategy

Key elements of our growth strategy are to:

*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 retail footprint to a portfolio focused on Full Line Design Galleries. Our Full Line Design Galleries are sized based on the market potential and the size of our assortment. Based on our analysis, we believe we have opportunities to operate Full Line Design Galleries in 60 to 70 locations in the United States and Canada.

*Expand Our Offering and Increase Our Market Share.* We believe we have a significant opportunity to increase our market share by growing our merchandise assortment, introducing new products and categories, expanding our service offerings and exploring and testing new business opportunities complementary to our core business.

*Increase Brand Awareness.* We will continue to increase our brand awareness and customer loyalty through our real estate transformation, our circulation strategy, our digital marketing initiatives, and our advertising and public relations activities and events.

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*Pursue International Expansion.* We plan to strategically expand our business into select countries outside of the United States and Canada over the next several years. We believe that our luxury brand positioning and unique aesthetic will have strong international appeal.

*Increase Operating Margins.* We have the opportunity to continue to improve our operating margins by leveraging our fixed occupancy costs and scalable infrastructure. We believe that our real estate transformation, specifically consolidating multiple Galleries into single Full Line Design Galleries, will allow us to better leverage our fixed occupancy costs.

### **Products**

We are merchants of luxury home furnishings offering collections of timeless, updated classics and reproductions. We operate as a curator of products that we regard as the finest historical design. Our luxury products embody our design aesthetic and reflect inspiration from across the centuries and around the globe. Our objective is to position RH as a lifestyle brand and design authority by offering dominant merchandise assortments across a growing number of categories, including furniture, lighting, textiles, bathware, décor, outdoor and garden, tableware and children's furnishings.

### **Product Development**

We have architected a proprietary product development platform that is fully integrated from ideation to presentation. We have streamlined our product development organization and process to shorten product lead times and enhance our ability to introduce more new products with each collection. 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 the channel conflicts and functional redundancies often found in other retail organizations.
- *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 on a large scale with a high level of quality and value, including both distinctive original designs and reinterpretations of antiques.
- *Facility*—We have built the *RH Center of Innovation and 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 have enabled us to reduce our product costs.

### **Sales Channels**

We distribute our products through a fully integrated sales platform comprised of our stores, catalogs and websites. We believe the level of integration among all of our channels and our approach to the market distinguishes us from most other retailers. For fiscal 2013, sales of products originating in our stores represented 53% of our net revenues, while sales from our direct business represented 47% of our net revenues. 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.

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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. Our catalog mailings serve as a key driver of sales through both our websites and retail stores. Through our Source Book strategy, we have expanded the page count and circulation of our catalogs to expose more customers to a broader product assortment. 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 both in our Source Books and in our stores. Our retail stores reinforce our luxury brand aesthetic and showcase product collections in lifestyle settings consistent with the presentation in our direct channels. In addition, our store associates use iPads and other devices to allow customers to shop our entire merchandise assortment while in the store.

We maintain a database of customer information, which include sales patterns, detailed purchasing information, certain demographic information, geographic locations and email addresses of our customers. As of February 1, 2014, our customer database contained approximately 15.0 million names. This database supports our ability to analyze our customers' buying behaviors across sales channels and facilitates the development of targeted marketing strategies. We segment our customer files based on multiple variables, and we tailor our catalog 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.

In addition to our core channels, we are also expanding into professional services channels, including Trade and Contract. In the Trade channel, we work directly with independent interior designers purchasing for their businesses. Separately, we sell directly to customers who make purchases with the assistance of their own interior designers or decorators, which we refer to as "designer-assisted sales." We are also expanding our Contract business, which services hospitality, real estate development, and other business clients. These channels offer additional avenues for reaching new customers, including both businesses and individuals.

### **Stores**

#### *Retail Stores*

As of February 1, 2014, we operated a total of 70 retail stores throughout the United States and Canada, consisting of 62 Galleries, 5 Full Line Design Galleries and 3 Baby & Child Galleries. Our retail stores are located primarily in upscale malls and street locations. We believe situating our stores in desirable locations with high visibility is critical to the success of our business, and we identify store locations based on several store specific aspects including geographic location, demographics, and proximity to other high-end specialty retail stores. 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 and catalog circulation to maximize each market's sales potential and increase our return on invested capital.

We currently operate three distinct store types with the following selling square footage as of February 1, 2014: (1) our Full Line Design Gallery format, which averaged approximately 21,600 selling square feet, (2) our Gallery format, which averaged approximately 7,400 selling square feet, and (3) our Baby & Child Gallery format. We are in the process of introducing larger versions of our Full Line Design Gallery format, as discussed further below. We anticipate that our Full Line Design Galleries will include dedicated Baby & Child retail space and we will continue to evaluate potential opportunities for stand-alone Baby & Child Galleries in other markets.

Our store formats convey a design aesthetic and shopping environment that is highly differentiated from other home furnishings retailers. We have reconceptualized 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 in our catalogs and on our websites. Products in our stores are presented in fully appointed rooms, emphasizing collections over individual pieces. This presentation encourages a higher average order value as customers are inspired to purchase a full collection of products to replicate the design aesthetic found in our stores. Our goal is to optimize our selling space to display a greater number of products, which should result in higher sales productivity and profitability. On average, our retail stores display

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less than 20% of our current product assortment. Based on our historical performance, when a product is presented on the selling floor, we experience a significant increase in sales for that product across all of our channels. Our newer, larger store model, the Full Line Design Gallery, significantly enhances our merchandise presentation and customer experience to capitalize on this opportunity for sales growth.

Full Line Design Galleries are shopping destinations in iconic or high-profile locations with high customer visibility that enhance the RH brand. Our strategy is to size these new Full Line Design Galleries based on the potential of each market and the size of our assortment. Based on recent trends and our plans for product assortment expansion and new businesses, we are generally targeting a range of 25,000 to 60,000 square feet for new locations. Our goal is to accommodate a dominant presentation of certain core product categories such as hardware, bathware, rugs and flooring, windows, bed and bath linens, our expanded living, dining, bed and bath assortment, Baby & Child, Small Spaces, RH Design Services, and in many markets, a year-round Outdoor & Garden assortment. This increased size will also support other brand-enhancing offerings such as cafés and wine bars.

The table below highlights certain information regarding our retail stores open during the three years ended February 1, 2014.

	<u>Fiscal Year</u>		
	<u>2013</u>	<u>2012</u>	<u>2011</u>
Stores open at beginning of period	71	74	91
Stores opened	2	5	5
Stores closed	(3)	(8)	(22)
Stores open at end of period	<u>70</u>	<u>71</u>	<u>74</u>

We continually analyze opportunities to selectively consolidate stores in connection with openings of our Full Line Design Galleries or close stores which have been under-performing or are no longer consistent with our brand positioning. In many cases, we continue to operate a store until its lease has expired in order to effect the closure in a cost-efficient manner. In fiscal 2011, we recorded a charge of \$3.2 million, relating primarily to closing stores prior to lease expiration.

The following list shows the number of retail stores in each U.S. state and each Canadian province where we operate as of February 1, 2014:

<u>Location</u>	<u>Store</u>	<u>Location</u>	<u>Store</u>	<u>Location</u>	<u>Store</u>
Alabama	1	Massachusetts	1	Rhode Island	1
Arizona	1	Michigan	1	Tennessee	1
California	17	Minnesota	1	Texas	6
Colorado	1	Missouri	2	Utah	1
Connecticut	2	New Jersey	2	Virginia	2
Florida	4	New York	3	Washington	1
Georgia	1	North Carolina	2	District of Columbia	1
Illinois	3	Ohio	3	Alberta	2
Indiana	1	Oklahoma	1	British Columbia	1
Louisiana	1	Oregon	1	Ontario	2
Maryland	1	Pennsylvania	2		
				<b>Total</b>	<u>70</u>

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### *Outlet Stores*

As of February 1, 2014, we operated 16 outlet stores in 13 states in the United States and 1 outlet store in Canada. Our outlet stores are branded as Restoration Hardware Outlet or RH Outlet and located primarily in large outlet malls. Our outlet stores serve as an efficient means to sell discontinued or irregular inventory outside of our core sales channels.

### *Source Books*

We produce a series of catalogs, that we refer to as Source Books, to showcase our merchandise assortment. In 2013, these included our Interiors, Outdoor, Baby & Child, Objects of Curiosity, Small Spaces and Tableware Source Books. Our catalogs are one of our primary branding and advertising vehicles. We have been expanding the page counts of our Source Books, which allow us to showcase nearly our entire product assortment. For example, our Spring 2013 Source Books presented over 80% of our product assortment at the time of publication. We have found that when we display a greater merchandise assortment in our Source Books, we experience increased sales across all of our channels. As in our retail stores, our Source Books present our merchandise in lifestyle settings that represent 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 catalogs is coordinated by our in-house personnel in our *RH Center of Innovation & Product Leadership*, providing us greater control over the brand image presented to our customers, while also reducing our catalog production costs.

We use our catalogs to drive sales across all of our channels, and we generally experience increased sales of the products featured in our catalogs. We mail our catalogs to addresses from our proprietary customer database, as well as to addresses provided to us by third parties. We also use customer data that we collect to determine which prospective customers are most likely to respond to our catalogs.

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

### *E-Commerce*

Our primary websites, [www.restorationhardware.com](http://www.restorationhardware.com) and [www.rh.com](http://www.rh.com), provide our customers with the ability to purchase our merchandise online. In May 2008, we launched [www.rhbabyandchild.com](http://www.rhbabyandchild.com), an e-commerce enabled website devoted to our children's furnishings category. In May 2011, we launched apps for smartphones and tablets that enable customers to browse our growing product assortment.

Our e-commerce platform provides simplicity and ease of use while allowing customers to experience the RH lifestyle reflected in our catalogs and throughout our stores. We update our websites on a regular basis to reflect product availability and special offers. In fiscal 2013, our websites logged approximately 22.2 million unique visits, an increase of 17% over fiscal 2012.

We display substantially all of our current product assortment on our websites. The websites also offer a 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. For example, 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.

### **Marketing and Advertising**

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 catalog circulation,



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promotional mailings, email communications, online and print advertisements and public relations activities and events. We maintain a database of approximately 15.0 million customers, which includes sales patterns, detailed purchasing information, demographic data, geographic locations and postal and email addresses. We use this information 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.

Our stores and our Source Books are the primary branding and advertising vehicles for the RH brands. The highly-differentiated design aesthetic and shopping environment of our stores drive customer traffic not only to our stores but also to our direct channels. 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 store openings and product launches. We also engage print advertising in brand-relevant publications such as *Architectural Digest*, *Elle Décor*, *Town and Country*, *Veranda*, *DuJour* and others, and from time to time have also engaged in online advertising. We believe that these efforts will drive increased brand awareness, leading to higher sales in our stores and our direct business over time.

### **Sourcing**

We do not own or operate any manufacturing facilities; instead, we contract with third-party vendors for the manufacture of our merchandise. Our sourcing strategy focuses on identifying and using vendors that can provide the 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. 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 by selectively inspecting inbound shipments at our distribution facilities. In fiscal 2013, we sourced approximately 75% of our purchase dollar volume from approximately 33 vendors. In fiscal 2013, one vendor accounted for approximately 12% of our purchase dollar volume. Based on total dollar volume of purchases for fiscal 2013, approximately 69% of our products were sourced in Asia, the majority of which originated from China, 26% from the United States and the remainder from other regions.

We have a limited number of long-term merchandise supply contracts but 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. Over the last several years, we engaged in a sourcing initiative to develop closer relationships with our vendors in order to achieve better efficiencies and further improve our product development process. Through this process, we have eliminated the use of most third party purchasing agents in favor of a model in which we directly manage our vendors. We have achieved significant cost savings and other efficiencies from this initiative.

### **Distribution and Delivery**

We manage the distribution and delivery of our products through nine facilities, each of which serves all of our sales channels:

- Our West Jefferson, Ohio facility is approximately 1,224,000 square feet. It serves as our distribution center for all of our small parcel direct-to-customer orders and retail store replenishment. It is also the site of one of our three customer service centers.
- Our North East, Maryland facility is approximately 1,195,000 square feet and is located near our Baltimore facility. It serves as our primary furniture distribution center for the Eastern regions of the United States and Canada.

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- Our Mira Loma, California facility is approximately 886,000 square feet. It serves as a furniture distribution center for the Western regions of the United States and Canada, as well as the furniture home delivery hub for the greater Los Angeles metropolitan area.
- Our Grand Prairie, Texas facility is approximately 859,000 square feet. It supports our furniture distribution for the Central and Southern regions within the United States and houses our newest customer service center. This facility also serves as the furniture delivery hub for the greater Dallas metropolitan area and central Texas region.
- Our Baltimore, Maryland facility is approximately 508,000 square feet. It serves as a secondary furniture distribution center for the Eastern regions of the United States and Canada, as well as a furniture home delivery hub for the greater Baltimore and Washington, D.C. metropolitan areas.
- Our Tracy, California facility is approximately 284,000 square feet. It serves as the furniture home delivery hub for the San Francisco Bay Area region and as a supplemental storage facility for our furniture distribution network. This location also houses our largest customer service center.
- Our Avenel, New Jersey facility is approximately 114,000 square feet. It serves as the furniture delivery hub for the greater New York/New Jersey metropolitan area.
- Our Pompano Beach, Florida facility is approximately 101,000 square feet. It services as the furniture delivery hub for the greater Miami metropolitan area and southern Florida region.
- Our Houston, Texas facility is approximately 71,000 square feet. It serves as the furniture delivery hub for the greater Houston metropolitan area and eastern Texas region.

We offer a white glove home delivery service for our larger merchandise and furniture categories, where our delivery personnel assist our customers by delivering fully assembled items to the location of their choice. We operate portions of our home delivery services in seven key markets to leverage operating costs and improve our customers' delivery experience, while reducing returns and damage to our products. We plan to continue this trend of in-sourcing these services in additional markets over time, including in 2014, while managing deliveries in other markets through third-party vendors.

Through expansions and upgrades to our warehousing, distribution and delivery operations over the last seven years, we have improved our supply chain and fulfillment capabilities, and have built a scalable infrastructure with significant capacity to support our future growth. We believe our enhanced supply chain and fulfillment operations allow us to manage customer orders and distribute merchandise to stores and 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.

We intend to continue to strengthen our supply chain operations through a number of key initiatives in 2014 designed to improve our fulfillment and delivery logistics performance and to achieve greater efficiencies in the management of our inventories.

### **Management and Information Technology**

We use industry-standard information technology systems to provide customer service, business process support, and business intelligence across our sales channels. Our technology team continues to systematically upgraded several of our core systems, including:

- Implementing new inventory management capabilities to improve inventory productivity and service levels across our supply chain;
- Implementing enhanced special order capabilities optimizing processes to support our increasingly expanding product assortment;

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- Enhancing our in-store and web commerce capabilities with state-of-the art technology to optimize performance and improve the customer shopping experience;
- Implementing supply chain technology and enhancements to support our expanding supply chain network improving operating efficiencies, accuracy, and service levels; and
- Implementing a new enterprise data warehouse platform upgrade enhancing performance to equip management with more timely analysis of the current business trends, results, and comparisons to our historical performance.

We believe these substantial upgrades to our information technology systems provide management with the ability to drive ongoing improvement in our operating model, focus on efficiency opportunities, and increase management control. New access to results through our technology tools also equips management to more timely identify, analyze and respond to business trends.

Over the next several years, we intend to further enhance our IT capabilities to support our growth. Key initiatives include:

- Further enhancing our delivery, order orchestration, inventory optimization solutions and order management to maximize operating efficiencies focused on enhancing the end-to-end customer experience;
- Implementing enhanced in-store, web, and care center customer service and commerce technology to provide enhanced customer insight and capabilities to support our luxury customer experience; and
- Continuing our expansion and redefinition of business intelligence capabilities to optimize information for timely decision making.

We are committed to a high level of integration in technology across our business. We believe our approach to technology demonstrates an appropriate balance of strategic planning and innovation to support both today's business and tomorrow's growth.

## **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 we compete primarily on the basis of design, quality, value and customer service. We believe our distinct combination of design, quality and value allows us to compete effectively and we believe we differentiate ourselves from competitors based on the strength of our brand, products and our fully integrated multi-channel business model. We compete with the interior design trade and specialty merchants by providing a broader product assortment at an exceptional value based both upon the price and quality of our products. We compete against certain other home furnishings retailers primarily by offering what we believe is 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 of our 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.

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### **Employees**

As of February 1, 2014, we had approximately 3,600 employees, of which approximately 1,000 were part-time employees. As of that date, approximately 1,900 of our employees were based in our stores. None of our employees is 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” and “Baby & Child” 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 “restorationhardware.com,” “rh.com,” “rhhbabyandchild.com,” and others that include our trademarks. These domain names are perpetually renewable. We own design patents or pending applications to protect the ornamental appearance of several of our products. These design patents are valid for 14 years from the date of issuance. We own copyrights, including copyright registrations or pending applications, for several of our catalogs. We believe that our trademarks, design patents, and copyrights have significant value and we will vigorously protect them against infringement.

### **Fluctuation in Quarterly Results**

Our quarterly results have historically varied depending upon a variety of factors, including our product offerings, promotional events, store openings, shifts in the timing of holidays and timing of catalog releases, 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.

### **Regulation and Legislation**

We are subject to labor and employment laws, laws governing truth-in-advertising, privacy laws, safety regulations and other laws, including consumer protection regulations that regulate retailers and govern the promotion and sale of merchandise and the operation of stores and warehouse facilities. We monitor changes in these laws and believe that we are in material compliance with applicable laws.

### **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, with the SEC. You may read and copy the reports and other information we file with the SEC at the SEC’s Public Reference Room at 100 F Street, N.E., Room 1580, Washington, D.C. 20549. You may also obtain copies of this information by mail from the public reference section of the SEC, 100 F Street, N.E., Washington, D.C. 20549, at prescribed rates. You may obtain information regarding the operation of the public reference room by calling 1-800-SEC-0330. The SEC also 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](http://www.restorationhardware.com) and [www.rh.com](http://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

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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 Restoration Hardware, Inc., 15 Koch Road, Suite J, Corte Madera, CA 94925, Attention: Investor Relations; telephone: 415-945-3500; e-mail: [investorrelations@rh.com](mailto: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. 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. 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.*

#### **Risks Related to Our Business**

##### ***Growth in our business may not be sustained and may not generate a corresponding improvement in our results of operations.***

We may not be able to maintain or improve the levels of growth that we have experienced in the recent past. In addition, although we have recently experienced strong comparable brand revenue growth and comparable store sales, if our future comparable brand revenue growth and comparable store sales fail to meet market expectations or decline, the price of our common stock could decline. Various factors affect these measures, including the number, size and location of stores we open, close, remodel or expand in any period, the overall economic and general retail sales environment, consumer preferences and demand, our ability to efficiently source and distribute products, changes in our product offerings, competition, current local and global economic conditions, changes in catalog circulation and the success of marketing programs. These factors may cause our comparable brand revenue growth and comparable store sales results to be materially lower than recent periods and our expectations, which could harm our results of operations and result in a decline in the price of our common stock.

Although we have recently experienced sales growth as a result of a number of new business initiatives, this sales growth may not continue and the level of our sales could decrease if customer response to our product offerings is not sustained. Many factors can influence customer response to our product offerings and store formats including responses from our competitors, who may introduce similar products or merchandise formats. In addition, sales levels for particular merchandise or product categories may not continue over time if customer demand levels are not sustained. The level of customer response to our Full Line Design Galleries may vary in different markets and store locations. Similarly, the level of customer response to our Source Book catalog format, in which we display a greater percentage of our product assortment, may vary in different markets. In addition, there can be no assurance that we will be able to migrate customer demand successfully when we choose to close a store in a particular location in favor of a Full Line Design Gallery in the same or an adjacent market location. While our objective is to retain a high percentage of customer demand from store locations that we close, there can be no assurance that we will retain a high percentage of sales from stores closed in the future or that we will continue to retain a high percentage of sales from stores previously closed.

In addition, these developments in our business could result in material changes in our operating costs, including increased merchandise inventory costs and costs for paper and postage associated with the mailing and

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shipping of catalogs and products. We cannot assure you that we will succeed in offsetting these expenses with increased efficiency or that cost increases associated with our business will not have an adverse effect on our financial results.

***If we fail to successfully anticipate consumer preferences and demand, or to manage our inventory commensurate with demand, our results of operations may be adversely affected.***

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. If this occurs, our sales may decline significantly, and we may be required to mark down certain products to sell the resulting excess inventory or to sell such inventory through our outlet stores, either of which could have a material adverse effect on our financial condition and results of operations.

In addition, we must manage our merchandise in stock and inventory levels to track consumer demand. Much of our merchandise requires that we provide vendors with significant ordering lead time, frequently before market factors are known. In addition, 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 not able to anticipate consumer demand for our different product offerings, or successfully manage inventory levels for products that are in demand, we may experience:

- back orders, order cancellations and lost sales for products that are in high demand for which we did not stock adequate inventory; and
- overstock inventory levels for products that have lower consumer demand, requiring us to take markdowns or other steps to sell slower-moving merchandise.

As a result of these and other factors, we are vulnerable to demand and pricing shifts and to misjudgments in the selection and timing of merchandise purchases.

***Changes in consumer spending or the housing market may significantly harm our revenue and results of operations.***

Our business depends on consumer demand for our products and, consequently, is sensitive to a number of factors that influence consumer spending in the retail home furnishings sector, 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 refinancings and home equity lines of credit. We believe that a number of these factors have had, and may continue to have, an adverse impact on the retail home furnishings sector, and have also affected our business and results, and these factors may make it difficult for us to accurately predict our operating and financial results for future periods. We believe that the housing market has been experiencing a recovery after a prolonged downtrend, and rising levels of home purchases and remodelings, in turn, have increased consumer spending on home furnishings. However, the overall economic outlook remains uncertain and there can be no assurance that any economic or housing recovery will be sustained or that our business will continue to perform well even in a stronger housing market.

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***We are undertaking a large number of business initiatives at the same time and if these new initiatives are not successful, they may have a negative impact on our operating results.***

We are experiencing rapid growth and undertaking a large number of new business initiatives. For example, we have developed and continue to refine and enhance our Full Line Design Gallery format which involves larger store square footage. We plan to continue to open Full Line Design Galleries in select major metropolitan markets and we expect to close a number of our older stores and replace them with the Full Line Design Gallery format. We also continue to add new product categories and to expand product assortments. For example, we introduced our new Tableware category in Spring 2013. We are currently contemplating other new product lines and extensions and complementary brand-enhancing businesses, as well as expanding sales to international markets. In addition, we are continuing a number of new initiatives in other areas of our business, including product sourcing and distribution and management information systems. For example, we have reduced the use of third-party buying agents in most foreign locations. Further, our Source Book strategy continues to evolve. We may incur costs for these new initiatives before we realize any corresponding revenue.

The number of current business initiatives could strain our financial, operational and management resources. In addition, these initiatives may not be successful. If we are not successful in managing our current growth and the large number of new initiatives that are underway, we might experience an adverse impact on our financial performance and results of operations. All of the foregoing risks may be compounded in 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, we may experience inadequate return on investment for some of our business initiatives, which would have a negative effect on our operating results.

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

We do not own or operate any manufacturing facilities. We instead purchase all of our merchandise from a large number of vendors, many of which are the sole sources for particular products. Our growth strategy includes expanding the amount of products we sell, 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 may have limited production capacity. In addition, some of our vendors are small and undercapitalized firms. A number of our vendors, particularly our artisan vendors, may have limited resources, production capacities and operating histories. As a result, the capacity of some of our vendors to meet our supply requirements has been, and may in the future be, constrained at various times and 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. In fiscal 2013, we purchased approximately 74% of our merchandise from vendors that are located abroad. Our ability to obtain desired merchandise in sufficient quantities could be impaired by events that adversely affect our vendors or the locations in which they operate, such as difficulties or problems associated with our vendors' operations, business, finances, labor, economic environment, importation of products, costs, production, insurance and reputation. Failure of vendors to produce adequate quantities of merchandise in a timely manner has resulted in back orders and lower revenue in certain periods of our business operation. While we believe our vendors have the capacity to meet our demand, we cannot assure you that our vendors will be able to produce adequate quantities of merchandise in a timely manner in the future.

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We also do not have long-term contracts or other contractual assurances of continued supply, pricing or access to new products with our vendors, and generally we transact business with our vendors on an order-by-order basis. Therefore, any vendor could discontinue selling to us at any time. Any disruptions we experience in our ability to obtain our products in a timely fashion or in the quantities required could have a material adverse effect on our business.

***We may not be able to locate and develop relationships with a sufficient number of new vendors, which could lead to product shortages and customer backorders, which could harm our business.***

In the event that one or more of our vendors is unable 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. Even if we do identify such new vendors, we may experience product shortages and customer backorders as we transition our product requirements to incorporate the alternative suppliers. In addition, we cannot assure you that any new vendor with which we do business, particularly any new vendor abroad, would not be subject to the same or similar quality and quantity risks as our existing suppliers.

***We do not have exclusive relationships with most of our vendors, and there is a risk that our vendors may sell similar or identical products to our competitors, which could harm our business.***

Our arrangements with our vendors are generally not exclusive. As a result, most of our vendors might be able to sell similar or identical products to certain of our competitors, some of which purchase products in significantly greater volume. 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 access to such arrangements or products. Our vendors could also initiate or expand sales of their products through their own stores or through the Internet to the retail market and therefore compete with us directly or sell their products through outlet centers or discount stores, increasing the competitive pricing pressure we face.

***We may not have adequate remedies with our vendors for defective merchandise, which could damage our reputation and brand image and harm our business.***

If products that we purchase from vendors are damaged or prove to be defective, we may not be able to return products to these vendors and obtain refunds of our purchase price or obtain other indemnification from them. Our vendors' limited capacities may result in a vendor's inability to replace any defective merchandise in a timely manner. In addition, our vendors' limited capitalization or liquidity may mean that a vendor that has supplied defective merchandise will not be able to refund the purchase price to us or pay us any penalties or damages associated with any defects.

In addition, our vendors may not adhere to our quality control standards, and we might not identify a quality deficiency before merchandise ships to our stores or customers. Our vendors' failure to manufacture or import quality merchandise in a timely and effective manner 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 other government requirements could become subject to a recall, which could damage our reputation and brand image and harm our business.

***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 the continued service of our key personnel, including our Chairman and Chief Executive Officer, Gary Friedman. The loss of the services of our key personnel could make it more difficult to successfully operate our business and achieve our business goals. 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.



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Mr. Friedman's equity ownership in our Company has given him a substantial amount of personal wealth. As a result, it may be difficult for us to continue to retain and motivate him, and this wealth could affect his decisions about whether or not he will continue to perform services for us. If we do not succeed in retaining and motivating Mr. Friedman, we may be unable to achieve our historical growth rates.

Competition for qualified employees and personnel in the retail industry is intense. We may be unable to retain other existing personnel that are important to our business or hire additional qualified personnel. The process of locating 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. We cannot assure you that we will be successful in attracting and retaining qualified executives and personnel.

In addition, our success depends in part upon our ability to attract, motivate and retain a sufficient number of store employees who understand and appreciate our corporate culture and customers. Turnover in the retail industry is generally high. Excessive store 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 personnel capable of consistently providing a high level of customer service, our ability to open new stores may be impaired, the performance of our existing and new stores could be materially adversely affected and our brand image may be negatively impacted.

### ***Our former Co-Chief Executive Officer recently resigned from this position, which may divert management's attention and harm our operations.***

Our Co-Chief Executive Officer, Carlos Alberini, resigned from this position effective January 31, 2014. Mr. Alberini continues to serve as a member of our Board of Directors. Mr. Alberini has been a key contributor to the Company's recent success. While we have implemented a transition plan and are in the process of determining our future leadership structure in light of the departure of Mr. Alberini, the Company faces a variety of risks and uncertainties due to his resignation. Our business may experience adverse consequences as a result of his resignation and the resulting changes we make to our management organizational structure. If we determine a need to fill in the position of Co-Chief Executive Officer and to identify a suitable candidate, the process of implementing such leadership changes may be long, costly and may divert the board of directors' and management's attention from other business concerns. There can be no assurances that we will not experience other disruptions in our management structure arising from transitions in our leadership, or changes in our management structure, including as a result of the resignation of Mr. Alberini or the retention, in the future, of new executives to assist Mr. Friedman in his role as Chairman and Chief Executive Officer.

### ***Mr. Alberini currently beneficially owns a substantial number of shares of the Company's common stock, and any sales by Mr. Alberini of these shares could adversely impact our stock price.***

Mr. Alberini currently beneficially owns a total of 2,014,748 shares of common stock, which includes stock options to purchase 992,275 shares of the Company's common stock with an exercise price of \$46.50 per share that are vested and not subject to repurchase by the Company. Mr. Alberini has not yet exercised these options but can exercise them at any time during a 120-day post-termination exercise period on a cashless "net exercise" basis or through payment of the exercise price in cash or by such other means as permitted under the applicable option plan. If Mr. Alberini had fully exercised these options on a net exercise basis on March 10, 2014, the Company would have issued approximately 283,000 shares to him in full settlement of these options based on the closing stock price that day. If Mr. Alberini decides to sell all or some of his shares (including any shares received upon the exercise of his stock options), such transactions could adversely impact the market price of our common stock.

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**Gary Friedman was recently re-appointed as our Chairman and Chief Executive Officer. There can be no assurance that this transition will not have an adverse impact on us.**

Effective July 2, 2013, Gary Friedman was appointed to serve as our Co-Chief Executive Officer along with Carlos Alberini, and Mr. Friedman is now serving as our Chief Executive Officer. Mr. Friedman also serves as Chairman of our Board of Directors. Mr. Friedman previously served as Chairman and as Co-Chief Executive Officer with Mr. Alberini from June 2010 through October 2012. Prior to June 2010, Mr. Friedman was our Chief Executive Officer and Chairman. In October 2012, Mr. Friedman resigned as Co-Chief Executive Officer and as a director and agreed to serve in an advisory capacity as our Creator and Curator following an investigation by a special committee of non-management directors of the board assisted by independent counsel prompted by disclosure that Mr. Friedman and a Company employee were engaged in a personal relationship, described by the parties as consensual. The investigation concluded that Mr. Friedman engaged in activities that were inconsistent with the board of directors' expectations for executive conduct as previously communicated by the board of directors and failed to comply with certain Company policies. We incurred \$4.8 million of expenses related to the investigation in fiscal 2012. There can be no assurance that we will not incur expenses or claims in the future related to the conduct that was the subject of the investigation or similar conduct that has occurred in the past or, given Mr. Friedman's continued involvement with the Company, may occur in the future.

**Our operations have significant liquidity and capital requirements and depend on the availability of adequate financing on reasonable terms, and if we are unable to borrow sufficient capital, it could have a significant negative effect on our business.**

Our operations have significant liquidity and capital requirements. Among other things, we have invested significant capital expenditures in remodeling and opening new Galleries and these capital expenditures have increased and will continue to increase in fiscal 2014 and succeeding fiscal periods as we open additional Full Line Design Galleries, which may require us to undertake upgrades to historical buildings or construction of new buildings. During fiscal 2013, we spent \$93.9 million for capital expenditures. We anticipate our capital expenditure requirements to be approximately \$115 million to \$125 million for fiscal 2014. We plan to continue our growth and expansion, including opening Full Line Design Galleries in select major metropolitan markets, pursuing category extensions of our brand, and exploring new business areas. We own the building and land for our Gallery in San Francisco, but to date we have principally relied upon leases with landlords for our other locations. As we develop new Galleries in the future, we may explore other models for our real estate which could include joint ventures or other forms of equity ownership in the real estate interests associated with new sites and buildings. These approaches might require greater capital investment than a traditional store lease with a landlord.

We depend on our ability to generate cash flows from operating activities, as well as revolving borrowings under the Restoration Hardware, Inc. revolving line of credit, to finance the carrying costs of our inventory, to pay for capital expenditures and operating expenses and to support our growth strategy. As of February 1, 2014, we had borrowed \$85.4 million under the revolving line of credit and had \$261.7 million available for borrowing. Various factors may impact our lenders' willingness to provide funds to us, including:

- our continuing compliance with the terms of our revolving line of credit;
- the amount of availability under the revolving line of credit, which depends on various factors, including the amount of collateral available under the revolving line of credit, which relies on a borrowing base formula tied principally to the value of our assets, including our inventory; and
- our lenders' financial strength and ability to perform under the revolving line of credit.

If the cash flows from our operating activities are not sufficient to finance the carrying costs of inventory and to pay for capital expenditures and operating costs, and if we are unable to borrow a sufficient amount under the revolving line of credit to finance or pay for such expenditures and costs, it could have a significant negative effect on our business.

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We currently believe that our cash flow from operations and funds available under the revolving line of credit will satisfy our capital and operating requirements for the next twelve months. However, any weakening of, or other adverse developments concerning our sales performance or adverse developments concerning the availability of credit under the revolving line of credit, could limit the overall amount of funds available to us.

In addition, we may 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. However, we cannot assure you that we will be able to raise 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.

***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 of sizing stores to the potential of the market, 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 Full Line Design Galleries in key markets and relocating or closing selected stores in these or adjacent 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.

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 certain geographic markets when we close stores in that market;
- negotiate acceptable new lease terms or lease renewals, modifications or terminations;
- efficiently build and equip new stores or further remodel existing locations;
- source sufficient levels of inventory to meet the needs of changes in our store footprint on a timely basis;
- 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 and cost overruns in connection with the opening of new stores or the expansion or further 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.

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We have experienced delays in opening some new stores within the time frames we initially targeted, and may continue to experience such delays in the future. Any of these 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 leasing and other costs during the delay without associated store revenue at such location. New or remodeled stores may not be profitable or achieve our target return on investment. Unfavorable economic and business conditions and other events could also interfere with our plans to expand or modify store footprints. 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.

***Our operating results are subject to quarterly fluctuations, and results for any quarter may not necessarily be indicative of the results that may be achieved for the full fiscal year.***

Our quarterly results have historically varied depending upon a variety of factors, including our product offerings, promotional events, store openings, shifts in the timing of holidays and timing of catalog releases, 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.

Our results of operation 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. For example, we periodically engage in sales promotional activities that may disproportionately impact results in a particular quarter and we believe that period to period comparisons of our operating results are not necessarily meaningful and cannot be relied upon as indicators of future performance.

***Our business depends in part on a strong brand image. We continue to invest in the development of our brand and the marketing of our business, and if we are not able 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.***

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 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, catalog 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. Furthermore, our reputation could be jeopardized if we fail to maintain high standards for merchandise and service quality, 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.

***We are exploring opportunities to expand into new categories or complementary businesses. If we are not successful in these new categories or business areas, it may have an adverse effect on our results of operations and our reputation.***

We are engaged in ongoing efforts to explore new business opportunities that we believe can leverage our current business platform. We have developed a number of new product categories and extensions over the last several years, including Contemporary Art, Outdoor & Garden, Baby & Child and Small Spaces. We also have introduced other merchandise categories that enhance the customer experience in our Full Line Design Galleries, including fresh cut flowers, magazines and tea and a wine bar. We plan further brand-enhancing offerings, such

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as a café or restaurant adjacent to, or inside of, select Full Line Design Galleries. We are incubating a number of other new ideas for potential expansion of our business, some of which may become new core categories or new store concepts and others of which may be primarily offered as enrichment of the customer experience.

Developing and testing new business opportunities will involve us in business operations and areas of expertise that would be new to our organization and may require management time and resources. We may not achieve wide market acceptance or generate revenue sufficient to recoup the cost of developing and operating such new concepts, which in turn could have a material adverse effect on our results of operations. Any new businesses we enter may 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 results of operations and financial condition. 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.

### ***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 with these and other retailers for customers, suitable retail locations, vendors, qualified employees and management personnel. Many of our competitors have significantly greater financial, marketing and other resources than we do and therefore may be able to adapt to changes in customer preferences more quickly, 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. In addition, increased catalog mailings by our competitors may adversely affect response rates to our own catalog mailings. Moreover, increased competition may result, and has resulted in the past, in potential or actual litigation between us and our competitors relating to such activities as competitive sales, hiring practices and other matters. As a result, increased competition may adversely affect our future financial performance, and we cannot assure you that we will be able to compete successfully in the future.

We believe that our ability to compete successfully is determined by several factors, including, among other things, the quality of our product selection, our brand, our merchandise presentation and value proposition, customer service, pricing and store locations. We may not ultimately succeed in competing with other retailers in our market.

### ***Disruptions in the global financial markets may make it difficult for us to borrow a sufficient amount of capital to finance the carrying costs of inventory and to pay for capital expenditures and operating costs, which could negatively affect our business.***

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. Under the credit agreement governing the Restoration Hardware, Inc. revolving line of credit, each financial institution that is part of the syndicate for the revolving line of credit is responsible for providing a portion of the loans to be made under the revolving line of credit. Factors that have previously affected our borrowing ability under the revolving line of credit have included the borrowing base formula limitations, adjustments in the appraised value of our inventory used to calculate the borrowing base and the availability of each of our lenders to advance its portion of requested borrowing drawdowns under the facility. If, in connection with a disruption in the global financial markets or otherwise, any participant, or group of participants, with a significant portion of the commitments in the revolving line of credit fails to satisfy its obligations to extend credit under the facility, and if we are unable to find a replacement for such participant or group of participants on a timely basis (if at all), then our liquidity and our business may be materially adversely affected.

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***Reductions in the volume of mall traffic or closing of shopping malls as a result of unfavorable economic conditions or changing demographic patterns could significantly reduce our sales and leave us with unsold inventory.***

Most of our stores are currently located in shopping malls. Sales at these stores are derived, in part, from the volume of traffic in those malls. These stores benefit from the ability of the malls' "anchor" tenants, generally large department stores and other area attractions, to generate consumer traffic in the vicinity of our stores and the continuing popularity of the malls as shopping destinations. Unfavorable economic conditions, particularly in certain regions, have adversely affected mall traffic and resulted in the closing of certain anchor stores and have threatened the viability of certain commercial real estate firms which operate major shopping malls. A continuation of this trend, including failure of a large commercial landlord or continued declines in the popularity of mall shopping generally among our customers, could reduce our sales and leave us with excess inventory. We may respond by increasing markdowns or initiating marketing promotions to reduce excess inventory, which would further adversely impact our results of operations.

***Our business depends upon the successful operation of our distribution facilities, furniture home delivery hubs and customer service center, as well as our ability to fulfill orders and to deliver our merchandise to our customers in a timely manner.***

Our business depends upon the successful operation of our distribution centers, furniture home delivery hubs and customer service center, as well as our order management and fulfillment services and the re-stocking of 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.

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 fire, earthquakes (to which our California-based distribution and home delivery facilities in Tracy and Mira Loma and our corporate headquarters in Corte Madera are particularly vulnerable), power outages or other natural disasters, we could face shortages of inventory resulting in "out of stock" conditions in our stores, 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 center 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.

In January 2012, we opened a furniture home delivery hub in Avenel, New Jersey and, in February 2012, we opened a furniture distribution center in North East, Maryland. Further, we expanded into an additional 400,000 square feet at our West Jefferson, Ohio distribution center in May 2013, opened a furniture distribution center in Grand Prairie, Texas in September 2013 and in-sourced three home furniture delivery facilities in 2013. As a result of these and other efforts with respect to our distribution facilities, we may encounter operational difficulties with respect to our facilities, such as disruptions in transitioning fulfillment orders to the new distribution facilities and problems associated with operating new facilities or reducing the size and changing functions of existing facilities, and any such difficulties could have a material adverse effect on our business, financial condition and results of operations.

***Our results may be adversely affected by fluctuations in raw materials and energy costs.***

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. These prices may fluctuate based on a number of factors beyond our control, including: commodity prices including prices for oil, lumber and cotton, changes in supply and demand, general economic conditions, labor costs, competition, import duties, tariffs, anti-dumping duties, currency exchange rates and government regulation. In addition, energy costs have fluctuated dramatically in the

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past. These fluctuations may result in an increase in our transportation costs for freight and distribution, utility costs for our retail stores and overall costs to purchase products from our vendors. Accordingly, changes in the value of the U.S. dollar relative to foreign currencies 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 would be harmed. Any such cost increase could reduce our earnings to the extent we are unable to adjust the prices of our products.

### ***We are subject to risks associated with our dependence on foreign imports for our merchandise.***

Based on total volume dollar purchases, in fiscal 2013 we purchased approximately 74% of our merchandise from vendors located outside the United States, including 69% from Asia, the majority of which originated from China. 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 trade and cost factors that impact the specific countries where our vendors are located, including Asia. Our future success will depend in large part upon our ability to maintain our existing foreign vendor relationships and to develop new ones. While we rely on our long-term relationships with our foreign vendors, we have no long-term contracts with them and transact business on an order by order basis. Additionally, many of our imported products are subject to existing duties, tariffs, anti-dumping duties and quotas that may limit the quantity of some types of goods which we may import into the United States. 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, charges on or assessment of additional import duties, tariffs, anti-dumping duties and quotas, loss of "most favored nation" trading status by the United States in relation to a particular foreign country, 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, economic uncertainties, including inflation, foreign government regulations, trade restrictions, including the United States retaliating against protectionist foreign trade practices and political unrest, increased labor costs and other similar factors that might affect the operations of our vendors in specific countries such as China.

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.

In addition, there is a risk that compliance lapses by our vendors could occur which could lead to investigations by U.S. government agencies responsible for international trade compliance. Resulting penalties or enforcement actions could delay future imports/exports or otherwise negatively impact our business. In addition, there remains a risk that one or more of our foreign vendors will not adhere to applicable legal requirements or our global compliance standards such as fair labor standards, the prohibition on child labor and other product safety or manufacturing safety standards. The violation of applicable legal requirements by any of our vendors or the failure to adhere to labor, manufacturing safety and other laws by any of our vendors, or the divergence of the labor practices followed by any of our vendors from those generally accepted in the United States, could disrupt our supply of products from our vendors or the shipment of products to us, result in potential liability to us and harm our reputation and brand and subject us to boycotts by our customers or activist groups, any of which could negatively affect our business and operating results.

### ***We extend unsecured credit to our vendors.***

Some of our vendors have limited cash flows and/or access to capital and require us to advance payments in order for them to be able to meet our supply requirements. We typically advance a portion of the payments to be made to such vendors under our purchase orders prior to the delivery of the ordered products. These advance payments are unsecured. These vendors may become insolvent and their failure to repay our advances, and any related failure to deliver products to us, could have a material adverse impact on our results of operations.

***We rely upon independent third-party transportation providers for the majority of our product shipments.***

We currently rely upon independent third-party transportation providers for our product shipments to our stores and to our customers outside of certain areas. Our utilization of their delivery services for shipments, or those of any other shipping companies we may elect to use, is subject to risks, including increases in fuel prices, which would increase our shipping costs, and strikes, work stoppages and inclement weather, which may impact the shipping companies' abilities to provide delivery services that adequately meet our shipping needs. 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.

***We may be exposed to risks and costs associated with protecting the integrity and security of our customers' information.***

A significant number of customer purchases across all of our channels are made using credit cards. Additionally, a significant number of our customer orders are placed through our websites, and we process, store, and transmit large amounts of data, including personal information, for our customers. Also, we depend in part throughout our operations on the secure transmission of confidential information over public networks. Our information systems are subject to damage or interruption from power outages, computer and telecommunications failures, computer viruses, security breaches including credit card breaches, vandalism, catastrophic events, and human error. Our operations may further be impacted by security breaches that occur at third party vendors.

In order for our business to function successfully, we and other market participants must be able to handle and transmit confidential information, including credit card information, securely. We are not fully compliant with Payment Card Industry, or PCI, Data Security Standards and there can be no assurance that in the future we will be able to operate our facilities and our customer service and sales operations in accordance with PCI or other industry recommended practices. We intend to obtain compliance with PCI Data Security Standards and will incur additional expenses to attain and maintain PCI compliance. Further, there is increased litigation over personally identifiable information and we may be subject to one or more claims or lawsuits related to intentional or unintentional exposure of our customer's personally identifiable information. Even if we are compliant with such standards, we still may not be able to prevent security breaches involving customer transaction data.

Any breach could cause consumers to lose confidence in the security of our website and choose not to purchase from us. If a computer hacker or other criminal is able to circumvent our security measures, he or she could destroy or steal valuable information or disrupt our operations. Because techniques used to obtain unauthorized access or to sabotage systems change frequently and often are not recognized until launched against a target, we may be unable to anticipate these techniques or to implement adequate preventative measures. 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. 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.

In addition, 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. We collect and store personal information from consumers in the course of doing business. 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 amounts 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



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of our inability to comply fully with any such law, our business, operating results 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. If any of the current proposals are adopted, we may be subject to more extensive requirements to protect the customer information that we process in connection with the purchases of our products.

***Material damage to, or interruptions in, our information systems as a result of external factors, staffing shortages and 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.***

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 in connection with rebuilding our supply chain and infrastructure. Such systems are subject to damage or interruption from power outages, computer and telecommunications failures, computer viruses, security breaches and natural disasters. Damage or interruption to our information systems may require a significant investment to fix or replace them, and we may suffer interruptions in our operations in the interim. Management information system failures or telecommunications system problems may disrupt operations. In addition, costs and potential problems and interruptions associated with the implementation of new or upgraded systems and technology or with maintenance or adequate support of existing systems could also disrupt or reduce the efficiency of our operations. Any material interruptions or failures in our systems may have a material adverse effect on our business or results of operations.

We also rely heavily on our information technology staff. If we cannot meet our staffing needs in this area, we may not be able to fulfill our technology initiatives while continuing to provide maintenance on existing systems.

We rely on certain software vendors to maintain and periodically upgrade many of these systems so that they can continue to support our business. The software programs supporting many of our systems were licensed to us by independent software developers. The inability of these developers or us to continue to maintain and upgrade these information systems and software programs would disrupt or reduce the efficiency of our operations if we were unable to convert to alternate systems in an efficient and timely manner.

We are vulnerable to various risks and uncertainties associated with our websites, including changes in required technology interfaces, website downtime and other technical failures, costs and technical issues as we upgrade our website software, computer viruses, changes in applicable federal and state regulation, security breaches, legal claims related to our website operations and e-commerce fulfillment and other consumer privacy concerns. 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.

***Our failure to successfully manage the costs of our catalog and promotional mailings could have a negative impact on our business.***

Catalog mailings are an important component of our business. Increases in costs relating to paper, printing, shipping rates and other catalog distribution costs would affect the cost of our catalog mailings. In 2013, we continued expanding the page counts of our catalogs. In 2013, we also reduced the frequency of Source Books circulated to one mailing per year. We 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. The market price for paper has fluctuated significantly during the past three fiscal years and may continue to fluctuate in the future.

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Future increases in shipping rates, paper costs or printing costs would have a negative impact on our operating results to the extent that we are unable to offset such increases 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 catalogs. Customer response to our catalogs depends substantially on product assortment, product availability and creative presentation, the selection of customers to whom the catalogs are mailed, changes in mailing strategies, the page size, page count, frequency and timing of delivery of the 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 been and 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 sales, or if our catalog circulation optimization strategy is not successful, our results of operations could be negatively impacted.

### ***Our failure to successfully anticipate merchandise returns might have a negative impact on our business.***

We record a reserve for merchandise returns based on historical return trends together with current product sales performance in each reporting period. If actual returns are greater than those projected and reserved for by management, additional sales returns might be recorded in future periods. In addition, to the extent that returned merchandise is damaged, we often do not receive full retail value from the resale or liquidation of the merchandise. Further, the introduction of new merchandise, changes in merchandise mix, changes in consumer confidence or other competitive and general economic conditions may cause actual returns to exceed merchandise return reserves. Adverse economic conditions in the past have resulted in an increase in our merchandise returns. Any significant increase in merchandise returns that exceeds our reserves could harm our business and operating results.

### ***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.***

Certain of the products we sell are subject to regulation by the federal Consumer Product Safety Commission and similar state and international regulatory authorities, which require certification and testing of certain regulated substances, among other requirements. For example, in August 2008, the Consumer Product Safety Improvement Act of 2008, or CPSIA, was signed into law. In general, the CPSIA bans the sale of children's products containing lead in excess of certain maximum standards, and imposes other restrictions and requirements on the sale of children's products, including importing, testing and labeling requirements. Our products have, from time to time, been subject to recall for product safety reasons, and issues of product safety could result in future product recalls, other actions by applicable government authorities or product liability claims. Product safety concerns may also require us, whether on a voluntary or involuntary basis, to remove selected products from our stores, particularly with respect to our Baby & Child brand. Product recalls and removal of products and defending such 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.

### ***There are claims made against us and/or our management from time to time that can result in litigation or regulatory 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 litigation, claims and other proceedings relating to the conduct of our business, including purported class action litigation. Such legal proceedings may include claims related to our employment practices, claims of intellectual property infringement, including with respect to trademarks and trade dress, claims asserting unfair competition and unfair business practices, claims

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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 United States 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 or our management could result in unexpected expenses and liability and could also materially adversely affect our operations and our reputation.

### ***Labor activities could cause labor relations difficulties for us.***

Currently none of our employees is 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 previously at our Baltimore distribution center. We cannot predict the negative effects that any future organizational 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.

### ***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 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, 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 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 also cannot assure you that the steps taken by us to protect our intellectual property rights will be adequate to prevent infringement of such rights by others, including imitation of our products and misappropriation of our brand. 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.

### ***We are subject to risks associated with occupying substantial amounts of space, including future increases in occupancy costs. We may choose in the future to acquire some of our store locations, which will subject us to additional risks.***

We lease all but one of our retail store locations and we also lease our outlet stores, our corporate headquarters and our nine distribution and home delivery facilities. The initial lease term of our retail stores generally ranges from ten to fifteen years, and certain leases contain renewal options for up to fifteen years. Most leases for our retail stores provide for a minimum rent, typically including escalating rent increases, plus a percentage rent based upon sales after certain minimum thresholds are achieved, as well as common area

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maintenance charges, real property insurance and real estate taxes. We purchased the building and land for our store in San Francisco, but to date we have principally relied upon leases with landlords for our other locations. As we develop new stores in the future, we may explore other models for our real estate which could include joint ventures or other forms of equity ownership in the real estate interests associated with new sites and buildings. These approaches might require additional capital investment and could present different risks than a traditional store lease with a landlord, including greater financial exposure if a new store location is not as successful as we originally target in our plans.

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.

### ***Compliance with laws 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, privacy, safety, environmental and zoning and occupancy laws and other laws, including consumer protection regulations that regulate retailers generally or govern our business. If these regulations 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, 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. In addition, newly enacted United States health care laws and 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.

### ***Because of our international operations, we could be adversely affected by violations of applicable U.S. federal and state or foreign laws and regulations, such as the United States Foreign Corrupt Practices Act and similar worldwide anti-bribery, anti-corruption and anti-kickback laws.***

We source substantially all of our products abroad, and we are increasing the level of our international sourcing activities in an effort to obtain more of our products directly from vendors located abroad. 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

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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.

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

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 disasters or other similar events, including floods, hurricanes, earthquakes, widespread illness or fires. In particular, our corporate headquarters is located in Northern California, and other parts of our operations including distribution facilities are located in Northern and Southern California, each of which is in a seismically active region susceptible to earthquakes that could disrupt our operations and affect our operating results. 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 in the United States or threats of terrorist attacks in the United States in the future, 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 operating results, revenue and costs.

***We have experienced net losses in the past and we may experience net losses in the future.***

We experienced a net loss of \$7.1 million in fiscal 2010. We achieved profitability in fiscal 2011 with net income of \$20.6 million. We experienced a GAAP net loss of \$12.8 million in fiscal 2012 as a result of certain non-recurring and other items. We may experience net losses in the future, and we cannot assure you that we will return to profitability in future periods.

***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 operating results.***

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. Under United States federal and state income tax laws, if over a rolling three-year period, the cumulative change in our ownership exceeds 50%, our ability to utilize our net operating loss carryforwards to offset future taxable income may be limited. Changes in ownership can occur due to transactions in our stock or the issuance of additional shares of our common stock or, in certain circumstances, securities convertible into our common stock. Certain transactions we have completed, including our going private transaction in June 2008, and the sale of shares contemplated in our initial public offering may impact the timing of the utilization of our net operating loss carryforwards. Furthermore, it is possible that transactions in our stock that may not be within our control may cause us to exceed the 50% cumulative change threshold and may impose a limitation on the utilization of our net operating loss carryforwards in the future. Any such limitation on the timing of utilizing our net operating loss carryforwards would increase the use of cash to settle our tax obligations. 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. Further, tax legislation may be enacted in the future that could negatively impact our current or future tax structure and effective tax rates.

***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. 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, in May 2013, the Financial Accounting Standards Board (“FASB”) issued an exposure draft outlining proposed changes to current lease accounting in FASB Accounting Standards Codification (“ASC”) 840 – *Leases*. The proposed new accounting pronouncement, if ultimately adopted in its proposed form, could result in significant changes to current accounting, including the capitalization of leases on the balance sheet that currently are recorded off balance sheet as operating leases. While this change would not impact the cash flow related to our store leases, it could adversely impact our balance sheet and could therefore impact our ability to raise financing from banks or other sources.

***Our total assets include intangible assets with an indefinite life, goodwill and trademarks, and substantial amounts of long lived assets, principally property and equipment. Changes to estimates or projections used to assess the fair value of these assets, or operating results 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 and trademarks, and substantial amounts of property and equipment. We make certain estimates and projections in connection with 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 are significant, our results of operations would be adversely affected. In that regard, we recorded \$1.4 million and \$2.1 million impairment charges on long-lived assets of certain underperforming stores in fiscal 2013 and fiscal 2010, respectively, and we recorded charges amounting to \$3.2 million related to retail store closures in fiscal 2011. No such related charges were recorded in fiscal 2012.

***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. Our first assessment of the effectiveness of our internal control over financial reporting since becoming a public company in 2012 is included within this Form 10-K. Management concluded that our internal control over financial reporting was effective as of February 1, 2014. However, 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 in the future 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, or if they interpret the relevant requirements differently from us. 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. If we fail to timely achieve and maintain the adequacy of our internal control over financial reporting, we may not be able to

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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.

### ***We incur costs as a public company, and our management is required to devote substantial time to compliance matters.***

As a public company, we incur significant legal, accounting, and other expenses, including costs resulting from public company reporting obligations under the Exchange Act and the rules and regulations regarding corporate governance practices, including those under the Sarbanes-Oxley Act, the Dodd-Frank Act, and the listing requirements of the stock exchange on which our securities are listed. Our management and other personnel need to devote a substantial amount of time to ensure that we comply with all of these requirements. The reporting requirements, rules, and regulations increase our legal and financial compliance costs and make some activities more time-consuming and costly.

These rules and regulations make it more difficult and more expensive for us to obtain director and officer liability insurance, and we may be required to accept reduced policy limits and coverage or incur substantially higher costs to obtain the same or similar coverage. These factors could also make it more difficult for us to attract and retain qualified persons to serve on our board of directors, particularly to serve on our audit and compensation committees, or as executive officers.

### ***New regulations related to “conflict minerals” may force us to incur additional expenses, may make the sourcing of our products more complex and may result in damage to our reputation with customers.***

On August 22, 2012, under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd-Frank”), the SEC adopted new requirements for companies that use certain minerals and metals in their products, known as “conflict minerals,” whether or not these products are manufactured by third parties. Some of these minerals are commonly used in many products and may be used in some of the products we offer. These requirements require companies to diligence, disclose, and report whether such minerals, if used in the products of the company, originate from the Democratic Republic of Congo and adjoining countries. The implementation of these new requirements could adversely affect the sourcing, availability, and pricing of such minerals if they are found to be used in our products and necessary for their functionality. Since we source substantially all of our products abroad, we may not be able to sufficiently verify the origins of these minerals and metals used in our products through the due diligence procedures that we implement, which may harm our reputation and affect our compliance with the SEC regulations. The first report is due on May 31, 2014 for the 2013 calendar year.

## **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 may be volatile. 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 operating results 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 the public float;
- stock price performance of our competitors;

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- 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 disasters or other similar events;
- issuances or expected issuances of capital stock; 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. In the past, stockholders have instituted securities class action litigation following periods of market volatility. If we were involved in securities litigation, we could incur substantial costs and our resources and the attention of management could be diverted from our business.

Our filings and public disclosures have attracted the attention of a hedge fund manager whose investment strategies we believe include making investments that increase in value when stock prices decline. The fund manager has informed us of the fund's negative view of our Company and business and has threatened to publicize those views. There can be no assurance that this fund manager will not attempt to influence the broader investment community or otherwise attempt to disparage our Company or our brand, which could negatively affect our stock price.

### ***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 also 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. All of our outstanding shares of common stock are freely tradable, except for (i) 76,983 shares as of March 21, 2014 issued under our 2012 Equity Replacement Plan that are subject to additional time-based resale restrictions and (ii) certain other shares of our common stock that are held or acquired by our directors, executive officers and other affiliates, as that term is defined in the Securities Act of 1933, as amended (the "Securities Act"), which are restricted securities under the Securities Act.

### ***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;



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- 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.

### ***Effective May 20, 2013, we ceased to be a “controlled company” within the meaning of the New York Stock Exchange (“NYSE”) rules upon completion of our May 2013 offering. However, we may continue to rely on exemptions from certain corporate governance requirements during a one-year transition period until May 20, 2014.***

Effective May 20, 2013, Home Holdings LLC, a Delaware limited liability company (“Home Holdings”), ceased to control a majority of our voting common stock. As a result, we ceased to be a “controlled company” within the meaning of the NYSE corporate governance standards. In accordance with NYSE requirements, before we ceased to be a “controlled company,” we appointed at least one independent member to each of the compensation and nominating and governance committees. NYSE rules also require that we appoint at least a majority of independent members to such committees within 90 days of the date we ceased to be a “controlled company,” or August 18, 2013. We complied with this requirement within the period prescribed by the rules. Our audit committee is fully independent.

NYSE rules also require that we appoint compensation, and nominating and governance committees composed entirely of independent directors and appoint a majority of independent directors to our board of directors within one year of such date, or May 20, 2014. Although we expect that our board and committees will meet these independence requirements by the May 20, 2014 deadline, we do not currently have compensation, and nominating and governance committees composed entirely of independent directors or a majority of independent directors on our board of directors. Accordingly, until such time that our board and committees meet these independence, stockholders will not have the same protections afforded to stockholders of companies that are currently required to comply with such corporate governance requirements.

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### Item 1B. Unresolved Staff Comments

None.

### Item 2. Properties

We leased approximately 1,030,000 gross square feet for 61 Galleries, 5 Full Line Design Galleries, 3 Baby & Child Galleries and 17 outlet stores that were open as of February 1, 2014. The initial lease term of our retail stores is generally 10 –15 years. Certain leases contain renewal options for up to 20 years.

Most leases for our retail stores provide for a minimum rent, typically including escalating rent increases. In addition, certain leases have a percentage rent based upon sales after minimum thresholds are achieved. Leases generally require us to pay insurance, utilities, real estate taxes and repair and maintenance expenses. We also lease approximately 20,000 square feet for offsite storage.

#### *Leased Properties*

The following table summarizes the location and size of our leased distribution centers and corporate facilities occupied as of February 1, 2014:

Location	Purpose	Lease Expiration	Occupied Square Footage (Approximate)
<i>Distribution Centers</i>			
West Jefferson, Ohio	Distribution center	April 2028	1,224,000
North East, Maryland	Distribution center	February 2028	1,195,000
Mira Loma, California	Distribution center / Home delivery	June 2020	886,000
Grand Prairie, Texas	Distribution center / Home delivery	August 2028	859,000
Baltimore, Maryland	Distribution center / Home delivery	June 2014	508,000
Tracy, California	Home delivery	September 2016	284,000
Avenel, New Jersey	Home delivery	November 2016	114,000
Pompano Beach, Florida	Home delivery	October 2020	101,000
Houston, Texas	Home delivery	August 2018	71,000
<i>Corporate Facilities</i>			
Corte Madera, California (1)	Corporate headquarters	(2)	267,000
Richmond, California	Warehouse	September 2022	259,000
San Rafael, California	Warehouse	July 2014	10,000
Pleasanton, California	Corporate office	June 2020	8,000

(1) Includes approximately 15,000 square feet of warehouse space.

(2) Lease agreements for our corporate headquarters expire between May 2020 and May 2028.

#### *Owned Properties*

We currently own one store, our approximately 8,000 square foot Gallery in San Francisco's Design District.

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.

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### **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. Such legal proceedings may include claims related to our employment practices, 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.

### **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 began trading on the NYSE, under the symbol “RH” on November 2, 2012. The following table sets forth the highest and lowest closing prices for our common stock on the NYSE for the periods indicated since our initial public offering.

	<u>Highest</u>	<u>Lowest</u>
<b>Fiscal 2012</b>		
Fourth Quarter (from November 2, 2012)	\$37.99	\$31.10
<b>Fiscal 2013</b>		
First Quarter	\$39.58	\$32.75
Second Quarter	\$77.18	\$39.55
Third Quarter	\$76.80	\$60.52
Fourth Quarter	\$76.25	\$54.96

The number of stockholders of record of our common stock as of February 1, 2014 was 58. This number excludes stockholders whose stock is held in nominee or street name by brokers.

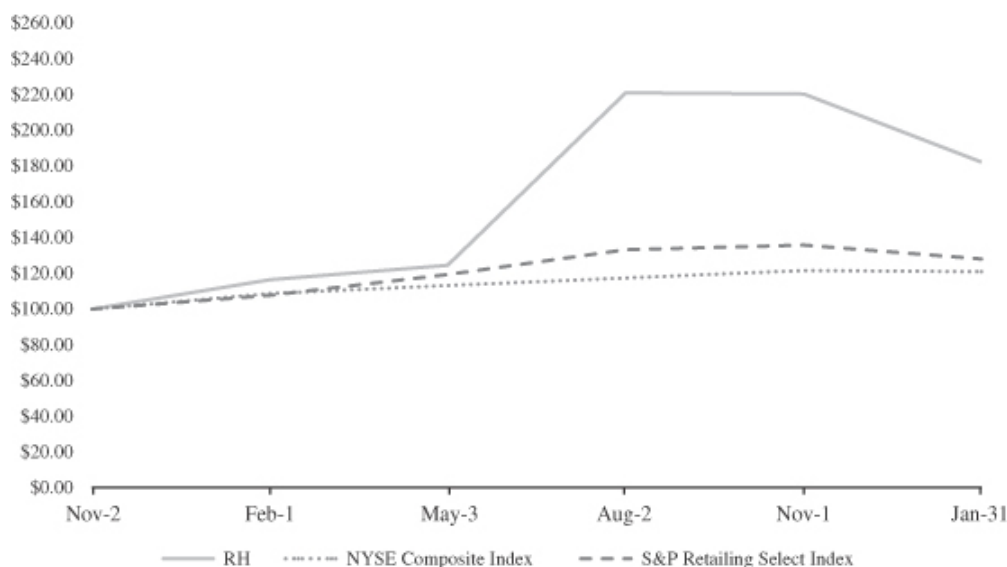
No dividends have been declared or paid on our common stock. We do not currently anticipate that we will pay any cash dividends on our common stock in the foreseeable future.

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**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 Securities Exchange Act of 1934, as amended (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 Restoration Hardware Holdings, Inc. 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 period from November 2, 2012 (the date our common stock commenced trading on the NYSE) through February 1, 2014 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 November 2, 2012 in the common stock of Restoration Hardware Holdings, Inc., 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.



	11/2/2012	2/1/2013	5/3/2013	8/2/2013	11/1/2013	1/31/2014
Restoration Hardware Holdings, Inc.	100.00	116.50	124.73	221.41	220.55	182.44
NYSE Composite Index	100.00	108.87	113.43	117.67	121.65	121.04
S&P Retailing Select Index	100.00	107.88	119.60	133.46	135.93	128.22

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### Repurchases of Common Stock during the Three Months Ended February 1, 2014

The following table provides information with respect to shares of common stock we repurchased during the three months ended February 1, 2014. For additional information, please see Note 12—*Share Repurchases* to our audited consolidated financial statements. These repurchases are related to certain options and awards granted under the Company's equity plans that contain a repurchase right.

	<u>Number of Shares</u>	<u>Average Purchase Price Per Share</u>
<i>November 3, 2013 to November 30, 2013</i>		
Employee transactions	2,470	\$ 75.11
<i>December 1, 2013 to January 4, 2013</i>		
No activity	—	—
<i>January 5, 2014 to February 1, 2014</i>		
No activity	—	—
Total	<u>2,470</u>	<u>\$ 75.11</u>

On March 10, 2014, we repurchased 238,290 shares of common stock from Carlos Alberini, our former Co-Chief Executive Officer, for a purchase price of \$65.06 per share, which was the closing sale price per share of our common stock on the New York Stock Exchange on that date, payable through the issuance of a promissory note. The shares repurchased were issued to Mr. Alberini under the Company's 2012 Equity Replacement Plan. For additional information, please see Note 20—*Subsequent Events*.

### Item 6. Selected Consolidated Financial Data

The following tables present Restoration Hardware Holdings, Inc.'s consolidated financial and operating data as of the dates and for the periods indicated.

Restoration Hardware Holdings, Inc. was formed as a Delaware corporation on August 18, 2011. On November 7, 2012, Restoration Hardware Holdings, Inc. completed an initial public offering and acquired all of the outstanding shares of capital stock of Restoration Hardware, Inc. In connection with the initial public offering, common stock of Restoration Hardware Holdings, Inc. was issued in replacement of prior unit awards under the Team Resto Ownership Plan. These transactions are referred to as the "Reorganization." Restoration Hardware Holdings, Inc. has not engaged in any business or other activities except in connection with its formation and the Reorganization. Accordingly, all financial and other information herein relating to periods prior to the completion of the Reorganization is that of Restoration Hardware, Inc.

The selected consolidated financial data as of February 1, 2014 and February 2, 2013 and for the fiscal years ended February 1, 2014, February 2, 2013 and January 28, 2012, were derived from consolidated financial statements included in *Item 8—Financial Statements and Supplementary Data*. The selected consolidated financial data as of January 28, 2012 and as of and for the periods ended January 29, 2011 and January 30, 2010 were derived from consolidated financial statements for such years not included herein.

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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.

	Year Ended				
	February 1, 2014	February 2, 2013	January 28, 2012	January 29, 2011	January 30, 2010
(dollars in thousands, excluding per square foot store data)					
<b>Statement of Operations Data:</b>					
Net revenues	\$ 1,550,961	\$ 1,193,046	\$ 958,084	\$ 772,752	\$ 625,685
Cost of goods sold	994,081	756,597	601,735	501,132	412,629
Gross profit	556,880	436,449	356,349	271,620	213,056
Selling, general and administrative expenses	502,029	505,485	329,506	274,836	238,889
Income (loss) from operations	54,851	(69,036)	26,843	(3,216)	(25,833)
Interest expense	(5,733)	(5,776)	(5,134)	(3,150)	(3,241)
Income (loss) before income taxes	49,118	(74,812)	21,709	(6,366)	(29,074)
Income tax expense (benefit) <sup>(1)</sup>	30,923	(62,023)	1,121	685	(423)
Net income (loss)	<u>\$ 18,195</u>	<u>\$ (12,789)</u>	<u>\$ 20,588</u>	<u>\$ (7,051)</u>	<u>\$ (28,651)</u>
Weighted-average number of basic shares outstanding	38,671,564	9,428,828	468	100	100
Basic net income (loss) per share	\$ 0.47	\$ (1.36)	\$ 43,991	\$ (70,510)	\$ (286,510)
Weighted-average number of diluted shares outstanding	40,416,630	9,428,828	468	100	100
Diluted net income (loss) per share	\$ 0.45	\$ (1.36)	\$ 43,991	\$ (70,510)	\$ (286,510)
<b>Other Financial and Operating Data:</b>					
Growth in net revenues:					
Stores <sup>(2)</sup>	27%	20%	22%	15%	(6)%
Direct	33%	30%	27%	37%	(15)%
Total	30%	25%	24%	24%	(10)%
Comparable brand revenue growth <sup>(3)</sup>	31%	28%	26%	26%	(10)%
Retail: <sup>(4)</sup>					
Comparable store sales change <sup>(5)</sup>	27%	28%	25%	19%	(7)%
Retail stores open at end of period	70	71	74	91	95
Retail sales per leased selling square foot <sup>(6)</sup>	\$ 1,395	\$ 1,143	\$ 846	\$ 635	\$ 525
Total leased square footage at end of period (in thousands)	798	768	808	970	1,015
Total leased selling square footage at end of period (in thousands) <sup>(7)</sup>	554	501	516	613	642
Average leased square footage (in thousands) <sup>(8)</sup>	793	784	913	1,014	1,042
Average leased selling square footage (in thousands) <sup>(8)</sup>	522	504	580	641	660
Direct:					
Catalogs circulated (in thousands) <sup>(9)</sup>	12,325	32,712	26,052	46,507	31,336
Catalog pages circulated (in millions) <sup>(9)</sup>	6,583	16,029	8,848	6,260	4,418
Direct as a percentage of net revenues <sup>(10)</sup>	47%	46%	44%	43%	39%
Capital expenditures	\$ 93,868	\$ 49,058	\$ 25,593	\$ 39,907	\$ 2,024
Adjusted net income (loss) <sup>(11)</sup>	\$ 69,101	\$ 37,739	\$ 26,451	\$ 3,025	\$ (18,483)
Adjusted EBITDA <sup>(12)</sup>	\$ 148,555	\$ 96,571	\$ 80,154	\$ 41,097	\$ 17,596

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	February 1, 2014	February 2, 2013	January 28, 2012	January 29, 2011	January 30, 2010
(in thousands)					
<b>Balance Sheet Data:</b>					
Cash and cash equivalents	\$ 13,389	\$ 8,354	\$ 8,512	\$ 13,364	\$ 13,186
Working capital (excluding cash and cash equivalents) <sup>(13)</sup>	284,785	267,905	156,506	103,894	57,058
Total assets	1,025,103	789,613	586,810	501,991	431,528
Line of credit	85,425	82,501	107,502	111,837	57,442
Term loan	—	—	14,798	—	—
Total debt (including current portion) <sup>(14)</sup>	87,621	87,029	131,040	116,995	61,652
Total stockholders' equity	545,272	451,611	250,463	215,804	221,079

- (1) As of the end of fiscal 2012, our U.S. operations achieved a position of cumulative profits (adjusted for permanent differences) for the most recent three-year period. We concluded that this record of cumulative profitability in recent years, coupled with our business plan for profitability in future periods, provided assurance that our future tax benefits more likely than not would be realized. Accordingly, in the three and twelve months ended February 2, 2013, we released all of our U.S. valuation allowance of \$57.2 million against net deferred tax assets.
- (2) Stores data represents retail stores plus outlet stores.
- (3) Comparable brand revenue growth includes retail comparable store sales, including Baby & Child Galleries, and direct net revenues. Comparable brand revenue growth excludes retail non-comparable store sales and outlet store net revenues. Refer to footnote (5) below for a definition of comparable store sales. Because fiscal 2012 was a 53-week year, comparable brand revenue growth percentage for fiscal 2012 excludes the extra week of revenue.
- (4) Retail data has been calculated based upon retail stores, which includes our Baby & Child Galleries and excludes outlet stores.
- (5) Comparable store sales have been calculated based upon retail stores that were open at least fourteen full months as of the end of the reporting period and did not change square footage by more than 20% between periods. If a store is closed for seven days during a month, that month will be excluded from comparable store sales. Comparable store net revenues exclude revenues from outlet stores. Because fiscal 2012 was a 53-week year, comparable store sales change percentage for fiscal 2012 excludes the extra week of sales.
- (6) Retail sales per leased selling square foot is calculated by dividing total net revenues for all retail stores, comparable and non-comparable, by the average leased selling square footage for the period.
- (7) Leased selling square footage is retail space at our stores used to sell our products. Leased selling square footage excludes backrooms at retail stores used for storage, office space or similar matters. Leased selling square footage excludes exterior sales space located outside a store, such as courtyards, gardens and rooftops. Leased selling square footage for fiscal 2013, fiscal 2012 and fiscal 2011 includes approximately 4,500 square feet related to one owned store location.
- (8) Average square footage (leased or leased selling, as applicable) is calculated for each quarter by taking the total applicable square footage at the beginning of the quarter plus the total applicable square footage at the end of the quarter and dividing by two. Average square footage for periods of six, nine and twelve months is calculated by averaging the average square footage for the quarters within such periods.
- (9) The catalogs and catalog pages circulated from period to period do not take into account different page sizes per catalog distributed. Page sizes and page counts vary for different catalog mailings and we sometimes mail different versions of a catalog at the same time. Accordingly, period to period comparisons of catalogs circulated and catalog pages circulated do not take these variations into account.
- (10) Direct revenues include sales through our catalogs and websites.
- (11) Adjusted net income (loss) 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 (loss) as consolidated net income (loss), adjusted for the impact of certain non-recurring and other items that we do not consider representative of our ongoing operating performance. Adjusted net income (loss) is included in this filing because management believes that adjusted net income (loss) provides



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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, 2014	February 2, 2013	January 28, 2012	January 29, 2011	January 30, 2010
	(in thousands)				
<b>Statement of Operations Data:</b>					
Net income (loss)	\$ 18,195	\$ (12,789)	\$ 20,588	\$ (7,051)	\$ (28,651)
Adjustments pre-tax:					
Management and pre-IPO board fees <sup>(a)</sup>	—	4,258	10,715	4,793	4,620
Non-cash and other one-time compensation <sup>(b)</sup>	63,155	115,055	6,350	—	—
Terminated operations <sup>(c)</sup>	—	—	1,580	352	2,604
Severance and other transaction costs <sup>(d)</sup>	—	—	621	1,797	1,521
Impairment of long-lived assets <sup>(e)</sup>	—	—	—	2,115	2,304
Lease termination costs <sup>(f)</sup>	—	(386)	3,110	—	—
Inventory write-down amortization <sup>(g)</sup>	—	—	—	—	(12,780)
Special committee investigation and remediation <sup>(h)</sup>	—	4,778	—	—	—
Initial public offering costs <sup>(i)</sup>	—	10,755	—	—	—
Anti-dumping exposure <sup>(j)</sup>	—	3,250	—	—	—
Non-capitalized IPO costs <sup>(k)</sup>	—	—	—	2,351	—
Follow-on offering fees <sup>(l)</sup>	2,895	—	—	—	—
Subtotal adjusted items	66,050	137,710	22,376	11,408	(1,731)
Impact of income tax items <sup>(m)</sup>	(15,144)	(87,182)	(16,513)	(1,332)	11,899
Adjusted net income (loss)	<u>\$ 69,101</u>	<u>\$ 37,739</u>	<u>\$ 26,451</u>	<u>\$ 3,025</u>	<u>\$ (18,483)</u>

- (a) Includes fees and expenses paid in accordance with our management services agreement with Home Holdings, as well as fees and expense reimbursements paid to our board of directors prior to the initial public offering.
- (b) Fiscal 2013 includes a \$33.7 million non-cash compensation charge related to the one-time, fully vested option granted to Mr. Friedman upon his reappointment as Chairman and Co-Chief Executive Officer in July 2013 and a \$29.5 million non-cash compensation charge related to the performance-based vesting of certain shares granted to Mr. Friedman. Fiscal 2012 includes a \$92.0 million non-cash compensation charge related to equity grants at the time of the Reorganization, as well as a non-cash compensation charge of \$23.1 million related to the performance-based vesting of certain shares granted to Mr. Alberini and Mr. Friedman. Fiscal 2011 includes a \$6.4 million compensation charge related to the repayment of loans owed to Home Holdings by Gary Friedman, through the reclassification by Home Holdings of Mr. Friedman's Class A and Class A-1 ownership units into an equal number of Class A Prime and Class A-1 Prime ownership units. Mr. Friedman served as our Chairman and Co-Chief Executive Officer at the time of such loan repayment.
- (c) Includes costs related to the restructuring of our Shanghai office location.
- (d) Generally includes executive severance and other related costs.
- (e) Includes costs related to impairment of long-lived assets related to our retail store operations.
- (f) Includes lease termination costs for retail stores that were closed prior to their respective lease termination dates. The lease termination amount in fiscal 2012 includes changes in estimates regarding liabilities for future lease payments for closed stores.

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- (g) Represents non-cash impact of amortizing, over the period of the inventory turn, the net fair value adjustment to inventory recorded in connection with the purchase price allocation for the acquisition of all of the outstanding capital stock of Restoration Hardware, Inc. by Home Holdings on June 16, 2008.
  - (h) Represents legal and other professional fees incurred in connection with the investigation conducted by the special committee of the board of directors relating to our Chief Executive Officer, Gary Friedman, and our subsequent remedial actions.
  - (i) Represents costs incurred in connection with our initial public offering, including a fee of \$7.0 million to Catterton Management Company, LLC (“Catterton”), Tower Three Partners LLC (“Tower Three”) and GJK Capital Advisors, LLC (“Glenhill”) in accordance with our management services agreement, payments of \$2.2 million to certain former executives and bonus payments to employees of \$1.3 million.
  - (j) Represents expense incurred as a result of increased tariff obligations of one of our foreign suppliers following the U.S. Department of Commerce’s review of the anti-dumping duty order on wooden bedroom furniture from China for the period from January 1, 2011 through December 31, 2011.
  - (k) Represents costs related to our initial public offering.
  - (l) Represents legal and other professional fees incurred in connection with our follow-on offerings in May 2013 and July 2013.
  - (m) As of the end of fiscal 2012, our U.S. operations achieved a position of cumulative profits for the most recent three-year period. We concluded that this record of cumulative profitability in recent years, coupled with our business plan for profitability in future periods provided assurance that our future tax benefits more likely than not would be realized. Accordingly, in fiscal 2012, we released all of our U.S. valuation allowance against net deferred tax assets. In addition, income tax items exclude the tax benefit related to the resolution of our Canada Revenue Agency examination in fiscal 2012, exclude the tax benefit from the utilization of federal and state net operating losses, and assume a normalized tax rate of 40% for all periods.
- (12) 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 and provision for income taxes. We define adjusted EBITDA as consolidated net income (loss) before depreciation and amortization, interest expense and provision for income taxes, adjusted for the impact of certain non-recurring and other items that we do not consider representative of our ongoing operating performance.

We believe that EBITDA and adjusted EBITDA are useful measures of operating performance, as they eliminate expenses that are not reflective of the 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 EBITDA as one of the primary methods for planning and forecasting overall expected performance and for evaluating on a quarterly and annual basis actual results against such expectations, and as the basis of our Management Incentive Plan (“MIP”), which is our cash based-incentive compensation program designed to motivate and reward annual performance for eligible employees. Additionally, EBITDA is frequently used by analysts, investors and other interested parties to evaluate companies in our industry. We use EBITDA and adjusted EBITDA, alongside other GAAP measures such as gross profit, operating income (loss) and net income (loss), to measure profitability, as a key profitability target in our annual and other budgets, and to compare our performance against that of peer companies.

EBITDA and adjusted EBITDA are not GAAP measures of our financial performance or liquidity and should not be considered as alternatives to net income (loss) or net income (loss) per share as a measure of financial performance, cash flows from operating activities as a measure of liquidity, or any other performance measure derived in accordance with GAAP and they should not be construed as an inference that our future results will be unaffected by unusual or non-recurring items. Additionally, EBITDA and adjusted EBITDA are not intended to be measures of free cash flow for management’s discretionary use, as they do not consider certain cash requirements such as tax payments and debt service requirements and certain other cash costs that may recur in the future. EBITDA and adjusted EBITDA contain certain other

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limitations, including the failure to reflect our cash expenditures, cash requirements for working capital needs and cash costs to replace assets being depreciated and amortized. In addition, these non-GAAP measures exclude certain non-recurring and other charges.

In evaluating these non-GAAP measures, you should be aware that in the future we may incur expenses that are the same as or similar to some of the adjustments in these non-GAAP measures. Our presentation of these non-GAAP measures should not be construed to imply that our future results will be unaffected by any such adjustments. Management compensates for these limitations by relying primarily on our GAAP results and by using these non-GAAP only supplementally. These non-GAAP measures are not necessarily comparable to other similarly titled captions of other companies due to different methods of calculation.

	Year Ended				
	February 1, 2014	February 2, 2013	January 28, 2012	January 29, 2011	January 30, 2010
	(in thousands)				
<b>Statement of Operations Data:</b>					
Net income (loss)	\$ 18,195	\$ (12,789)	\$ 20,588	\$ (7,051)	\$ (28,651)
Depreciation and amortization	27,654	26,748	29,186	31,263	43,065
Interest expense	5,733	5,776	5,134	3,150	3,241
Income tax expense (benefit)	30,923	(62,023)	1,121	685	(423)
EBITDA	82,505	(42,288)	56,029	28,047	17,232
Management and pre-IPO board fees <sup>(n)</sup>	—	4,258	10,715	4,793	4,620
Non-cash and other one-time compensation <sup>(o)</sup>	63,155	116,157	7,907	1,119	592
Terminated operations <sup>(p)</sup>	—	—	1,580	352	2,604
Severance and other transaction costs <sup>(q)</sup>	—	—	621	1,797	1,521
Impairment of long-lived assets <sup>(r)</sup>	—	—	—	2,115	2,304
Lease termination costs <sup>(s)</sup>	—	(386)	3,110	—	—
Inventory write-down amortization <sup>(t)</sup>	—	—	—	—	(12,780)
Special committee investigation and remediation <sup>(u)</sup>	—	4,778	—	—	—
Initial public offering costs <sup>(v)</sup>	—	10,755	—	—	—
Anti-dumping exposure <sup>(w)</sup>	—	3,250	—	—	—
Non-capitalized IPO costs <sup>(x)</sup>	—	—	—	2,351	—
Follow-on offering fees <sup>(y)</sup>	2,895	—	—	—	—
Other <sup>(z)</sup>	—	47	192	523	1,503
Adjusted EBITDA	<u>\$ 148,555</u>	<u>\$ 96,571</u>	<u>\$ 80,154</u>	<u>\$ 41,097</u>	<u>\$ 17,596</u>

(n) Includes fees and expenses paid in accordance with our management services agreement with Home Holdings, as well as fees and expense reimbursements paid to our board of directors prior to the initial public offering.

(o) Fiscal 2013 includes a \$33.7 million non-cash compensation charge related to the one-time, fully vested option granted to Mr. Friedman upon his reappointment as Chairman and Co-Chief Executive Officer in July 2013 and a \$29.5 million non-cash compensation charge related to the performance-based vesting of certain shares granted to Mr. Friedman. Fiscal 2012 includes a \$92.0 million non-cash compensation charge related to equity grants at the time of the Reorganization, as well as a non-cash compensation charge of \$23.1 million related to the performance-based vesting of certain shares granted to Mr. Alberini and Mr. Friedman. Fiscal 2011 includes a \$6.4 million compensation charge related to the repayment of loans owed to Home Holdings by Mr. Friedman, through the reclassification by Home Holdings of Mr. Friedman's Class A and Class A-1 ownership units into an equal number of Class A Prime and Class A-1 Prime ownership units. Mr. Friedman served as our Chairman and Co-Chief Executive Officer at the time of such loan repayment. In addition, amounts include stock-based compensation expense incurred prior to our initial public offering.

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- (p) Includes the impact of divesting our Brocade Home brand, closing four temporary clearance centers operated from October 2008 to March 2010, costs related to closing The Michaels Furniture Company and costs related to the restructuring of our Shanghai office location.
  - (q) Generally includes executive severance and other related costs.
  - (r) Includes costs related to impairment of long-lived assets related to our retail store operations prior to our initial public offering.
  - (s) Includes lease termination costs for retail stores that were closed prior to their respective lease termination dates. The lease termination amount in fiscal 2012 includes changes in estimates regarding liabilities for future lease payments for closed stores.
  - (t) Represents non-cash impact of amortizing, over the period of the inventory turn, the net fair value adjustment to inventory recorded in connection with the purchase price allocation for the acquisition of all of the outstanding capital stock of Restoration Hardware, Inc. by Home Holdings on June 16, 2008.
  - (u) Represents legal and other professional fees incurred in connection with the investigation conducted by the special committee of the board of directors relating to Mr. Friedman and our subsequent remedial actions.
  - (v) Represents costs incurred in connection with our initial public offering, including a fee of \$7.0 million to Catterton, Tower Three and Glenhill in accordance with our management services agreement, payments of \$2.2 million to certain former executives and bonus payments to employees of \$1.3 million.
  - (w) Represents expense incurred as a result of increased tariff obligations of one of our foreign suppliers following the U.S. Department of Commerce's review of the anti-dumping duty order on wooden bedroom furniture from China for the period from January 1, 2011 through December 31, 2011.
  - (x) Represents costs related to our efforts to pursue an initial public offering.
  - (y) Represents legal and other professional fees incurred in connection with our follow-on offerings in May 2013 and July 2013.
  - (z) Represents items which management believes are not indicative of our ongoing operating performance. Fiscal 2009 includes one-time start-up costs associated with Baby & Child, occupancy costs for corporate office space exited by us as part of the acquisition of all of the outstanding capital stock of Restoration Hardware, Inc. by Home Holdings on June 16, 2008, and foreign exchange gains and losses. Fiscal 2010 and fiscal 2011 include consulting fees related to organizational matters, state franchise tax amounts and foreign exchange gains and losses.
- (13) Working capital is defined as current assets, excluding cash and cash equivalents, less current liabilities, excluding the current portion of long-term debt.
- (14) Total debt (including current portion) includes the revolving line of credit, term loan, and capital lease obligations.

## **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 collections of timeless, updated classics and reproductions 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, tableware and children's furnishings. Our business is fully integrated across our multiple channels of distribution, consisting of our stores, catalogs and websites. We position our stores as showrooms for our brand, while our Source Books and websites act as virtual extensions of our stores. As of February 1, 2014, we operated 62 Galleries, 5 Full Line Design Galleries and 3 Baby & Child Galleries, as well as 17 outlet stores throughout the United States and Canada.

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In order to drive growth across our business, we are focused on the following 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 retail footprint to a portfolio focused on Full Line Design Galleries. Our Full Line Design Galleries are sized based on the market potential and the size of our assortment. Based on our analysis, we believe we have opportunities to operate Full Line Design Galleries in 60 to 70 locations in the United States and Canada.
- *Expand Our Offering and Increase Our Market Share.* We believe we have a significant opportunity to increase our market share by:
  - Growing our merchandise assortment;
  - Introducing new products and categories;
  - Expanding our service offerings; and
  - Exploring and testing new business opportunities complementary to our core business.
- *Increase Brand Awareness.* We will continue to increase our brand awareness and customer loyalty through our real estate transformation, our Source Book circulation strategy, our digital marketing initiatives, and our increased advertising and public relations activities and events.
- *Pursue International Expansion.* We plan to strategically expand our business into select countries outside of the United States and Canada over the next several years. We believe that our luxury brand positioning and unique aesthetic will have strong international appeal.
- *Increase Operating Margins.* We have the opportunity to continue to improve our operating margins by leveraging our fixed occupancy costs and scalable infrastructure.

Our fiscal 2013 results reflect the ongoing strength of our business. We have continued to increase market share, and at the same time invested in our infrastructure and supply chain to support future growth. Key financial achievements of fiscal 2013 include:

- Net revenues increased 30% to \$1.6 billion in fiscal 2013, on top of a 25% increase in fiscal 2012 and a 24% increase in fiscal 2011.
- The fourth quarter of fiscal 2013 marked our 16<sup>th</sup> consecutive quarter of double-digit net revenue growth.
- Net income increased to \$18.2 million in fiscal 2013 from a net loss of \$12.8 million in fiscal 2012.

### **Factors Affecting Our Operating Results**

Various factors affected our results for the periods presented in this “Management’s Discussion and Analysis of Financial Condition and Results of Operations” including the following:

*Overall Economic Trends.* The industry in which we operate is cyclical, and consequently our revenues are affected by general economic conditions. For example, reduced consumer confidence and lower availability and higher cost of consumer credit reduces demand for our products and limits our ability to increase prices or sustain price increases. We expect that some of the economic factors that have been in place for the last several years, including the continuing economic uncertainty (particularly in the housing market in the United States) may continue in future periods. For more information, see “Risk Factors—Changes in consumer spending or the housing market may significantly harm our revenue and 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 development of new larger Full Line Design Galleries in a number of new locations, the optimization of our store sizes to better fit

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anticipated demand in a given market, the expansion of our product categories and services and changes in the ways in which we market with our catalogs. Although these initiatives are designed to create growth in our business and continuing improvement in our operating results, the timing of expenditures related to these initiatives, as well as the achievement of returns on our investments, may affect our results of operation in future periods, and we may not achieve the desired benefits. Opening Full Line Design Galleries will require significant capital expenditures, and retail store closures may lead to charges including lease termination and other exit costs. These changes could affect our results of operation in future periods. In addition, the investments required to continue our strategic initiatives may have a negative impact on cash flows in future periods and could create pressure on our liquidity if we do not achieve the desired results from these initiatives in a timely manner. We expect that we will continue to incur significant capital expenditures as part of our initiative to open more Full Line Design Galleries over the next several years, and that these expenditures will have an impact on our cash flows during this time. For fiscal 2013, we incurred total capital expenditures of \$93.9 million and we anticipate our capital expenditure requirements to be approximately \$115 million to \$125 million for fiscal 2014.

*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 during recent periods, which we believe has been a contributing factor in our sales and operating results. Periods in which our products have achieved strong customer acceptance generally have had more favorable results. If we misjudge the market for our products, 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.

*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. While we believe our vendors have adequate capacity to meet our current and anticipated demand, 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.

*Fluctuation in Quarterly Results.* Our quarterly results have historically varied depending upon a variety of factors, including our product offerings, promotional events, store openings, shifts in the timing of holidays and timing of catalog releases, 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. See “Risk Factors—Our operating results are subject to quarterly fluctuations, and results for any quarter may not necessarily be indicative of the results that may be achieved for the 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 operating results, including net revenues, gross profit, selling, general and administrative expenses and adjusted EBITDA and adjusted net income.

*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 upon receipt of product by our customers.

*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 market reserves; inbound freight; all freight costs to get merchandise to our stores; design, buying and allocation costs; occupancy costs related to store operations, such as rent and

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common area maintenance; depreciation and amortization of leasehold improvements, equipment and other assets in our stores and distribution centers; and all logistics costs associated with shipping product to our customers, which are only partially offset by shipping income collected from customers. 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 hubs 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.

*Selling, General and Administrative Expenses.* Selling, general and administrative expenses include all operating costs not included in cost of goods sold. These expenses include all payroll and payroll related expenses, store expenses other than occupancy and expenses related to many of our operations at our 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. Selling, general and administrative expenses as a percentage of net revenues is usually higher in lower-volume quarters and lower in higher-volume quarters because a significant portion of the costs are relatively fixed.

Our recent revenue growth has been accompanied by increased selling, general and administrative expenses, excluding certain one-time and non-cash items discussed in “Basis of Presentation and Results of Operations” below. The most significant components of these increases are payroll costs, as well as credit card fees due to increased revenue. We expect these expenses to continue to increase as we continue to open new stores, develop new product categories and otherwise grow our business. These increases were partially offset by a decrease in advertising and marketing costs as a result of modifying our Source Book strategy for fiscal 2013 and eliminating our Fall Source Book.

*Adjusted EBITDA and Adjusted Net Income.* We believe that 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 EBITDA as one of the primary methods for planning and forecasting overall expected performance and for evaluating on a quarterly and annual basis actual results against such expectations, and as the basis of our MIP.

We define adjusted EBITDA as consolidated net income (loss) before depreciation and amortization, interest expense and provision for income taxes, adjusted for the impact of certain non-recurring and other items that we do not consider representative of our ongoing 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 is more reflective of other factors that affect our operating performance.

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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 ongoing operating performance.

### Basis of Presentation and Results of Operations

On November 7, 2012, Restoration Hardware Holdings, Inc. completed an initial public offering and acquired all of the outstanding shares of capital stock of Restoration Hardware, Inc. In connection with the initial public offering, common stock of Restoration Hardware Holdings, Inc. was issued in replacement of prior unit awards under the Team Resto Ownership Plan. These transactions are referred to as the "Reorganization." Prior to the Reorganization, Restoration Hardware Holdings, Inc. had not engaged in any business or other activities except in connection with its formation and the Reorganization. Accordingly, all financial and other information herein relating to periods prior to the completion of the Reorganization is that of Restoration Hardware, Inc.

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

	Year Ended		
	February 1, 2014	February 2, 2013	January 28, 2012
(dollars in thousands, excluding per square foot store data)			
<b>Statement of Operations Data:</b>			
Net revenues	\$ 1,550,961	\$ 1,193,046	\$ 958,084
Cost of goods sold	994,081	756,597	601,735
Gross profit	556,880	436,449	356,349
Selling, general and administrative expenses	502,029	505,485	329,506
Income (loss) from operations	54,851	(69,036)	26,843
Interest expense	(5,733)	(5,776)	(5,134)
Income (loss) before income taxes	49,118	(74,812)	21,709
Income tax expense (benefit)	30,923	(62,023)	1,121
Net income (loss)	<u>\$ 18,195</u>	<u>\$ (12,789)</u>	<u>\$ 20,588</u>
<b>Other Financial and Operating Data:</b>			
Growth in net revenues:			
Stores <sup>(1)</sup>	27%	20%	22%
Direct	33%	30%	27%
Total	30%	25%	24%
Comparable brand revenue growth <sup>(2)</sup>	31%	28%	26%
Retail: <sup>(3)</sup>			
Comparable store sales change <sup>(4)</sup>	27%	28%	25%
Retail stores open at beginning of period	71	74	91
Stores opened	2	5	5
Stores closed	3	8	22
Retail stores open at end of period	70	71	74
Retail sales per leased selling square foot <sup>(5)</sup>	\$ 1,395	\$ 1,143	\$ 846
Total leased square footage at end of period (in thousands)	798	768	808
Total leased selling square footage at end of period (in thousands) <sup>(6)</sup>	554	501	516
Average leased square footage (in thousands) <sup>(7)</sup>	793	784	913
Average leased selling square footage (in thousands) <sup>(7)</sup>	522	504	580



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	Year Ended		
	February 1, 2014	February 2, 2013	January 28, 2012
	(dollars in thousands, excluding per square foot store data)		
<b>Direct:</b>			
Catalogs circulated (in thousands) <sup>(8)</sup>	12,325	32,712	26,052
Catalog pages circulated (in millions) <sup>(8)</sup>	6,583	16,029	8,848
Direct as a percentage of net revenues <sup>(9)</sup>	47%	46%	44%
Capital expenditures	\$ 93,868	\$ 49,058	\$ 25,593

- (1) Stores data represents retail stores plus outlet stores. Net revenues for outlet stores for fiscal 2013, fiscal 2012 and fiscal 2011 were \$89.6 million, \$54.3 million and \$43.9 million, respectively.
- (2) Comparable brand revenue growth includes retail comparable store sales, including Baby & Child Galleries, and direct net revenues. Comparable brand revenue growth excludes retail non-comparable store sales and outlet store net revenues. Refer to footnote (4) below for a definition of comparable store sales. Because fiscal 2012 was a 53-week year, comparable brand revenue growth percentage for fiscal 2012 excludes the extra week of revenue.
- (3) Retail data has been calculated based upon retail stores, which includes our Baby & Child Galleries and excludes outlet stores.
- (4) Comparable store sales have been calculated based upon retail stores that were open at least fourteen full months as of the end of the reporting period and did not change square footage by more than 20% between periods. If a store is closed for seven days during a month, that month will be excluded from comparable store sales. Comparable store net revenues exclude revenues from outlet stores. Because fiscal 2012 was a 53-week year, comparable store sales change percentage for fiscal 2012 excludes that extra week of sales.
- (5) Retail sales per leased selling square foot is calculated by dividing total net revenues for all retail stores, comparable and non-comparable, by the average leased selling square footage for the period.
- (6) Leased selling square footage is retail space at our stores used to sell our products. Leased selling square footage excludes backrooms at retail stores used for storage, office space or similar matters. Leased selling square footage excludes exterior sales space located outside a store, such as courtyards, gardens and rooftops. Leased selling square footage includes approximately 4,500 square feet related to one owned store location.
- (7) Average square footage (leased or leased selling, as applicable) is calculated for each quarter by taking the total applicable square footage at the beginning of the quarter plus the total applicable square footage at the end of the quarter and dividing by two. Average square footage for periods of six, nine and twelve months is calculated by averaging the average square footage for the quarters within such periods.
- (8) The catalogs and catalog pages circulated from period to period do not take into account different page sizes per catalog distributed. Page sizes and page counts vary for different catalog mailings and we sometimes mail different versions of a catalog at the same time. Accordingly, period to period comparisons of catalogs circulated and catalog pages circulated do not take these variations into account.
- (9) Direct revenues include sales through our catalogs and websites.

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The following table sets forth our consolidated statement of operations data as a percentage of total revenues.

	<b>Year Ended</b>		
	<b>February 1, 2014</b>	<b>February 2, 2013</b>	<b>January 28, 2012</b>
<b>Statement of Operations Data:</b>			
Net revenues	100.0%	100.0%	100.0%
Cost of goods sold	<u>64.1</u>	<u>63.4</u>	<u>62.8</u>
Gross profit	35.9	36.6	37.2
Selling, general and administrative expenses	<u>32.4</u>	<u>42.4</u>	<u>34.4</u>
Income (loss) from operations	3.5	(5.8)	2.8
Interest expense	<u>(0.3)</u>	<u>(0.5)</u>	<u>(0.5)</u>
Income (loss) before income taxes	3.2	(6.3)	2.3
Income tax expense (benefit)	<u>2.0</u>	<u>(5.2)</u>	<u>0.1</u>
Net income (loss)	<u>1.2%</u>	<u>(1.1)%</u>	<u>2.2%</u>

We operate a fully integrated distribution model through our stores, catalogs and websites. The following table shows a summary of our Stores net revenues, which include all sales for orders placed in retail stores as well as sales through outlet stores, and our Direct net revenues which include sales through our catalogs and websites.

	<b>Year Ended</b>		
	<b>February 1, 2014</b>	<b>February 2, 2013</b>	<b>January 28, 2012</b>
	(in thousands)		
Stores	\$ 818,372	\$ 643,306	\$ 534,411
Direct	<u>732,589</u>	<u>549,740</u>	<u>423,673</u>
Net revenues	<u>\$ 1,550,961</u>	<u>\$ 1,193,046</u>	<u>\$ 958,084</u>

### **Fiscal 2013 Compared to Fiscal 2012**

#### ***Net revenues***

Net revenues increased \$357.9 million, or 30.0%, to \$1,551.0 million in fiscal 2013 compared to \$1,193.0 million in fiscal 2012. We had 70 and 71 retail stores open at February 1, 2014 and February 2, 2013, respectively. Stores sales increased \$175.1 million, or 27.2%, to \$818.4 million in fiscal 2013 compared to \$643.3 million in fiscal 2012 due in large part to our comparable store sales increase of 27% in fiscal 2013 compared to fiscal 2012. Direct sales increased \$182.8 million, or 33.3%, to \$732.6 million in fiscal 2013 compared to \$549.7 million in fiscal 2012. Our comparable brand revenue growth increased by 31% in fiscal 2013 compared to fiscal 2012. We believe that the increase in comparable brand revenue, comparable store sales and direct sales was due primarily to our customers' favorable reaction to our merchandise assortment, including the expansion of existing product categories, and the introduction of new product categories.

#### ***Gross profit***

Gross profit increased \$120.4 million, or 27.6%, to \$556.9 million in fiscal 2013 from \$436.4 million in fiscal 2012. As a percentage of net revenues, gross margin decreased 0.7% to 35.9% of net revenues in fiscal 2013 from 36.6% of net revenues in fiscal 2012.

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In fiscal 2012, we incurred a \$3.3 million charge related to increased tariff obligations of one of our foreign suppliers following the U.S. Department of Commerce's review of the anti-dumping duty order on wooden bedroom furniture from China for the period from January 1, 2011 through December 31, 2011. Excluding the impact associated with this obligation, gross margin decreased 1.0% to 35.9% of net revenues in fiscal 2013 from 36.9% in fiscal 2012. This decrease was primarily driven by strategic pricing on new product introductions and changes in product mix. In addition, gross profit as a percentage of net revenues decreased due to increased freight costs resulting from a larger percentage of furniture sales during the period, which incur higher shipping costs than our other products. These decreases in gross profit as a percentage of net revenues were partially offset by improvement in store occupancy costs from improved leverage on the fixed portion of such costs.

### ***Selling, general and administrative expenses***

Selling, general and administrative expenses decreased \$3.5 million, or 0.7%, to \$502.0 million in fiscal 2013 compared to \$505.5 million in fiscal 2012.

Selling, general and administrative expenses in fiscal 2013 included: (i) a \$33.7 million non-cash compensation charge related to the one-time, fully vested option to Mr. Friedman upon his reappointment as Chairman and Co-Chief Executive Officer, (ii) a \$29.5 million non-cash compensation charge related to the performance-based vesting of certain shares granted to Mr. Friedman in connection with the Reorganization and initial public offering, and (iii) \$2.9 million of costs incurred in connection with our follow-on offerings in May 2013 and July 2013.

Selling, general and administrative expenses for fiscal 2012 included (i) a \$92.0 million non-cash compensation charge related to equity grants at the time of the Reorganization and initial public offering, (ii) a \$23.1 million non-cash compensation charge related to the performance-based vesting of certain shares granted to Mr. Alberini and Mr. Friedman in connection with the Reorganization and initial public offering, (iii) \$10.8 million of costs incurred in connection with our initial public offering, including a fee of \$7.0 million to Catterton, Tower Three and Glenhill in accordance with our management services agreement, payments of \$2.2 million to certain former executives and bonus payments to employees of \$1.3 million, and (iv) \$4.8 million of legal and other professional fees incurred in connection with the investigation conducted by the special committee of the board of directors relating to Mr. Friedman and our subsequent remedial actions.

The increase in selling, general and administrative expenses, excluding the one-time and non-cash compensation items mentioned above, was primarily related to an increase in employment costs, an increase in credit card fees due to increased revenues and an increase in corporate occupancy costs. These increases were partially offset by a decrease in advertising and marketing costs as a result of modifying our Source Book strategy in fiscal 2013 to eliminate the Fall Source Book.

Excluding the one-time and non-cash compensations items in fiscal 2013 and fiscal 2012 mentioned above, selling, general and administrative expenses were 28.1% of net revenues in fiscal 2013 compared to 31.4% of net revenues in fiscal 2012. The improvement in selling, general and administrative expenses as a percentage of net revenues was primarily driven by a decrease in advertising and marketing costs due to the change in the Source Book strategy.

### ***Interest expense***

Interest expense was \$5.7 million in fiscal 2013 compared to \$5.8 million in fiscal 2012. This decrease was primarily due to a decrease in the average borrowings under the revolving line of credit in fiscal 2013 compared to fiscal 2012 partially offset by interest expense of \$1.1 million in fiscal 2013 related to accounting for build-to-suit transactions under ASC 840 for certain of our Full Line Design Galleries.

***Income tax expense (benefit)***

Income tax expense increased \$92.9 million to a \$30.9 million expense in fiscal 2013 compared to a benefit of \$62.0 million in fiscal 2012. Our effective tax rate was 63.0% in fiscal 2013 compared to 82.9% in fiscal 2012. The fiscal 2013 effective tax rate was significantly impacted by (i) non-deductible stock-based compensation and (ii) other non-deductible expenses. The fiscal 2012 effective tax rate was significantly impacted by (i) our reporting a loss before income taxes, (ii) the release of the U.S. valuation allowance against our net deferred tax assets, and (iii) non-deductible stock-based compensation. By the end of fiscal 2012, our U.S. operations achieved a position of cumulative profits (adjusted for permanent differences) for the most recent three-year period, and this coupled with our business plan for profitability in future periods, provided assurance that our future tax benefits are more likely than not to be realized. Accordingly, in the fourth quarter of fiscal 2012 we released \$57.2 million of our U.S. valuation allowance against net deferred tax assets.

**Fiscal 2012 Compared to Fiscal 2011**

***Net revenues***

Net revenues increased \$234.9 million, or 24.5%, to \$1,193.0 million in fiscal 2012 compared to \$958.1 million in fiscal 2011. We had 71 and 74 retail stores open at February 1, 2014 and January 28, 2012, respectively. Stores sales increased \$108.9 million, or 20.4%, to \$643.3 million in fiscal 2012 compared to \$534.4 million in fiscal 2011 due in large part to our comparable store sales increase of 28% in fiscal 2012 compared to fiscal 2011, partially offset by having fewer stores open during fiscal 2012 compared to fiscal 2011. Direct sales increased \$126.0 million, or 29.8%, to \$549.7 million in fiscal 2012 compared to \$423.7 million in fiscal 2011. Our comparable brand revenue growth increased by 28% in fiscal 2012 compared to fiscal 2011. We believe that the increase in comparable brand revenue, comparable store sales and direct sales was due primarily to our customers' favorable reaction to our merchandise assortment, including the expansion of existing product categories, new product categories, and an increase in catalog pages circulated.

***Gross profit***

Gross profit increased \$80.1 million, or 22.5%, to \$436.4 million in fiscal 2012 from \$356.3 million in fiscal 2011. As a percentage of net revenues, gross margin decreased 0.6% to 36.6% of net revenues in fiscal 2012 from 37.2% of net revenues in fiscal 2011.

In fiscal 2012, we incurred a \$3.3 million charge related to increased tariff obligations of one of our foreign suppliers following the U.S. Department of Commerce's review of the anti-dumping duty order on wooden bedroom furniture from China for the period from January 1, 2011 through December 31, 2011. Excluding the impact associated with this obligation, gross margin decreased 0.3% to 36.9% of net revenues in fiscal 2012 from 37.2% in fiscal 2011. This decrease was primarily driven by changes in product mix, strategic pricing on new product introductions and increased promotional activity. In addition, gross margin decreased due to increased freight costs resulting from a higher percentage of furniture sales during the period, as furniture deliveries require greater shipping costs than our other products. These decreases in gross margins as a percentage of net revenues were partially offset by improvement in occupancy costs from improved leverage on the fixed portion of our store and distribution center occupancy costs.

***Selling, general and administrative expenses***

Selling, general and administrative expenses increased \$176.0 million, or 53.4%, to \$505.5 million in fiscal 2012 compared to \$329.5 million in fiscal 2011.

Selling, general and administrative expenses for fiscal 2012 included (i) a \$92.0 million non-cash compensation charge related to equity grants at the time of the Reorganization and initial public offering, (ii) a \$23.1 million non-cash compensation charge related to the performance-based vesting of certain shares granted

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to Mr. Alberini and Mr. Friedman in connection with the Reorganization and initial public offering, (iii) \$10.8 million of costs incurred in connection with our initial public offering, including a fee of \$7.0 million to Catterton, Tower Three and Glenhill in accordance with our management services agreement, payments of \$2.2 million to certain former executives and bonus payments to employees of \$1.3 million, and (iv) \$4.8 million of legal and other professional fees incurred in connection with the investigation conducted by the special committee of the board of directors relating to Mr. Friedman and our subsequent remedial actions.

Selling, general and administrative expenses for fiscal 2011 included a \$6.4 million non-cash compensation charge related to the repayment of loans to Mr. Friedman from Home Holdings through the reclassification by Home Holdings of certain pre-Reorganization ownership units in Home Holdings held by Mr. Friedman at that time.

The increase in selling, general and administrative expenses, excluding the one-time and non-cash compensation items mentioned above, was primarily related to advertising and marketing costs associated with increased catalog circulation, an increase in employment costs, an increase in credit card fees increased due to growth in revenues and an increase in occupancy costs.

Excluding the one-time and non-cash compensations items mentioned above, selling, general and administrative expenses were 31.8% of net revenues in fiscal 2012 compared to 33.7% of net revenues in fiscal 2011. The improvement in selling, general and administrative expenses as a percentage of net revenues was primarily driven by reductions in employment costs, professional fees and occupancy costs, in each case as a percentage of net revenues, due to leverage on the fixed portion of these expenses. These reductions were partially offset by an increase in advertising and marketing costs associated with increased catalog circulation.

### ***Interest expense***

Interest expense was \$5.8 million in fiscal 2012 compared to \$5.1 million in fiscal 2011. This increase was primarily due to the higher interest rate under the modified revolving line of credit agreement entered into in August 2011, higher borrowings under the revolving line of credit, as well as interest related to the term loan entered into in January 2012.

### ***Income tax expense (benefit)***

Income tax benefit increased \$63.1 million to a \$62.0 million benefit in fiscal 2012 compared to an expense of \$1.1 million in fiscal 2011. Our effective tax rate was 82.9% in fiscal 2012 compared to 5.2% in fiscal 2011. The increase in the tax benefit was primarily attributable to the reversal of the U.S. valuation allowance against our net deferred tax assets, resulting in a \$57.2 million benefit in our provision for income taxes. By the end of fiscal 2012, our U.S. operations achieved a position of cumulative profits (adjusted for permanent differences) for the most recent three-year period. We concluded that this record of cumulative profitability in recent years, coupled with our business plan for profitability in future periods, provided assurance that our future tax benefits are more likely than not to be realized. Accordingly, in the fourth quarter of fiscal 2012, we released all of our U.S. valuation allowance against net deferred tax assets.

## **Quarterly Results**

The following table sets forth our historical quarterly consolidated statements of income for each of the last eight fiscal quarters ended through February 1, 2014. 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 present fairly 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*.

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Our quarterly results have historically varied depending upon a variety of factors, including our product offerings, promotional events, store openings, shifts in the timing of holidays and timing of catalog releases, 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. During these peak periods of working capital requirements, we have historically increased our borrowings under the Restoration Hardware, Inc. revolving line of credit. As such, results of a period shorter than a full year may not be indicative of results expected for the entire year.

	Fiscal 2012				Fiscal 2013			
	First Quarter	Second Quarter <sup>(1)</sup>	Third Quarter <sup>(1)</sup>	Fourth Quarter <sup>(2)</sup>	First Quarter <sup>(3)</sup>	Second Quarter <sup>(4)</sup>	Third Quarter	Fourth Quarter
	(dollars in thousands)							
Net revenues	\$ 217,914	\$ 292,906	\$ 284,171	\$ 398,055	\$ 301,337	\$ 382,098	\$ 395,832	\$ 471,694
Cost of goods sold	142,646	178,779	182,291	252,881	199,460	242,872	255,032	296,717
Gross profit	75,268	114,127	101,880	145,174	101,877	139,226	140,800	174,977
Selling, general, and administrative expenses	77,365	94,465	99,886	233,769	101,366	167,006	116,940	116,717
Income (loss) from operations	(2,097)	19,662	1,994	(88,595)	511	(27,780)	23,860	58,260
Interest expense	(1,575)	(1,479)	(1,544)	(1,178)	(840)	(1,191)	(2,165)	(1,537)
Income (loss) before income taxes	(3,672)	18,183	450	(89,773)	(329)	(28,971)	21,695	56,723
Income tax expense (benefit)	56	567	(1,235)	(61,411)	(168)	(11,136)	12,146	30,081
Net income (loss)	<u>\$ (3,728)</u>	<u>\$ 17,616</u>	<u>\$ 1,685</u>	<u>\$ (28,362)</u>	<u>\$ (161)</u>	<u>\$ (17,835)</u>	<u>\$ 9,549</u>	<u>\$ 26,642</u>
Adjusted net income (loss) <sup>(5)</sup>	\$ (1,324)	\$ 12,245	\$ 2,662	\$ 24,156	\$ 2,257	\$ 19,793	\$ 13,017	\$ 34,034
Adjusted EBITDA <sup>(6)</sup>	\$ 6,159	\$ 28,738	\$ 12,973	\$ 48,701	\$ 11,231	\$ 40,778	\$ 30,591	\$ 65,955
Comparable brand revenue growth <sup>(7)</sup>	23%	30%	27%	29%	39%	30%	38%	24%
Comparable store sales <sup>(8)</sup>	26%	31%	29%	26%	41%	26%	29%	17%

- (1) The second and third quarters of fiscal 2012 include \$2.0 million and \$2.8 million, respectively, of legal and other professional fees incurred in connection with the investigation conducted by the special committee of the board of directors relating to our Chief Executive Officer, Gary Friedman, and our subsequent remedial actions.
- (2) The fourth quarter of fiscal 2012 includes (i) a \$92.0 million non-cash compensation charge related to equity grants at the time of the Reorganization, (ii) a non-cash compensation charge of \$23.1 million related to the performance-based vesting of certain shares granted to Mr. Alberini and Mr. Friedman, (iii) costs incurred in connection with our initial public offering, including a fee of \$7.0 million to Catterton, Tower Three and Glenhill in accordance with our management services agreement, payments of \$2.2 million to certain former executives and bonus payments to employees of \$1.3 million and (iv) \$3.3 million incurred as a result of increased tariff obligations of one of our foreign suppliers following the U.S. Department of Commerce's review of the anti-dumping duty order on wooden bedroom furniture from China for the period from January 1, 2011 through December 31, 2011. In addition, as of the end of fiscal 2012, our U.S. operations achieved a position of cumulative profits (adjusted for permanent differences) for the most recent three-year period. We concluded that this record of cumulative profitability in recent years, coupled with our business plan for profitability in future periods, provided assurance that our future tax benefits more likely than not would be realized. Accordingly, in the fourth fiscal quarter of 2012, we released all of our U.S. valuation allowance of \$57.2 million against net deferred tax assets.

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- (3) The first quarter of fiscal 2013 includes (i) a \$3.3 million non-cash compensation charge related to the performance-based vesting of certain shares granted to Mr. Friedman and (ii) \$0.8 million of costs incurred in connection with our follow-on offering in May 2013.
- (4) The second quarter of fiscal 2013 includes (i) a \$33.7 million non-cash compensation charge related to the one-time, fully vested option granted to Mr. Friedman upon his reappointment as Chairman and Co-Chief Executive Officer in July 2013, (ii) a \$26.2 million non-cash compensation charge related to the performance-based vesting of certain shares granted to Mr. Friedman and (iii) \$2.1 million of legal and other professional fees incurred in connection with our follow-on offerings in May 2013 and July 2013.
- (5) Adjusted net income (loss) is a supplemental measure of financial performance that is not required by, or presented in accordance with, GAAP. We define adjusted net income (loss) as consolidated net income (loss), adjusted for the impact of certain non-recurring and other items that we do not consider representative of our ongoing operating performance. Adjusted net income (loss) is included in this filing because management believes that adjusted net income (loss) 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 (loss) for the periods indicated below.

	Fiscal 2012				Fiscal 2013			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
Net income (loss)	\$(3,728)	\$17,616	\$ 1,685	\$ (28,362)	\$ (161)	\$(17,835)	\$ 9,549	\$26,642
Adjustments pre-tax:								
Management and board fees <sup>(a)</sup>	889	1,198	1,198	973	—	—	—	—
Non-cash and other one-time compensation <sup>(b)</sup>	—	—	—	115,055	3,323	59,832	—	—
Lease termination costs <sup>(c)</sup>	575	(961)	—	—	—	—	—	—
Special committee investigation <sup>(d)</sup>	—	1,989	2,789	—	—	—	—	—
Initial public offering costs <sup>(e)</sup>	—	—	—	10,755	—	—	—	—
Anti-dumping exposure <sup>(f)</sup>	—	—	—	3,250	—	—	—	—
Follow-on offering fees <sup>(g)</sup>	—	—	—	—	767	2,128	—	—
Subtotal adjusted items	1,464	2,226	3,987	130,033	4,090	61,960	—	—
Impact of income tax items <sup>(h)</sup>	940	(7,597)	(3,010)	(77,515)	(1,672)	(24,332)	3,468	7,392
Adjusted net income (loss)	<u>\$(1,324)</u>	<u>\$12,245</u>	<u>\$ 2,662</u>	<u>\$ 24,156</u>	<u>\$ 2,257</u>	<u>\$ 19,793</u>	<u>\$13,017</u>	<u>\$34,034</u>

(a) Includes fees and expenses paid in accordance with our management services agreement with Home Holdings, as well as fees and expense reimbursements paid to our board of directors prior to the initial public offering.

(b) The fourth quarter of fiscal 2012 includes a \$92.0 million non-cash compensation charge related to equity grants at the time of the Reorganization, as well as a non-cash compensation charge of \$23.1 million related to the performance-based vesting of certain shares granted to Mr. Alberini and Mr. Friedman. The first quarter of fiscal 2013 includes a non-cash compensation charge of \$3.3 million related to the performance-based vesting of certain shares granted to Mr. Friedman. The second quarter of fiscal 2013 includes a \$33.7 million non-cash compensation charge related to the one-time, fully vested option granted to Mr. Friedman upon his reappointment as Chairman and Co-Chief Executive

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Officer in July 2013 and a \$26.2 million non-cash compensation charge related to the performance-based vesting of certain shares granted to Mr. Friedman.

- (c) Represents changes in estimates of future lease payments related to lease termination cost liabilities for retail stores that were closed prior to their respective lease termination dates.
- (d) Represents legal and other professional fees incurred in connection with the investigation conducted by the special committee of the board of directors relating to our Chief Executive Officer, Gary Friedman, and our subsequent remedial actions.
- (e) Represents costs incurred in connection with our initial public offering, including a fee of \$7.0 million to Catterton, Tower Three and Glenhill in accordance with our management services agreement, payments of \$2.2 million to certain former executives and bonus payments to employees of \$1.3 million.
- (f) Represents expense incurred as a result of increased tariff obligations of one of our foreign suppliers following the U.S. Department of Commerce's review of the anti-dumping duty order on wooden bedroom furniture from China for the period from January 1, 2011 through December 31, 2011.
- (g) Represents legal and other professional fees incurred in connection with our follow-on offerings in May 2013 and July 2013.
- (h) As of the end of fiscal 2012, our U.S. operations achieved a position of cumulative profits for the most recent three-year period. We concluded that this record of cumulative profitability in recent years, coupled with our business plan for profitability in future periods provided assurance that our future tax benefits more likely than not would be realized. Accordingly, in the fourth quarter of fiscal 2012, we released all of our U.S. valuation allowance against net deferred tax assets. In addition, income tax items exclude the tax benefit related to the resolution of our Canada Revenue Agency examination in the third quarter of fiscal 2012, exclude the tax benefit from the utilization of federal and state net operating losses, and assume a normalized tax rate of 40% for all periods.

- (6) 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. For further discussion of the use of EBITDA and Adjusted EBITDA, see footnote 12 to the table included in "Selected Consolidated Financial Data".

	Fiscal 2012				Fiscal 2013			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
	(in thousands)							
Net income (loss)	\$(3,728)	\$17,616	\$ 1,685	\$(28,362)	\$ (161)	\$(17,835)	\$ 9,549	\$26,642
Depreciation and amortization	6,424	6,468	6,593	7,263	6,630	6,598	6,731	7,695
Interest expense	1,575	1,479	1,544	1,178	840	1,191	2,165	1,537
Income tax expense (benefit)	56	567	(1,235)	(61,411)	(168)	(11,136)	12,146	30,081
EBITDA	4,327	26,130	8,587	(81,332)	7,141	(21,182)	30,591	65,955
Management and board fees <sup>(i)</sup>	889	1,198	1,198	973	—	—	—	—
Non-cash and other one-time compensation <sup>(i)</sup>	387	351	364	115,055	3,323	59,832	—	—
Lease termination costs <sup>(k)</sup>	575	(961)	—	—	—	—	—	—
Special committee investigation <sup>(l)</sup>	—	1,989	2,789	—	—	—	—	—
Initial public offering costs <sup>(m)</sup>	—	—	—	10,755	—	—	—	—
Anti-dumping exposure <sup>(n)</sup>	—	—	—	3,250	—	—	—	—
Follow-on offering fees <sup>(o)</sup>	—	—	—	—	767	2,128	—	—
Other <sup>(p)</sup>	(19)	31	35	—	—	—	—	—
Adjusted EBITDA	<u>\$ 6,159</u>	<u>\$28,738</u>	<u>\$12,973</u>	<u>\$ 48,701</u>	<u>\$11,231</u>	<u>\$ 40,778</u>	<u>\$30,591</u>	<u>\$65,955</u>



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- (i) Includes fees and expenses paid in accordance with our management services agreement with Home Holdings, as well as fees and expense reimbursements paid to our board of directors prior to the initial public offering.
  - (j) The fourth quarter of fiscal 2012 includes a \$92.0 million non-cash compensation charge related to equity grants at the time of the Reorganization, as well as a non-cash compensation charge of \$23.1 million related to the performance-based vesting of certain shares granted to Mr. Alberini and Mr. Friedman. The first quarter of fiscal 2013 includes a non-cash compensation charge of \$3.3 million related to the performance-based vesting of certain shares granted to Mr. Friedman. The second quarter of fiscal 2013 includes a \$33.7 million non-cash compensation charged related to the one-time, fully vested option granted to Mr. Friedman upon his reappointment as Chairman and Co-Chief Executive Officer in July 2013 and a \$26.2 million non-cash compensation charge related to the performance-based vesting of certain shares granted to Mr. Friedman. In addition, amounts include stock-based compensation expense incurred prior to our initial public offering.
  - (k) Represents changes in estimates of future lease payments related to lease termination cost liabilities for retail stores that were closed prior to their respective lease termination dates.
  - (l) Represents legal and other professional fees incurred in connection with the investigation conducted by the special committee of the board of directors relating to Mr. Friedman and our subsequent remedial actions.
  - (m) Represents costs incurred in connection with our initial public offering, including a fee of \$7.0 million to Catterton, Tower Three and Glenhill in accordance with our management services agreement, payments of \$2.2 million to certain former executives and bonus payments to employees of \$1.3 million.
  - (n) Represents expense incurred as a result of increased tariff obligations of one of our foreign suppliers following the U.S. Department of Commerce's review of the anti-dumping duty order on wooden bedroom furniture from China for the period from January 1, 2011 through December 31, 2011.
  - (o) Represents legal and other professional fees incurred in connection with our follow-on offerings in May 2013 and July 2013.
  - (p) Represents items which management believes are not indicative of our ongoing operating performance which includes foreign exchange gains and losses.
- (7) Comparable brand revenue growth includes retail comparable store sales, including Baby & Child Galleries, and direct net revenues. Comparable brand revenue growth excludes retail non-comparable store sales and outlet store net revenues. Refer to footnote (8) below for a definition of comparable store sales. Because the fourth quarter of fiscal 2012 was a 14-week quarter, comparable brand revenue growth percentage for fourth quarter of fiscal 2012 excludes the extra week of revenue.
- (8) Comparable store sales have been calculated based upon retail stores that were open at least fourteen full months as of the end of the reporting period and did not change square footage by more than 20% between periods. If a store is closed for seven days during a month, that month will be excluded from comparable store sales. Comparable store net revenues exclude revenues from outlet stores. Because the fourth quarter of fiscal 2012 was a 14-week quarter, comparable store sales change percentage for fourth quarter of fiscal 2012 excludes the extra week of sales.

## **Liquidity and Capital Resources**

### ***General***

Our business relies on cash flows from operations and the revolving line of credit as our primary sources of liquidity. Our primary cash needs are for merchandise inventories, payroll, Source Books and other catalogs, store rent, capital expenditures associated with opening new stores and updating existing stores, as well as infrastructure and information technology. The most significant components of our working capital are cash and cash equivalents, merchandise inventories, accounts receivable, accounts payable and other current liabilities. Our working capital varies as a result of increases in our inventory levels and costs related to our catalogs and our borrowings have generally increased as a result of the growth of our business and ongoing transformation of

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our retail stores. We believe that cash expected to be generated from operations, and borrowing availability under the revolving line of credit or other financing arrangements, will be sufficient to meet working capital requirements, anticipated capital expenditures and payments due under our revolving line of credit for at least the next 12 – 24 months. Our investments in capital expenditures for fiscal 2013 totaled \$93.9 million. We expect to have capital expenditures of approximately \$115 million to \$125 million in fiscal 2014, primarily related to our efforts to continue our growth and expansion, including construction of Full Line Design Galleries and infrastructure investments.

### **Cash Flow Analysis**

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

	Year Ended		
	February 1, 2014	February 2, 2013	January 28, 2012
	(in thousands)		
Provided by (used in) operating activities	\$ 87,521	\$ (3,864)	\$ 17,121
Used in investing activities	(93,868)	(49,368)	(25,593)
Provided by financing activities	11,505	53,052	3,371
Increase (decrease) in cash and cash equivalents	5,035	(158)	(4,852)
Cash and cash equivalents at end of period	13,389	8,354	8,512

### **Net Cash Used In Operating Activities**

Cash from operating activities consists primarily of net income (loss) adjusted for non-cash items including depreciation and amortization, stock-based compensation and the effect of changes in working capital and other activities.

For fiscal 2013, net cash provided by operating activities was \$87.5 million and consisted of net income of \$18.2 million and non-cash items of \$99.2 million, offset by a decrease in working capital and other activities of \$29.9 million. Non-cash items of \$99.2 million include stock-based compensation expense of \$67.6 million, depreciation and amortization of \$27.7 million, and an increase in our deferred income tax of \$5.6 million. The decrease in working capital and other activities consisted primarily of increases in inventory of \$100.9 million to support our growth, increases in prepaid expenses of \$22.8 million primarily due to an increase in vendor deposits and capitalized catalog costs, and increases in accounts receivable of \$5.0 million due to revenue growth and tenant improvements. These uses of cash from working capital components were partially offset by increases in accrued liabilities and accounts payable of \$57.3 million primarily due to timing of payments, increases in other current liabilities of \$30.4 million due to federal and state tax liabilities and an increase in our customer return reserve, increases in deferred revenue and customer deposits of \$7.3 million due to the timing of shipments made at fiscal year end, as well as increases in deferred rent and lease incentives of \$7.2 million primarily due to entering into new lease agreements for Full Line Design Gallery and new distribution center locations.

For fiscal 2012, net cash used in operating activities was \$3.9 million and consisted of an increase in working capital and other activities of \$73.0 million and a net loss of \$12.8 million, offset by non-cash items of \$81.9 million. Non-cash items of \$81.9 million include a \$92.0 million compensation charge related to equity activity at the time of the Reorganization, a compensation charge of \$23.1 million related to the performance-based vesting of certain shares granted to Mr. Alberini and Mr. Friedman subsequent to the Reorganization and depreciation and amortization of \$26.7 million, offset by the release of our U.S. valuation allowance in fiscal 2012 of \$57.2 million and a decrease in our non-cash income tax adjustments of \$4.7 million. The increase in working capital and other activities consisted primarily of increases in inventory of \$107.5 million as part of our strategy to improve our inventory position to meet demand levels, prepaid expenses of \$24.5 million primarily

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due to an increase in catalog costs associated with the Source Book strategy and accounts receivable of \$5.3 million due to timing of payments received related to our credit card receivables. These uses of cash from working capital components were partially offset by increases in accrued liabilities and accounts payable of \$36.2 million primarily due to timing of payments, increases in deferred revenue and customer deposits of \$16.2 million due to the timing of shipments made at fiscal year end, as well as increases in deferred rent and lease incentives of \$10.9 million primarily due to entering into new lease agreements for Full Line Design Gallery locations.

For fiscal 2011, net cash provided by operating activities was \$17.1 million and consisted of net income of \$20.6 million and non-cash items of \$48.6 million, offset by an increase in working capital and other activities of \$52.1 million. Non-cash items of \$48.6 million include expenses of \$6.4 million related to the repayment of the executive loan by Mr. Friedman and \$6.0 million for the management fee to Catterton, Tower Three and Glenhill, both incurred by Home Holdings on our behalf and reflected as capital contributions. The increase in working capital and other activities consisted primarily of increases in inventory of \$39.5 million in anticipation of future demand and as a result of the increased capacity due to opening a new distribution center in fiscal 2011, prepaid expenses of \$36.4 million primarily due to an increase in catalog costs associated with the Source Book strategy and accounts receivable of \$7.3 million due to timing of payments received related to our credit card receivables. These uses of cash from working capital components were offset by sources of cash from increases in accrued liabilities and accounts payable of \$14.4 million primarily due to timing of payments, increases in deferred revenue and customer deposits of \$11.4 million due to the timing of shipments made at fiscal year end, as well as increases in other current liabilities of \$3.9 million primarily due to an increase in gift certificate-related liabilities.

### ***Net Cash Used In Investing Activities***

Investing activities consist primarily of investments in capital expenditures related to new store openings and improvements and in supply chain and systems infrastructure.

For fiscal 2013, net cash used in investing activities was \$93.9 million primarily as a result of investments in new stores, investment in supply chain and systems infrastructure, renovations to our corporate headquarters and investment in information technology.

For fiscal 2012, net cash used in investing activities was \$49.4 million primarily as a result of investments in new stores, investment in supply chain and systems infrastructure and the purchase of a new domain name.

For fiscal 2011, capital expenditures were \$25.6 million as a result of investments in new stores and investment in supply chain and systems infrastructure.

### ***Net Cash Provided By Financing Activities***

Financing activities consist primarily of borrowings and repayments related to the revolving line of credit, term loan and capital contributions.

For fiscal 2013, net cash provided by financing activities was \$11.5 million primarily due to net proceeds from the exercise of stock options of \$7.6 million, excess tax benefits from the exercise of stock options of \$3.7 million and net borrowings under the revolving line of credit of \$2.9 million, partially offset by payments on capital lease obligations of \$2.6 million.

For fiscal 2012, net cash provided by financing activities was \$53.1 million primarily due to the issuance of common stock which generated proceeds of \$106.8 million, partially offset by issuance costs of \$9.1 million. This overall increase in cash provided by the initial public offering was partially offset by net repayments under the revolving line of credit of \$25.0 million, the repayment in full of the term loan of \$15.0 million and payments on capital lease obligations of \$4.2 million.

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For fiscal 2011, net cash provided by financing activities was \$3.4 million primarily due to entering into an amendment to Restoration Hardware, Inc.'s credit agreement, for the purpose of incorporating a term loan facility for \$15.0 million in January 2012. This increase is offset by net repayments under the revolving line of credit of \$4.6 million, debt issuance costs related to the amended credit agreement and term loan of \$2.8 million, as well as payments on capital lease obligations of \$4.2 million.

### ***Revolving Line of Credit***

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. This credit agreement modified a previous facility under which Restoration Hardware, Inc. had a revolving line of credit for up to \$190.0 million. Under the credit agreement, which has a maturity date of August 3, 2016, Restoration Hardware, Inc. has a revolving line of credit available of up to \$417.5 million (following Restoration Hardware, Inc.'s exercise of the commitment increase option on November 1, 2012, as described below), of which \$10.0 million is available to Restoration Hardware Canada, Inc. The credit agreement was further amended in January 2012 to add a \$15.0 million term loan facility with a maturity date of July 6, 2015, which was repaid in full on November 7, 2012, as described below.

Under the credit agreement's commitment increase provision, Restoration Hardware, Inc. had the option to increase the amount of the revolving line of credit by up to an additional \$100.0 million, provided that, among other things, the existing lenders or additional lenders agreed to participate in the increased loan commitments under the revolving line of credit, no default under the credit agreement then existed or would result from such increase and sufficient borrowing base collateral was available to support increased loan amounts. On November 1, 2012, Restoration Hardware, Inc. increased the amount of the revolving line of credit by \$100.0 million pursuant to this commitment increase provision.

On November 7, 2012, Restoration Hardware, Inc. made payments of \$75.7 million on its revolving line of credit and repaid its outstanding term loan of \$15.0 million in full. Such payments were funded from the proceeds received as a result of our initial public offering.

The availability of credit at any given time under the revolving line of credit is limited by reference to a borrowing base formula based upon numerous factors, including the value of eligible inventory, eligible accounts receivable, eligible real estate, and, in the case of the term loan, registered trade names and reserves established by the administrative agent. As a result of the borrowing base formula, the 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 Restoration Hardware, Inc.'s assets, including accounts receivable, inventory, intangible assets, property, equipment, goods and fixtures.

Borrowings under the revolving line of credit are subject to interest, at the borrowers' option, at either the bank's reference rate or LIBOR (or the 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 weighted-average interest rate for the revolving line of credit was 2.80% as of February 1, 2014.

As of February 1, 2014, \$85.4 million was outstanding under the revolving line of credit. As of February 1, 2014, Restoration Hardware, Inc.'s undrawn borrowing availability under the revolving line of credit was \$261.7 million and there were \$18.9 million in outstanding letters of credit.

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

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transactions with affiliates, along with other restrictions and limitations typical to credit agreements of this type and size. The credit agreement does not contain any significant financial or coverage ratio covenants unless the availability under the revolving line of credit is less than the greater of (i) \$17.5 million and (ii) 10% of the lesser of (A) the aggregate maximum commitments under the revolving line of credit and (B) the domestic borrowing base. If the availability under the revolving line of credit is less than the foregoing amount, then Restoration Hardware, Inc. is required to maintain a consolidated fixed charge coverage ratio of at least one to one. Such ratio is approximately the ratio on the last day of each month on a trailing twelve-month basis of (a) (i) consolidated EBITDA (as defined in the agreement) minus (ii) capital expenditures, minus (iii) the income taxes paid in cash to (b) the sum of (i) debt service charges plus (ii) certain dividends and distributions paid. As of February 1, 2014, Restoration Hardware, Inc. was in compliance with all covenants, and if the availability under the revolving line of credit were less than the amount described above, Restoration Hardware, Inc. would have been in compliance with the consolidated fixed charge coverage ratio described in the previous sentence. The credit agreement requires a daily sweep of cash to prepay the loans under the credit agreement while (i) an event of default exists or (ii) the availability under the revolving line of credit for extensions of credit to Restoration Hardware, Inc. is less than the greater of (A) \$20.0 million and (B) 15% of the lesser of the aggregate maximum commitments and the domestic borrowing base.

### **Contractual Obligations**

We enter into long term contractual obligations and commitments, primarily debt obligations and non-cancelable operating leases, in the normal course of business. As of February 1, 2014, our contractual cash obligations over the next several periods were as follows:

	Payments Due by Period				
	Total	2014	2015-2016	2017-2018	Thereafter
			(in thousands)		
Revolving line of credit <sup>(1)</sup>	\$ 85,425	\$ —	\$ 85,425	\$ —	\$ —
Capital lease obligations	2,256	1,844	341	71	—
Operating leases <sup>(2)</sup>	612,667	68,709	119,368	100,599	323,991
Other long-term obligations <sup>(3)</sup>	143,001	48,352	17,510	16,659	60,480
Letters of credit	18,862	18,862	—	—	—
Total	<u>\$ 862,211</u>	<u>\$ 137,767</u>	<u>\$ 222,644</u>	<u>\$ 117,329</u>	<u>\$ 384,471</u>

- (1) Excludes estimated interest under the revolving line of credit. Interest costs for the revolving line of credit have been estimated based on interest rates in effect for our indebtedness as of February 1, 2014, as well as estimated borrowing levels in the future based upon planned inventory purchases. Actual borrowing levels and interest costs may differ. The revolving line of credit has a maturity date of August 3, 2016.
- (2) We enter into operating leases in the normal course of business. Most lease arrangements provide us with the option to renew the leases at defined terms. The future operating lease obligations would change if we were to exercise these options, or if we were to enter into additional new operating leases. Amounts above do not include estimated contingent rent due under operating leases of \$2.0 million at February 1, 2014.
- (3) Other long-term obligations include estimated timing and amounts of payments for rent and tenant improvements associated with build-to-suit lease arrangements.

The liability of \$1.4 million as of February 1, 2014, for unrecognized tax benefits associated with uncertain tax positions (see Note 10—*Income Taxes* to our audited consolidated financial statements) has not been included in the contractual obligations table above because 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, 2014.

## **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.

Management evaluated the development and selection of its critical accounting policies and estimates and believes that the following involve a higher degree of judgment or complexity and are most significant to reporting our 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. With respect to critical accounting policies, even a relatively minor variance between actual and expected experience can potentially have a materially favorable or unfavorable impact on subsequent results of operations. However, our historical results for the periods presented in the consolidated financial statements have not been materially impacted by such variances. More information on all of our significant accounting policies can be found in Note 3—*Significant Accounting Policies* to our audited consolidated financial statements.

### ***Revenue Recognition***

We recognize revenues and the related cost of goods sold when merchandise is received by our customers. Revenues from “cash-and-carry” store sales are recognized at the point of sale in the store. Revenues from direct-to-customer and home-delivered sales are recognized when the merchandise is delivered to the customer. Discounts provided to customers are accounted for as a reduction of sales.

We recognize shipping and handling fees as revenue when the merchandise is received by our customers. Costs of shipping and handling are included in cost of goods sold.

Sales tax collected is not recognized as revenue as it is ultimately remitted to governmental authorities.

We reserve for projected merchandise returns based on actual, historical experience and various other assumptions that we believe to be reasonable. Actual merchandise returns are monitored regularly and have not been materially different from the estimates recorded. Merchandise returns are granted for various reasons, including delays in product delivery, product quality issues, customer preference and other similar matters. Product returned often represents merchandise that can be resold. Amounts refunded to customers are generally made by issuing the same payment tender as used in 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.

### ***Merchandise Inventories***

Our merchandise inventories are composed of finished goods and are carried at the lower of cost or market, with cost determined on a weighted-average cost method and market determined based on the estimated net realizable value. To determine if the value of inventory should be marked down below original cost, we consider 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 significant estimates used in inventory valuation are obsolescence (including excess and slow-moving inventory and lower of cost or market reserves)

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and estimates of inventory shrinkage. We adjust our inventory for obsolescence based on historical trends, aging reports, specific identification and our estimates of future retail sales prices.

Reserves for shrinkage are estimated and recorded throughout the period as a percentage of net sales 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 our annual physical inventory count. Actual inventory shrinkage and obsolescence can vary from estimates due to factors including the mix of our inventory (which ranges from large furniture to decorative accessories) and execution against loss prevention initiatives in our stores, distribution centers, off-site storage locations and with third-party transportation providers.

Due to these factors, our obsolescence and shrinkage reserves contain uncertainties. Both estimates have calculations 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. If actual observed obsolescence or periodic updates of our shrinkage estimates differ from our original estimates, we adjust our inventory reserves accordingly throughout the period. Management does not believe that changes in the assumptions used in these estimates would have a significant effect on our net income or inventory balances. We have not made any material changes to our assumptions included in the calculations of the obsolescence and shrinkage reserves during the periods presented or recorded significant adjustments related to the physical inventory process.

### ***Advertising Expenses***

Advertising expenses primarily represent the costs associated with our catalog mailings, as well as print and website marketing.

### ***Capitalized Catalog Costs***

Capitalized catalog costs consist primarily of third-party incremental direct costs to prepare, print and distribute our Source Books. Such costs are capitalized and amortized over their expected period of future benefit. Such amortization is based upon the ratio of actual revenues to the total of actual and estimated future revenues on an individual Source Book basis. Estimated future revenues are based upon various factors such as the total number of Source Books and pages circulated, the probability and magnitude of consumer response and the merchandise assortment offered. Each Source Book is generally fully amortized within a twelve-month period and the majority of the amortization occurs within the first six to ten months, with the exception of the Holiday Source Books, which are generally fully amortized within a four-month period. Capitalized catalog costs are evaluated for realizability on a regular basis by comparing the carrying amount associated with each Source Book to the estimated probable remaining future sales associated with that Source Book.

Our catalog amortization calculation requires management to make assumptions and to apply judgment regarding a number of factors, including market conditions, the selling environment and the probability and magnitude of consumer response to certain Source Books and merchandise assortment offered. If actual revenues associated with our Source Books differ from our original estimates, we adjust our catalog amortization schedules accordingly. Changes in the expected period of benefit could impact the timing of the catalog amortization expense recorded to the consolidated statement of operations.

During fiscal 2013, we modified our Source Book strategy and eliminated our Fall Source Book. We therefore made changes to our assumptions regarding the estimated future revenues and the period over which such revenues would be earned related to our Spring 2013 Source Books. As a result, the amortization period for the Spring 2013 Source Books increased from an eight- to nine-month period to a twelve-month period.

*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.

***Impairment of Goodwill and Long-Lived Assets***

*Goodwill*

We evaluate goodwill annually to determine whether it is impaired. Goodwill is also tested between annual impairment tests if an event occurs 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 our 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. If an impairment indicator exists, we test the intangible asset for recoverability. We have identified only one single reporting unit. We selected the fourth fiscal quarter to perform our annual goodwill impairment testing.

We qualitatively assess goodwill impairment to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount. During fiscal 2013, we performed a qualitative analysis examining key events and circumstances affecting fair value and determined it is more likely than not that the reporting unit's fair value is greater than its carrying amount. As such, no further analysis was required for purposes of testing of our goodwill for impairment.

For goodwill not qualitatively assessed or if goodwill is qualitatively assessed and it is determined it is not more likely than not that the reporting unit's fair value is greater than its carrying amount, a two-step quantitative approach is used. In the first step, we compare the fair value of the reporting unit, generally defined as the same level as or one level below an operating segment, to its carrying value. If the fair value of the reporting unit exceeds the carrying value of the net assets assigned to that unit, goodwill is considered not impaired and we are not required to perform further testing. If the carrying value of the net assets assigned to the reporting unit exceeds the fair value of the reporting unit, then we must perform the second step of the impairment test in order to determine the implied fair value of the reporting unit's goodwill. If the carrying value of a reporting unit's goodwill exceeds its implied fair value, then we would record an impairment loss equal to the difference. The assumptions used in such valuations are subject to volatility and may differ from actual results.

Our tests for impairment of goodwill resulted in a determination that the fair value of the Company substantially exceeded the carrying value of our net assets as of February 1, 2014. We do not anticipate any material impairment charges in the near term.

*Long-Lived Assets*

Long-lived assets, such as property and equipment and intangible assets subject to amortization, 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, a product recall or an adverse action or assessment by a regulator. If the sum of the estimated undiscounted future cash flows related to the asset are 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.



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We evaluate long-lived tangible assets at an individual store level, which is the lowest level at which independent cash flows can be identified. We evaluate corporate assets or other long-lived assets that are not store-specific at the consolidated level.

Since there is typically no active market for our long-lived tangible assets, we estimate fair values based on the expected future cash flows. We estimate future cash flows based on store-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***

We lease stores, distribution facilities, office space and certain equipment under various leases. We classify leases at the inception of the lease as a build-to-suit lease, a capital lease or an operating lease.

We are sometimes involved in the construction of leased stores. As a result of this involvement, we are deemed the “owner” for accounting purposes during the construction period, and are required to capitalize the construction costs on our consolidated balance sheets (referred to as build-to-suit leases). We establish assets and liabilities for the estimated construction costs incurred under build-to-suit lease arrangements to the extent we are involved in the construction of structural improvements or take construction risk prior to commencement of a lease. Upon completion of the project, we perform a sale-leaseback analysis pursuant to Accounting Standards Codification (“ASC”) 840 – *Leases*, to determine if we can remove the assets from our consolidated balance sheets. In many of our leases, we are reimbursed a portion of the construction costs via adjusted rental payments and/or cash payments or have terms which fix the rental payments for a significant percentage of the leased asset’s economic life. These items generally are considered “continuing involvement,” which precludes us from derecognizing the assets from our consolidated balance sheets when construction is complete. In conjunction with these leases, we also record financing obligations equal to the cash proceeds or fair market value of the assets received from the landlord. At the end of the lease term, including exercise of any renewal options, the net remaining financing obligation over the net carrying value of the fixed asset will be recognized as a non-cash gain on sale of the property. We do not report rent expense for the properties which are owned for accounting purposes. Rather, rental payments under the lease are recognized as a reduction of the financing obligation and interest expense.

In a capital or an operating lease, the expected lease term begins with the date that we take possession of the equipment or the leased space for construction and other purposes. The expected lease term may also include the exercise of renewal options if the exercise of the option is determined to be reasonably assured. The expected term is also used in the determination of whether a store is a capital or operating lease.

Some of our equipment is held under capital leases. These assets are included in property and equipment and depreciated over the term of the lease. We do not report rent expense for capital leases. Rather, rental payments under the lease are recognized as a reduction of the capital lease obligation and interest expense.

All other leases are considered operating leases in accordance with ASC 840. Assets subject to an operating lease and the related lease payments are not recorded on our consolidated balance sheets. For leases that contain lease incentives, premiums and minimum rental expenses, we recognize rental expense on a straight-line basis over the lease term, including the construction period. We record rental expense during the construction period. Tenant improvement allowances received from landlords are recorded as deferred rent, reported as a long-term liability on the consolidated balance sheets, and are amortized on a straight-line basis over the lease term, including the construction period.

### ***Stock-Based Compensation***

We use the straight-line method of accounting for stock-based compensation, which we believe is the predominant method used in our industry. We recognize the fair value of stock-based compensation in the consolidated financial statements as compensation expense over the requisite service period. In addition, excess tax benefits related to stock-based compensation awards are reflected as financing cash flows. 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 our stock on the date of grant. The fair value of each option award granted under our award plans subsequent to our initial public offering is estimated on the date of grant using a Black-Scholes Merton option pricing model with the following assumptions:

- Expected volatility—Based on the lack of historical data for our own shares, we base our expected volatility on a representative peer group that takes into account industry, market capitalization, stage of life cycle and capital structure.
- Expected term—Represents the period of time that options granted are expected to be outstanding. We 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.
- Risk-free interest rate—Based on the U.S. Treasury zero-coupon bond rate with a remaining term approximate of the expected term of the option.
- Dividend yield—As we have not paid dividends, nor do we currently plan to pay dividends in the future, the assumed dividend yield is zero.

Prior to the Reorganization, Home Holdings had granted performance-based units that vested and became deliverable upon achievement or satisfaction of performance conditions specified in the performance agreement or upon the return on investment attained by certain of the equity investors in Home Holdings at defined liquidity events, including an initial public offering or certain sale or merger transactions. We estimated the fair value of performance-based units awarded to employees at the grant date based on the fair value of the Company on such date. We also considered the probability of achieving the established performance targets in determining our stock-based compensation with respect to these awards. We recognize compensation cost over the performance period. When the performance is related to a specific event occurring in the future, we recognize the full expense at the time of the event. In connection with the initial public offering, shares of our common stock with substantially similar restrictions, terms and conditions were issued in replacement of these performance-based units.

### ***Income Taxes***

We account 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 our consolidated financial statements or tax returns. In estimating future tax consequences, we generally take into account all expected future events then known to us, other than changes in the tax law or rates which have not yet been enacted and which are not permitted to be considered. Accordingly, we may record a valuation allowance to reduce our 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 our 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 we are to determine that we are not more-likely-than-not able to realize our 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 our

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.

In assessing the need for a valuation allowance, we consider 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 the deferred tax assets will not be realized, we record a valuation allowance. The weight given to the positive and negative evidence is commensurate with the extent to which the evidence may be objectively verified. As such, it is generally difficult for positive evidence regarding projected future taxable income exclusive of reversing taxable temporary differences to outweigh objective negative evidence of recent financial reporting losses. United States GAAP states that cumulative losses in recent years are a significant piece of negative evidence that is difficult to overcome in determining that a valuation allowance is not needed against deferred tax assets.

Due to the historical losses incurred, we had recorded a full valuation allowance against the U.S. net deferred tax assets, excluding deferred tax liabilities related to indefinite lived intangibles, as well as against the net deferred tax assets in Shanghai.

A sustained period of profitability in our operations was required before we would change our judgment regarding the need for a full valuation allowance against our net deferred tax assets. Although we were profitable for the full fiscal 2011, the seasonality of our business continued to result in losses during certain quarters. We recorded a net loss of \$3.7 million in the first quarter of fiscal 2012, compared to a net loss of \$6.2 million in the same quarter of fiscal 2011, and net income of \$17.6 million in the second quarter of fiscal 2012, compared to net income of \$7.6 million in the same quarter of fiscal 2011. Due to the seasonality that was then affecting our business, historically our full year results substantially depended on the results from operations in the fourth quarter.

By the end of fiscal 2012, our U.S. operations achieved a position of cumulative profits (adjusted for permanent items) for the most recent three-year period. We concluded that this record of cumulative profitability in recent years, coupled with our business plan for profitability in future periods, provided assurance that our future tax benefits are more likely than not to be realized. Accordingly, in the fourth quarter of fiscal 2012, we released all of our U.S. valuation allowance against net deferred tax assets, resulting in a \$57.2 million benefit in our provision for income taxes. At February 1, 2014, we have retained a valuation allowance totaling \$0.2 million against deferred tax assets for our Shanghai operations.

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 a 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. We recognize interest and penalties related to unrecognized tax benefits in tax expense.

## **Recently Issued Accounting Pronouncements**

### ***Accounting for Leases***

The Financial Accounting Standards Board (“FASB”) is currently working on amendments to existing accounting standards governing a number of areas including, but not limited to, accounting for leases. In May 2013, the FASB issued a new exposure draft, *Leases* (the “Exposure Draft”), which would replace the existing guidance in ASC 840. Under the Exposure Draft, among other changes in practice, a lessee’s rights and obligations under most leases, including existing and new arrangements, would be recognized as assets and liabilities, respectively, on the balance sheet. Other significant provisions of the Exposure Draft include (i) defining the “lease term” to include the noncancellable period together with periods for which there is a

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significant economic incentive for the lessee to extend or not terminate the lease; (ii) defining the initial lease liability to be recorded on the balance sheet to contemplate only those variable lease payments that depend on an index or that are in substance “fixed”; and (iii) a dual approach for determining whether lease expense is recognized on a straight-line or accelerated basis, depending on whether the lessee is expected to consume more than an insignificant portion of the leased asset’s economic benefits. The comment period for the Exposure Draft ended on September 13, 2013. If and when effective, this Exposure Draft will likely have a significant impact on our consolidated financial statements. However, as the standard-setting process is still ongoing, we are unable to determine the impact this proposed change in accounting standards will have on our consolidated financial statements.

### ***Presentation of Unrecognized Tax Benefits***

In July 2013, the FASB issued an Accounting Standards Update, which requires that an unrecognized tax benefit, or a portion of an unrecognized tax benefit, should be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward, with certain exceptions. This guidance is effective for annual and interim reporting periods beginning after December 15, 2013, with early adoption permitted. We believe the adoption of this pronouncement will not have a material impact on our consolidated financial statements.

## **Item 7A. Quantitative and Qualitative Disclosure of Market Risks**

### ***Interest Rate Risk***

We are subject to interest rate risk in connection with borrowings under our revolving line of credit which bears interest at variable rates. At February 1, 2014, \$85.4 million was outstanding under the revolving line of credit. As of February 1, 2014, the undrawn borrowing availability under the revolving line of credit was \$261.7 million, and there were \$18.9 million in outstanding letters of credit. We currently do not engage in any interest rate hedging activity and we have no intention to do so in the foreseeable future. Based on the average interest rate on the revolving line of credit during the year ended February 1, 2014, and to the extent that borrowings were outstanding, 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.

### ***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 results of operations and financial condition have been immaterial.

**Item 8. Financial Statements and Supplementary Data****RESTORATION HARDWARE HOLDINGS, INC.  
CONSOLIDATED BALANCE SHEETS****(In thousands, except share amounts)**

	February 1, 2014	February 2, 2013
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 13,389	\$ 8,354
Accounts receivable—net	22,028	17,040
Merchandise inventories	453,845	353,329
Current deferred tax assets	21,400	37,006
Prepaid expense and other current assets	103,153	77,029
Total current assets	613,815	492,758
Property and equipment—net	214,909	111,406
Goodwill	122,424	122,601
Trademarks	47,410	47,410
Other intangible assets—net	1,298	2,713
Non-current deferred tax assets	16,980	6,873
Other assets	8,267	5,852
Total assets	<u>\$1,025,103</u>	<u>\$ 789,613</u>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable and accrued expenses	\$ 206,778	\$ 145,353
Deferred revenue and customer deposits	48,927	41,643
Current deferred tax liabilities	145	—
Other current liabilities	61,598	32,428
Total current liabilities	317,448	219,424
Revolving line of credit	85,425	82,501
Deferred rent and lease incentives	37,727	30,784
Other long-term obligations	39,231	5,293
Total liabilities	479,831	338,002
Commitments and contingencies (See Note 16 to the consolidated financial statements)	—	—
Stockholders' equity:		
Common stock, \$0.0001 par value per share, 180,000,000 shares authorized, 39,124,764 shares issued and outstanding as of February 1, 2014; 38,856,251 shares issued and 37,967,635 shares outstanding as of February 2, 2013	4	4
Additional paid-in capital	584,641	505,883
Accumulated other comprehensive income	629	1,211
Accumulated deficit	(37,292)	(55,487)
Treasury stock—at cost, 40,353 and zero shares, respectively	(2,710)	—
Total stockholders' equity	545,272	451,611
Total liabilities and stockholders' equity	<u>\$1,025,103</u>	<u>\$ 789,613</u>

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

**RESTORATION HARDWARE HOLDINGS, INC.**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**

(In thousands, except share and per share amounts)

	Year Ended		
	February 1, 2014	February 2, 2013	January 28, 2012
Net revenues	\$ 1,550,961	\$ 1,193,046	\$ 958,084
Cost of goods sold	994,081	756,597	601,735
Gross profit	556,880	436,449	356,349
Selling, general and administrative expenses	502,029	505,485	329,506
Income (loss) from operations	54,851	(69,036)	26,843
Interest expense	(5,733)	(5,776)	(5,134)
Income (loss) before income taxes	49,118	(74,812)	21,709
Income tax expense (benefit)	30,923	(62,023)	1,121
Net income (loss)	<u>\$ 18,195</u>	<u>\$ (12,789)</u>	<u>\$ 20,588</u>
Weighted-average shares used in computing basic net income (loss) per share	38,671,564	9,428,828	468
Basic net income (loss) per share	\$ 0.47	\$ (1.36)	\$ 43,991
Weighted-average shares used in computing diluted net income (loss) per share	40,416,630	9,428,828	468
Basic and diluted net income (loss) per share	\$ 0.45	\$ (1.36)	\$ 43,991

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

**RESTORATION HARDWARE HOLDINGS, INC.**  
**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)**

(In thousands)

	<u>Year Ended</u>		
	<u>February 1, 2014</u>	<u>February 2, 2013</u>	<u>January 28, 2012</u>
Net income (loss)	\$ 18,195	\$ (12,789)	\$ 20,588
Foreign currency translation adjustment—net of tax	(582)	61	163
Total comprehensive income (loss)	<u>\$ 17,613</u>	<u>\$ (12,728)</u>	<u>\$ 20,751</u>

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

**RESTORATION HARDWARE HOLDINGS, INC.**  
**CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY**

(In thousands, except share amounts)

	Common Stock		Additional Paid-In Capital	Accumulated Other Comprehensive Income (Loss)	Accumulated Deficit	Treasury Stock		Total Stockholders' Equity
	Shares	Amount				Shares	Amount	
<b>Balances—January 29, 2011</b>	100	\$ —	\$ 278,103	\$ 987	\$ (63,286)	—	\$ —	\$ 215,804
Stock-based compensation	—	—	1,557	—	—	—	—	1,557
Capital contribution—executive compensation	—	—	6,350	—	—	—	—	6,350
Capital contribution—management fee	—	—	6,000	—	—	—	—	6,000
Net income	—	—	—	—	20,588	—	—	20,588
Foreign currency translation adjustment—net of tax	—	—	—	163	—	—	—	163
Capitalization of Restoration Hardware Holdings, Inc.	900	—	1	—	—	—	—	1
<b>Balances—January 28, 2012</b>	1,000	—	292,011	1,150	(42,698)	—	—	250,463
Stock-based compensation	—	—	116,183	—	—	—	—	116,183
Conversion of Restoration Hardware Holdings, Inc. common stock upon Reorganization	(1,000)	—	—	—	—	—	—	—
Issuance of common stock upon Reorganization	32,188,891	3	(3)	—	—	—	—	—
Issuance of common stock—net of issuance costs	4,782,609	1	97,692	—	—	—	—	97,693
Vesting of stock awards	996,135	—	—	—	—	—	—	—
Net loss	—	—	—	—	(12,789)	—	—	(12,789)
Foreign currency translation adjustment— net of tax	—	—	—	61	—	—	—	61
<b>Balances—February 2, 2013</b>	37,967,635	4	505,883	1,211	(55,487)	—	—	451,611
Stock-based compensation	—	—	67,622	—	—	—	—	67,622
Issuance of restricted stock	6,667	—	—	—	—	—	—	—
Vested and delivered restricted stock units	4,161	—	(178)	—	—	—	—	(178)
Exercise of stock options—including tax benefit	298,038	—	11,314	—	—	—	—	11,314
Repurchases of common stock	(40,353)	—	—	—	—	40,353	(2,710)	(2,710)
Vesting of stock awards	888,616	—	—	—	—	—	—	—
Net income	—	—	—	—	18,195	—	—	18,195
Foreign currency translation adjustment—net of tax	—	—	—	(582)	—	—	—	(582)
<b>Balances—February 1, 2014</b>	39,124,764	\$ 4	\$ 584,641	\$ 629	\$ (37,292)	40,353	\$ (2,710)	\$ 545,272

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



**RESTORATION HARDWARE HOLDINGS, INC.**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

(In thousands)

	Year Ended		
	February 1, 2014	February 2, 2013	January 28, 2012
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>			
Net income (loss)	\$ 18,195	\$ (12,789)	\$ 20,588
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:			
Depreciation and amortization	27,654	26,748	29,186
Loss on disposal of property and equipment	—	—	674
Impairment of long-lived assets	1,385	—	—
Excess tax benefit from exercise of stock options	(3,685)	—	—
Stock-based compensation expense	67,622	116,183	1,557
Capital contribution—executive compensation	—	—	6,350
Capital contribution—management fee paid by Home Holdings on behalf of the Company	—	—	6,000
Release of valuation allowance	—	(57,185)	—
Deferred income taxes	5,602	(4,686)	4,299
Non-cash interest expense	671	863	573
Change in assets and liabilities:			
Accounts receivable	(4,995)	(5,282)	(7,280)
Merchandise inventories	(100,937)	(107,454)	(39,475)
Prepaid expense and other current assets	(22,819)	(24,454)	(36,371)
Other assets	(3,129)	(371)	(573)
Accounts payable and accrued expenses	57,318	36,154	14,374
Deferred revenue and customer deposits	7,282	16,224	11,418
Other current liabilities	30,351	2,689	3,915
Deferred rent and lease incentives	7,196	10,923	1,732
Other long-term obligations	(190)	(1,427)	154
Net cash provided by (used in) operating activities	<u>87,521</u>	<u>(3,864)</u>	<u>17,121</u>
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>			
Capital expenditures	(93,868)	(49,058)	(25,593)
Purchase of trademarks and other intangible assets	—	(310)	—
Net cash used in investing activities	<u>(93,868)</u>	<u>(49,368)</u>	<u>(25,593)</u>
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>			
Gross borrowings under revolving line of credit	1,670,876	1,344,468	1,007,330
Gross repayments under revolving line of credit	(1,667,952)	(1,369,469)	(1,011,937)
Proceeds from issuance of term loan	—	—	15,000
Repayment of term loan	—	(15,000)	—
Debt issuance costs	—	(426)	(2,835)
Payments on capital leases and other long-term obligations	(2,555)	(4,214)	(4,188)
Stock options exercised	7,629	—	—
Excess tax benefit from exercise of stock options	3,685	—	—
Tax withholdings related to issuance of stock-based awards	(178)	—	—
Capitalization of Restoration Hardware Holdings, Inc.	—	—	1
Proceeds from issuance of common stock—net of issuance costs	—	97,693	—
Net cash provided by financing activities	<u>11,505</u>	<u>53,052</u>	<u>3,371</u>
Effects of foreign currency exchange rate translation	(123)	22	249
Net increase (decrease) in cash and cash equivalents	<u>5,035</u>	<u>(158)</u>	<u>(4,852)</u>
Cash and cash equivalents			
Beginning of period	<u>8,354</u>	<u>8,512</u>	<u>13,364</u>
End of period	<u>\$ 13,389</u>	<u>\$ 8,354</u>	<u>\$ 8,512</u>
Cash paid for interest	\$ 5,038	\$ 5,382	\$ 3,737
Cash paid for taxes	1,521	1,861	1,697
Non-cash transactions:			
Property and equipment acquired under capital lease	238	—	7,770
Property and equipment acquired under build-to-suit	33,494	—	—
Property and equipment additions in accounts payable	4,204	3,505	645
Capital contribution—executive compensation	—	—	6,350
Capital contribution—management fee paid by Home Holdings on behalf of the Company	—	—	6,000

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

**RESTORATION HARDWARE HOLDINGS, INC.**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**NOTE 1—NATURE OF BUSINESS**

Restoration Hardware Holdings, Inc., 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, tableware and children’s furnishings. These products are sold through the Company’s stores, catalogs and websites. As of February 1, 2014, the Company operated a total of 70 retail stores and 17 outlet stores in 29 states, the District of Columbia and Canada, 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 LLC, a Delaware limited liability company (“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.” As a result of these transactions, as of November 1, 2012, 32,188,891 shares of the Company’s common stock were outstanding.

On November 7, 2012, the Company completed its initial public offering. In connection with its initial public offering, the Company issued and sold 4,782,609 shares of its common stock at a price of \$24.00 per share. In addition, certain of the Company’s stockholders sold an aggregate of 381,723 shares of common stock held by them in the initial public offering. Further, certain stockholders sold an additional aggregate of 774,650 shares of common stock held by them pursuant to the exercise by the offering’s underwriters of their option to purchase additional shares. The Company did not receive any proceeds from the sale of stock by its stockholders.

Prior to the Reorganization, Restoration Hardware Holdings, Inc. had not engaged in any business or other activities except in connection with its formation and the Reorganization. Accordingly, all financial and other information herein relating to periods prior to the completion of the Reorganization is that of Restoration Hardware, Inc.

On May 20, 2013, the Company completed a follow-on offering of 9,974,985 shares of common stock at an offering price of \$50.00 per share, which included 1,301,085 shares sold in connection with the full exercise of the option to purchase additional shares granted to the underwriters. All of the shares sold in the offering were sold by existing stockholders of the Company. No shares were sold by the Company in the offering, and, as such, the Company did not receive any of the proceeds from such sales. Effective May 20, 2013, the Company ceased being a subsidiary of Home Holdings, as a result of the sale, by Home Holdings, of a portion of its shares of the Company’s voting common stock, which resulted in Home Holdings owning less than a majority of the Company’s voting common stock after such sale.

On July 17, 2013, the Company completed a second follow-on offering of 8,000,000 shares of common stock at an offering price of \$70.00 per share. On August 14, 2013, in connection with the full exercise of the option to purchase additional shares granted to the underwriters, an additional 1,200,000 shares were sold at a price of \$70.00 per share. All of the shares sold in the offering were sold by existing stockholders of the

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Company. No shares were sold by the Company in the offering, and, as such, the Company did not receive any of the proceeds from such sales.

### **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.

#### **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, 2014 (“fiscal 2013”) and January 28, 2012 (“fiscal 2011”) each consisted of 52 weeks. The fiscal year ended February 2, 2013 (“fiscal 2012”) 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 highly liquid investments with original maturities of three months 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, 2014, the Company had four U.S. bank account balances that were in excess of the FDIC insurance limit and three Canadian bank account balance that was in excess of the CIDC insurance limit. 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 and tenant improvement allowances from the Company’s landlords in connection with new leases. Accounts receivable is presented net of allowance for doubtful accounts, which is recorded on a specific identification basis. The allowance for doubtful accounts was \$1.6 million and \$0.8 million as of February 1, 2014 and February 2, 2013, respectively.

#### **Merchandise Inventories**

The Company’s merchandise inventories are comprised of finished goods and are carried at the lower of cost or market, with cost determined on a weighted-average cost method and market determined based on the

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estimated net realizable value. To determine if the value of inventory should be marked down below original cost, the Company 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 significant estimates used in inventory valuation are obsolescence (including excess and slow-moving inventory and lower of cost or market reserves) and estimates of inventory shrinkage. The Company adjusts its inventory for obsolescence based on historical trends, aging reports, specific identification and its estimates of future retail sales prices.

Reserves for shrinkage are estimated and recorded throughout the period as a percentage of net sales 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 count. 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 decorative accessories) and execution against loss prevention initiatives in the Company's stores, distribution centers, off-site storage locations and with its third-party transportation providers.

Due to these factors, the Company's obsolescence and shrinkage reserves contain uncertainties. Both estimates have calculations 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. If actual obsolescence or shrinkage estimates change from the Company's original estimates, the Company will adjust its inventory reserves accordingly throughout the period. Management does not believe that changes in the assumptions used in these estimates would have a significant effect on the Company's net income (loss) or inventory balances. The Company's inventory reserve balances were \$9.3 million and \$5.9 million as of February 1, 2014 and February 2, 2013, respectively.

### **Advertising Expenses**

Advertising expenses primarily represent the costs associated with the Company's catalog mailings, as well as print and website marketing. Total advertising costs, recorded in selling, general and administrative expenses, were \$83.0 million, \$98.8 million, and \$66.9 million in fiscal 2013, fiscal 2012, and fiscal 2011, 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 amortized over their expected period of future benefit. Such amortization is based upon the ratio of actual revenues to the total of actual and estimated future revenues on an individual Source Book basis. Estimated future revenues are based upon various factors such as the total number of Source Books and pages circulated, the probability and magnitude of consumer response and the merchandise assortment offered. Each Source Book is generally fully amortized within a twelve-month period and the majority of the amortization occurs within the first six to ten months, with the exception of the Holiday Source Books, which are generally fully amortized within a four-month period. Capitalized catalog costs are evaluated for realizability on a regular basis by comparing the carrying amount associated with each Source Book to the estimated probable remaining future sales associated with that Source Book.

The Company's catalog amortization calculation requires management to make assumptions and to apply judgment regarding a number of factors, including market conditions, the selling environment and the probability and magnitude of consumer response to certain Source Books and merchandise assortment offered. If actual revenues associated with the Company's Source Books differ from its original estimates, the Company adjusts its catalog amortization schedules accordingly. Management does not believe that changes in the assumptions used in these estimates would have a significant effect on the Company's net income as changes in the assumptions do not impact the total cost of the Source Books to be amortized. However, changes in the assumptions could impact the timing of the future catalog amortization expense recorded to the consolidated statement of operations.

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During fiscal 2013, the Company modified its Source Book strategy and eliminated its Fall Source Book. The Company therefore made changes to its assumptions regarding the estimated future revenues and the period over which such revenues would be earned related to its Spring 2013 Source Books. As a result, the amortization period for the Spring 2013 Source Books increased from an eight- to nine-month period to a twelve-month period.

The Company had \$49.3 million and \$43.8 million of capitalized catalog costs that are included in prepaid expense and other current assets on the consolidated balance sheets as of February 1, 2014, and February 2, 2013, respectively.

### *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	40 years
Furniture, fixtures and equipment	3 to 7 years
Machinery and equipment	3 to 5 years
Computer software	3 years

The cost of leasehold improvements and lease acquisitions is amortized over the lesser of the useful life of the asset or the applicable lease term.

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 actual interest costs are being incurred.

Assets acquired under non-cancelable leases, which meet the criteria of capital leases, are capitalized in property and equipment and amortized over the lesser of the useful life of the asset or the applicable lease term.

The 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.

### **Intangible Assets**

Intangible assets reflect the value assigned to trademarks, core technologies and the fair market value of the Company's leases. Core technologies and the fair market value of the leases are amortized over their useful life. The Company does not amortize trademarks as the Company defines the life of the asset as indefinite.

### **Impairment**

#### *Goodwill*

The Company evaluates goodwill annually to determine whether it is impaired. Goodwill is also tested between annual impairment tests if an event occurs or circumstances change that would indicate that the fair

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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 GDP 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. If an impairment indicator exists, the Company tests the intangible asset for recoverability. The Company has identified only one single reporting unit. The Company selected the fourth fiscal quarter to perform its annual goodwill impairment testing.

The Company qualitatively assesses goodwill impairment to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount. During fiscal 2013, the Company performed a qualitative analysis examining key events and circumstances affecting fair value and determined it is more likely than not that the reporting unit's fair value is greater than its carrying amount. As such, no further analysis was required for purposes of testing of the Company's goodwill for impairment.

If goodwill is not qualitatively assessed or if goodwill is qualitatively assessed and it is determined it is not more likely than not that the reporting unit's fair value is greater than its carrying amount, a two-step quantitative approach is used. In the first step, the Company compares the fair value of the reporting unit, generally defined as the same level as or one level below an operating segment, to its carrying value. If the fair value of the reporting unit exceeds the carrying value of the net assets assigned to that unit, goodwill is considered not impaired and the Company is not required to perform further testing. If the carrying value of the net assets assigned to the reporting unit exceeds the fair value of the reporting unit, then the Company must perform the second step of the impairment test in order to determine the implied fair value of the reporting unit's goodwill. If the carrying value of a reporting unit's goodwill exceeds its implied fair value, then the Company would record an impairment loss equal to the difference.

The Company's tests for impairment of goodwill resulted in a determination that the fair value of the Company substantially exceeded the carrying value of the Company's net assets in fiscal 2013 and fiscal 2012. No impairment to goodwill has been recorded in any period.

### *Trademarks*

The Company annually evaluates whether trademarks continue to have an indefinite life. Trademarks 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. During fiscal 2013, the Company performed a qualitative analysis examining key events and circumstances affecting fair value and determined it is more likely than not that the asset's fair value is greater than its carrying amount. As such, no further analysis was required for purposes of testing of the Company's trademarks for impairment.

If trademarks are not qualitatively assessed or if trademarks 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. 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 operating results and projected future cash flows.

The Company tested the trademarks for impairment and concluded that there has been no impairment in any period.

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### *Long-Lived Assets*

Long-lived assets, such as property and equipment and intangible assets subject to amortization, 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, a product recall or an adverse action or assessment by a regulator. If the sum of the estimated undiscounted future cash flows related to the asset are 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.

The Company evaluates long-lived tangible assets at an individual store level, which is the lowest level at which independent cash flows can be identified. The Company evaluates corporate assets or other long-lived assets that are not store-specific at the consolidated level.

Since there is typically no active market for the Company's long-lived tangible assets, the Company estimates fair values based on the expected future cash flows. The Company estimates future cash flows based on store-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 recorded an impairment charge in fiscal 2013 of \$1.4 million related to the underperformance of a stand-alone Baby & Child Gallery, which is included in selling, general and administrative expenses on the consolidated statements of operations. The Company did not record an impairment charge on long-lived assets in fiscal 2012 or fiscal 2011.

### **Lease Accounting**

The Company leases stores, distribution facilities, office space and certain machinery and equipment under various leases. The Company classifies leases at the inception of the lease as a build-to-suit lease, a capital lease or an operating lease.

The Company is sometimes involved in the construction of leased stores. As a result of this involvement, the Company is deemed the "owner" for accounting purposes during the construction period, and is required to capitalize the construction costs on its consolidated balance sheets (referred to as build-to-suit leases). The Company establishes assets and liabilities for the estimated construction costs incurred under build-to-suit lease arrangements to the extent it is involved in the construction of structural improvements or takes construction risk prior to commencement of a lease. Upon completion of the project, the Company performs a sale-leaseback analysis pursuant to Accounting Standards Codification ("ASC") 840 – *Leases*, to determine if it can remove the assets from its consolidated balance sheets. In many of its leases, the Company is reimbursed a portion of the construction costs via adjusted rental payments and/or cash payments or has terms which fix the rental payments for a significant percentage of the leased asset's economic life. These items generally are considered "continuing involvement," which precludes the Company from derecognizing the assets from its consolidated balance sheets when construction is complete. In conjunction with these leases, the Company also records financing obligations equal to the cash proceeds or fair market value of the assets received from the landlord. At the end of the lease term, including exercise of any renewal options, the net remaining financing obligation over the net carrying value of the fixed asset will be recognized as a non-cash gain on sale of the property. The Company does not report rent expense for the properties which are owned for accounting purposes. Rather, rental payments under the lease are recognized as a reduction of the financing obligation and interest expense.

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During fiscal 2013, the Company determined that lease agreements for four future Full Line Design Gallery locations met the capitalization criteria under ASC 840. As a result, the Company recorded approximately \$33 million related to build-to-suit transactions, which is recorded within property and equipment, and other long-term obligations on the consolidated balance sheets.

In a capital or an operating lease, the expected lease term begins with the date that the Company takes possession of the equipment or the leased space for construction and other purposes. The expected lease term may also include the exercise of renewal options if the exercise of the option is determined to be reasonably assured. The expected term is also used in the determination of whether a store is a capital or operating lease.

Some of the Company's equipment is held under capital leases. These assets are included in property and equipment and depreciated over the term of the lease. The Company does not report rent expense for capital leases. Rather, rental payments under the lease are recognized as a reduction of the capital lease obligation and interest expense.

All other leases are considered operating leases in accordance with ASC 840. Assets subject to an operating lease and the related lease payments are not recorded on the consolidated balance sheets. For leases that contain lease incentives, premiums and minimum rental expenses, the Company recognizes rental expense on a straight-line basis over the lease term, including the construction period. The Company records rental expense during the construction period. Tenant improvement allowances received from landlords are recorded as deferred rent, reported as a long-term liability on the consolidated balance sheets, and are amortized on a straight-line basis over the lease term, including the construction period.

### **Debt Issuance Costs**

The Company capitalizes debt issuance costs related to its revolving line of credit. Capitalized costs related to the revolving line of credit are included in other assets on the consolidated balance sheets as deferred financing fees. Deferred financing fees are amortized utilizing the straight-line method and are included in interest expense on the consolidated statements of operations.

### **Revenue Recognition**

The Company recognizes revenues and the related cost of goods sold when merchandise is received by its customers. Revenues from "cash-and-carry" store sales are recognized at the point of sale in the store. Revenues from direct-to-customer and home-delivered sales are recognized when the merchandise is delivered to the customer. Discounts provided to customers are accounted for as a reduction of sales.

The Company recognizes shipping and handling fees as revenue when the merchandise is received by its customers. 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.



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The Company's customers may return purchased items for a refund. The Company provides an allowance for sales returns, net of cost of goods sold, based on historical return rates. A summary of the allowance for sales returns, presented net of cost of goods sold, is as follows (*in thousands*):

	Year Ended		
	February 1, 2014	February 2, 2013	January 28, 2012
Balance at beginning of fiscal year	\$ 5,206	\$ 3,181	\$ 3,403
Provision for sales returns	165,470	134,909	102,875
Actual sales returns	(158,534)	(132,884)	(103,097)
Balance at end of fiscal year	<u>\$ 12,142</u>	<u>\$ 5,206</u>	<u>\$ 3,181</u>

### Deferred Revenue and Customer Deposits

Deferred revenue represents the revenue associated with orders that have been shipped by the Company to its customers but have not yet been received by the customer. As the Company recognizes revenue when the merchandise is received by its customers, it is included as deferred revenue on the consolidated balance sheets while in-transit.

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 merchandise is received by the customer or at the time of cancellation of the order by the customer.

### Gift Certificates and Merchandise Credits

The Company sells gift certificates and issues merchandise credits to its customers in its stores and through its websites and product catalogs. Such gift certificates and merchandise credits do not have expiration dates. Revenue associated with gift certificates and merchandise credits is deferred until either (i) redemption of the gift certificate and merchandise credits or (ii) when the likelihood of redemption is remote and there exists no legal obligation to remit the value of unredeemed gift certificates or merchandise credits to the relevant jurisdictions (breakage). The breakage rate is based on monitoring of certificates issued, actual certificate redemptions and the Company's analysis of when it believes it is remote that redemptions will occur.

Redeemed gift certificates and merchandise credits are recorded in net revenues. Breakage resulted in a reduction of selling, general and administrative expenses on the consolidated statements of operations of \$2.9 million, \$1.8 million, and \$3.2 million in fiscal 2013, fiscal 2012, and fiscal 2011, respectively.

### 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 \$1.7 million related to health care coverage as of both February 1, 2014 and February 2, 2013.

The Company is self-insured for all workers' compensation claims related to incidents incurred after November 1, 2013 and prior to November 1, 2007. The Company had liabilities of \$1.7 million and \$1.0 million related to workers' compensation claims as of February 1, 2014 and February 2, 2013, respectively.

## Stock-Based Compensation

The Company recognizes the fair value of stock-based compensation in its consolidated financial statements as compensation expense over the requisite service period. In addition, excess tax benefits related to stock-based compensation awards are reflected as financing cash flows. 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 plans subsequent to its initial public offering is estimated on the date of grant using a Black-Scholes Merton option pricing model with the following assumptions:

- Expected volatility—Based on the lack of historical data for its own shares, the Company bases its expected volatility on a representative peer group that takes into account industry, market capitalization, stage of life cycle and capital structure.
- Expected term—Represents the period of time that options granted are expected to be outstanding. 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.
- Risk-free interest rate—Based on the U.S. Treasury zero-coupon bond rate with a remaining term approximate of the expected term of the option.
- Dividend yield—As the Company has not paid dividends, nor does it currently plan to pay dividends in the future, the assumed dividend yield is zero.

Prior to the Reorganization, Home Holdings had granted performance-based units that vested and became deliverable upon achievement or satisfaction of performance conditions specified in the performance agreement or upon the return on investment attained by certain of the equity investors in Home Holdings at defined liquidity events, including an initial public offering or certain sale or merger transactions. The Company estimated the fair value of performance-based units awarded to employees at the grant date based on the fair value of the Company on such date. The Company also considered the probability of achieving the established performance targets in determining its stock-based compensation with respect to these awards. The Company recognizes compensation cost over the performance period. When the performance is related to a specific event occurring in the future, the Company recognizes the full expense at the time of the event. At the time of the Reorganization, these performance-based units were replaced with shares of the Company's common stock with substantially similar restrictions, terms and conditions. Refer to Note 13—*Stock-Based Compensation*.

## 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, 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 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.

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Selling, general and administrative expenses for fiscal 2013 include a \$33.7 million non-cash compensation charged related to the one-time, fully vested option granted to Gary Friedman upon his reappointment as Chairman and Co-Chief Executive Officer in July 2013, a \$29.5 million non-cash compensation charge related to the performance-based vesting of certain shares granted to Mr. Friedman and \$2.9 million of costs incurred in connection with the Company's follow-on offerings in May 2013 and July 2013.

Selling, general and administrative expenses for fiscal 2012 include a \$92.0 million non-cash compensation charge related to equity grants at the time of the Reorganization, as well as a non-cash compensation charge of \$23.1 million related to the performance-based vesting of certain shares granted to the Company's then Co-Chief Executive Officers, Mr. Friedman and Carlos Alberini. Costs incurred in connection with the initial public offering, including a fee of \$7.0 million to Catterton Management Company, LLC ("Catterton"), Tower Three Partners LLC ("Tower Three") and GJK Capital Advisors, LLC ("Glenhill") in accordance with the Company's management services agreement, payments of \$2.2 million to certain former executives and bonus payments to employees of \$1.3 million, were included in selling, general and administrative expenses in fiscal 2012. In addition, legal and other professional fees of \$4.8 million, incurred in connection with the investigation conducted by the special committee of the board of directors relating to Mr. Friedman and the Company's subsequent remedial actions, are included in fiscal 2012 selling, general and administrative expenses.

### **Earnings (Loss) Per Share**

Basic earnings (loss) per share is computed as net income (loss) divided by the weighted-average number of common shares outstanding for the period. Diluted earnings (loss) per share is computed as net income (loss) divided by the weighted-average number of common shares outstanding for the period plus common stock equivalents consisting of shares subject to stock-based awards with exercise prices less than or equal to the average market price of the Company's common stock for the period, to the extent their inclusion would be dilutive. Potential dilutive securities are excluded from the computation of diluted earnings (loss) per share if their effect is anti-dilutive.

### **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

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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.

### **Fair Value of Financial Instruments**

The carrying values of cash and cash equivalents, accounts receivable, accounts payable and borrowings under the revolving line of credit approximate their estimated fair values.

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.

The Company's financial assets and liabilities were classified as Level 1 as of February 1, 2014, and February 2, 2013.

### **Comprehensive Income (Loss)**

Comprehensive income (loss) consists of net income (loss) and other comprehensive income (loss), which consists of foreign currency translation adjustments.

### **Foreign Currency Translation**

Local currencies are generally considered the functional currencies outside the United States of America. 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 (loss) section of the consolidated statements of stockholders' equity. Foreign currency gains (losses) resulting from foreign currency transactions are included in selling, general and administrative expenses on the consolidated statements of operations and have not been material in all periods presented.

### **Recently Issued Accounting Standards**

#### ***Accounting for Leases***

The Financial Accounting Standards Board ("FASB") is currently working on amendments to existing accounting standards governing a number of areas including, but not limited to, accounting for leases. In May 2013, the FASB issued a new exposure draft, *Leases* (the "Exposure Draft"), which would replace the existing

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guidance in ASC 840. Under the Exposure Draft, among other changes in practice, a lessee's rights and obligations under most leases, including existing and new arrangements, would be recognized as assets and liabilities, respectively, on the balance sheet. Other significant provisions of the Exposure Draft include (i) defining the "lease term" to include the noncancellable period together with periods for which there is a significant economic incentive for the lessee to extend or not terminate the lease; (ii) defining the initial lease liability to be recorded on the balance sheet to contemplate only those variable lease payments that depend on an index or that are in substance "fixed"; and (iii) a dual approach for determining whether lease expense is recognized on a straight-line or accelerated basis, depending on whether the lessee is expected to consume more than an insignificant portion of the leased asset's economic benefits. The comment period for the Exposure Draft ended on September 13, 2013. If and when effective, this Exposure Draft will likely have a significant impact on the Company's consolidated financial statements. However, as the standard-setting process is still ongoing, the Company is unable to determine the impact this proposed change in accounting standards will have on its consolidated financial statements.

### **Presentation of Unrecognized Tax Benefits**

In July 2013, the FASB issued an Accounting Standards Update, which requires that an unrecognized tax benefit, or a portion of an unrecognized tax benefit, should be presented in the financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward, with certain exceptions. This guidance is effective for annual and interim reporting periods beginning after December 15, 2013, with early adoption permitted. The Company believes the adoption of this pronouncement will not have a material impact on its consolidated financial statements.

### **NOTE 4—PREPAID EXPENSE AND OTHER CURRENT ASSETS**

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

	February 1, 2014	February 2, 2013
Capitalized catalog costs	\$ 49,274	\$ 43,828
Vendor deposits	36,694	20,383
Prepaid expense and other current assets	17,185	12,818
Total prepaid expense and other current assets	<u>\$ 103,153</u>	<u>\$ 77,029</u>

### **NOTE 5—PROPERTY AND EQUIPMENT**

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

	February 1, 2014	February 2, 2013
Leasehold improvements <sup>(1)</sup>	\$ 222,831	\$ 155,338
Computer software	50,005	33,459
Furniture, fixtures and equipment	35,419	27,076
Machinery and equipment	11,374	8,866
Land	5,396	2,388
Building	2,205	2,205
Build-to-suit property <sup>(2)</sup>	33,496	—
Equipment under capital leases <sup>(3)</sup>	6,222	8,879
Total property and equipment	366,948	238,211
Less—accumulated depreciation and amortization	(152,039)	(126,805)
Total property and equipment—net	<u>\$ 214,909</u>	<u>\$ 111,406</u>

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- (1) Leasehold improvements include construction in progress of \$35.2 million and \$25.9 million as of February 1, 2014, and February 2, 2013, respectively.
- (2) The Company capitalizes assets and records a corresponding long-term liability for build-to-suit lease agreements where it is considered the owner, for accounting purposes, during the construction period. For buildings under build-to-suit lease arrangements where the Company has taken occupancy and which do not qualify for sales recognition under the sale-leaseback accounting guidance, the Company has determined that it continues to be deemed the owner of these buildings. This is principally due to the Company's significant investment in tenant improvements. As a result, the buildings are depreciated over the shorter of their useful lives or the related leases' terms.
- (3) Accumulated depreciation and amortization include accumulated amortization related to equipment under capital leases of \$6.0 million and \$6.8 million as of February 1, 2014, and February 2, 2013, respectively.

The Company recorded depreciation expense of \$26.5 million, \$24.3 million, and \$26.2 million in fiscal 2013, fiscal 2012, and fiscal 2011, respectively.

### NOTE 6—GOODWILL AND INTANGIBLE ASSETS

The following sets forth the goodwill and intangible assets as of February 1, 2014 (*dollar amounts in thousands*):

	<u>Gross Carrying Amount</u>	<u>Accumulated Amortization</u>	<u>Foreign Currency Translation</u>	<u>Net Book Value</u>	<u>Useful Life</u>
<b>Intangible assets subject to amortization:</b>					
Core technologies	\$ 6,580	\$ (6,580)	\$ —	\$ —	5 years
<b>Fair value of leases</b>					
Fair market write-up	10,443	(9,187)	42	1,298	(2)
Fair market write-down	(2,591)	2,072	—	(519) <sup>(1)</sup>	(2)
Total intangible assets subject to amortization	14,432	(13,695)	42	779	
<b>Intangible assets not subject to amortization:</b>					
Goodwill	122,285	—	139	122,424	
Trademarks and domain names	47,410	—	—	47,410	
Total intangible assets	<u>\$184,127</u>	<u>\$ (13,695)</u>	<u>\$ 181</u>	<u>\$170,613</u>	

- (1) The fair market write-down of leases is included in other long-term obligations on the consolidated balance sheets.
- (2) The fair value of each lease is amortized over the life of the respective lease.

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The following sets forth the goodwill and intangible assets as of February 2, 2013 (*dollar amounts in thousands*):

	<u>Gross Carrying Amount</u>	<u>Accumulated Amortization</u>	<u>Foreign Currency Translation</u>	<u>Net Book Value</u>	<u>Useful Life</u>
<b>Intangible assets subject to amortization:</b>					
Core technologies	\$ 6,580	\$ (6,141)	\$ —	\$ 439	5 years
Fair value of leases					
Fair market write-up	10,737	(8,511)	48	2,274	(2)
Fair market write-down	(2,591)	1,789	—	(802) <sup>(1)</sup>	(2)
Total intangible assets subject to amortization	14,726	(12,863)	48	1,911	
<b>Intangible assets not subject to amortization:</b>					
Goodwill	122,285	—	316	122,601	
Trademarks and domain names	47,410	—	—	47,410	
Total intangible assets	<u>\$184,421</u>	<u>\$ (12,863)</u>	<u>\$ 364</u>	<u>\$171,922</u>	

(1) The fair market write-down of leases is included in other long-term obligations on the consolidated balance sheets.

(2) The fair value of each lease is amortized over the life of the respective lease.

The Company recorded amortization expense related to intangible assets of \$1.1 million, \$2.4 million, and \$2.8 million in fiscal 2013, fiscal 2012, and fiscal 2011, respectively.

The following table sets forth the remaining amortization of the intangible assets based on a straight-line method of amortization over the respective useful lives as of February 1, 2014 (*in thousands*):

2014	\$608
2015	96
2016	56
2017	19
Total amortization	<u>\$779</u>

## NOTE 7—ACCOUNTS PAYABLE, ACCRUED EXPENSES AND OTHER CURRENT LIABILITIES

Accounts payable and accrued expenses consist of the following (*in thousands*):

	<u>February 1, 2014</u>	<u>February 2, 2013</u>
Accounts payable	\$ 116,306	\$ 81,608
Accrued compensation	29,498	16,621
Accrued freight and duty	21,309	17,639
Accrued sales taxes	13,995	12,783
Accrued occupancy	6,306	5,842
Accrued catalog costs	7,663	6,906
Accrued professional fees	3,119	2,114
Other accrued expenses	8,582	1,840
Total accounts payable and accrued expenses	<u>\$ 206,778</u>	<u>\$ 145,353</u>

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Accounts payable included negative cash balances due to outstanding checks of \$25.5 million and \$28.1 million as of February 1, 2014, and February 2, 2013, respectively.

Other current liabilities consist of the following (*in thousands*):

	February 1, 2014	February 2, 2013
Federal and state tax payable	\$ 22,254	\$ 395
Unredeemed gift certificate and merchandise credit liability	18,830	18,435
Allowance for sales returns	12,142	5,206
Capital lease obligation—current	1,807	2,925
Other liabilities	6,565	5,467
Total other current liabilities	<u>\$ 61,598</u>	<u>\$ 32,428</u>

### NOTE 8—OTHER LONG-TERM LIABILITIES

Other long-term liabilities consist of the following (*in thousands*):

	February 1, 2014	February 2, 2013
Financing obligations under build-to-suit transactions	\$ 33,165	\$ —
Long-term notes payable for share repurchases	2,710	—
Unrecognized tax benefits	1,739	2,311
Other long-term liabilities	1,617	2,982
Total other long-term liabilities	<u>\$ 39,231</u>	<u>\$ 5,293</u>

Financing obligations under build-to-suit transactions relate to lease agreements where the Company is considered the owner, for accounting purposes, during the construction period. For these lease agreements, the Company capitalizes assets, which are included in property and equipment on the consolidated balance sheets, and records a corresponding long-term liability. For buildings under build-to-suit lease arrangements where the Company has taken occupancy and which do not qualify for sales recognition under the sale-leaseback accounting guidance, the Company has determined that it continues to be deemed the owner of these buildings. This is principally due to the Company's significant investment in tenant improvements.

### NOTE 9—REVOLVING LINE OF CREDIT

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. This credit agreement modified a previous facility under which Restoration Hardware, Inc. had a revolving line of credit for up to \$190.0 million. Under the credit agreement, which has a maturity date of August 3, 2016, Restoration Hardware, Inc. has a revolving line of credit available of up to \$417.5 million (following Restoration Hardware, Inc.'s exercise of the commitment increase option on November 1, 2012, as described below), of which \$10.0 million is available to Restoration Hardware Canada, Inc. The credit agreement was further amended in January 2012 to add a \$15.0 million term loan facility with a maturity date of July 6, 2015, which was repaid in full on November 7, 2012, as described below.

Under the credit agreement's commitment increase provision, Restoration Hardware, Inc. had the option to increase the amount of the revolving line of credit by up to an additional \$100.0 million, provided that, among other things, the existing lenders or additional lenders agreed to participate in the increased loan commitments under the revolving line of credit, no default under the credit agreement then existed or would result from such increase and sufficient borrowing base collateral was available to support increased loan amounts. On November 1, 2012, Restoration Hardware, Inc. increased the amount of the revolving line of credit by \$100.0 million pursuant to this commitment increase provision.



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On November 7, 2012, Restoration Hardware, Inc. made payments of \$75.7 million on its revolving line of credit and repaid its outstanding term loan of \$15.0 million in full. Such payments were funded from the proceeds received as a result of the Company's initial public offering.

The availability of credit at any given time under the revolving line of credit is limited by reference to a borrowing base formula based upon numerous factors, including the value of eligible inventory, eligible accounts receivable, eligible real estate, and, in the case of the term loan, registered trade names and reserves established by the administrative agent. As a result of the borrowing base formula, the 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 Restoration Hardware, Inc.'s assets, including accounts receivable, inventory, intangible assets, property, equipment, goods and fixtures.

Borrowings under the revolving line of credit are subject to interest, at the borrowers' option, at either the bank's reference rate or LIBOR (or the 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 weighted-average interest rate for the revolving line of credit was 2.80% as of February 1, 2014.

As of February 1, 2014, \$85.4 million was outstanding under the revolving line of credit and the undrawn borrowing availability under the revolving line of credit was \$261.7 million. There were \$18.9 million and \$19.5 million in outstanding letters of credit as of February 1, 2014, and February 2, 2013, respectively.

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 does not contain any significant financial or coverage ratio covenants unless the availability under the revolving line of credit is less than the greater of (i) \$17.5 million and (ii) 10% of the lesser of (A) the aggregate maximum commitments under the revolving line of credit and (B) the domestic borrowing base. If the availability under the revolving line of credit is less than the foregoing amount, then Restoration Hardware, Inc. is required to maintain a consolidated fixed charge coverage ratio of at least one to one. Such ratio is approximately the ratio on the last day of each month on a trailing twelve-month basis of (a) (i) consolidated EBITDA (as defined in the agreement) minus (ii) capital expenditures, minus (iii) the income taxes paid in cash to (b) the sum of (i) debt service charges plus (ii) certain dividends and distributions paid. As of February 1, 2014, Restoration Hardware, Inc. was in compliance with all covenants, and if the availability under the revolving line of credit were less than the amount described above, Restoration Hardware, Inc. would have been in compliance with the consolidated fixed charge coverage ratio described in the previous sentence. The credit agreement requires a daily sweep of cash to prepay the loans under the credit agreement while (i) an event of default exists or (ii) the availability under the revolving line of credit for extensions of credit to Restoration Hardware, Inc. is less than the greater of (A) \$20.0 million and (B) 15% of the lesser of the aggregate maximum commitments and the domestic borrowing base.

**NOTE 10—INCOME TAXES**

The following is a summary of the income tax expense (benefit) (*in thousands*):

	<b>Year Ended</b>		
	<b>February 1, 2014</b>	<b>February 2, 2013</b>	<b>January 28, 2012</b>
<b>Current</b>			
Federal	\$ 21,593	\$ —	\$ —
State	4,182	236	331
Foreign	(454)	(387)	595
Total current tax expense (benefit)	<u>25,321</u>	<u>(151)</u>	<u>926</u>
<b>Deferred</b>			
Federal	6,215	(48,745)	(76)
State	(596)	(12,903)	223
Foreign	(17)	(224)	48
Total deferred tax expense (benefit)	<u>5,602</u>	<u>(61,872)</u>	<u>195</u>
Total income tax expense (benefit)	<u>\$ 30,923</u>	<u>\$ (62,023)</u>	<u>\$ 1,121</u>

A reconciliation of the federal statutory tax rate to the Company's effective tax rate is as follows:

	<b>Year Ended</b>		
	<b>February 1, 2014</b>	<b>February 2, 2013</b>	<b>January 28, 2012</b>
Provision at federal statutory tax rate	35.0%	35.0%	34.0%
State income taxes—net of federal tax impact	5.8	0.7	5.6
Stock-based compensation	21.3	(30.0)	12.4
Valuation allowance	(0.1)	76.5	(49.4)
Foreign income	(0.2)	0.6	(2.0)
Net adjustments to tax accruals and other	1.2	0.1	4.6
Effective tax rate	<u>63.0%</u>	<u>82.9%</u>	<u>5.2%</u>

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Significant components of the Company's deferred tax assets and liabilities are as follows (*in thousands*):

	February 1, 2014	February 2, 2013
<b>Current deferred tax assets (liabilities)</b>		
Accrued expense	\$ 22,164	\$ 11,026
State tax benefit	428	(931)
Inventory	19,350	14,215
Deferred revenue	1,891	20,144
Net operating loss carryforwards	—	12,337
Construction allowance	(1,694)	(1,698)
Stock-based compensation	1,038	—
Prepaid expense and other	(21,896)	(18,056)
Current deferred tax assets	21,281	37,037
Valuation allowance	(26)	(31)
Net current deferred tax assets	21,255	37,006
<b>Non-current deferred tax assets (liabilities)</b>		
State tax benefit	(2,536)	(2,040)
Stock-based compensation	34,005	21,231
Deferred lease credits	12,884	9,687
Property and equipment	(12,362)	(5,975)
Net operating loss carryforwards	884	262
U.S. impact of Canadian transfer pricing	1,780	2,091
Trademarks	(19,327)	(19,361)
Other	1,832	1,240
Non-current deferred tax assets	17,160	7,135
Valuation allowance	(180)	(262)
Net non-current deferred tax assets	16,980	6,873
Net deferred tax assets	<u>\$ 38,235</u>	<u>\$ 43,879</u>

A reconciliation of the valuation allowance is as follows (*in thousands*):

	February 1, 2014	<u>Year Ended</u>	January 28, 2012
		February 2, 2013	
Balance at beginning of fiscal year	\$ 293	\$ 57,484	\$ 68,318
Charged to expense	—	(57,185)	299
Net changes in deferred tax assets and liabilities	(87)	(6)	(11,133)
Balance at end of fiscal year	<u>\$ 206</u>	<u>\$ 293</u>	<u>\$ 57,484</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 the end of fiscal year 2012, the Company's U.S. operations achieved a position of cumulative profits (adjusted for permanent differences) for the most recent three-year period. The Company concluded that this

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record of cumulative profitability in recent years, coupled with its business plan for profitability in future periods, provided assurance that its future tax benefits more likely than not would be realized. Accordingly, in fiscal 2012, the Company released all of its U.S. valuation allowance of \$57.2 million against net deferred tax assets.

As of February 1, 2014, the Company has retained a valuation allowance totaling \$0.2 million against deferred tax assets for its Shanghai operations.

As of February 1, 2014, the Company had state net operating loss carryovers of \$8.7 million. The state net operating loss carryovers will expire between 2014 and 2032. 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, 2014	February 2, 2013	January 28, 2012
Balance at beginning of fiscal year	\$ 1,841	\$ 2,505	\$ 9,015
Gross decreases—prior period tax positions	(151)	(57)	—
Gross decreases—current period tax positions	—	—	(14)
Consent for accounting method change	—	—	(6,496)
Lapses in statute of limitations	(295)	(607)	—
Balance at end of fiscal year	<u>\$ 1,395</u>	<u>\$ 1,841</u>	<u>\$ 2,505</u>

As of February 1, 2014 and February 2, 2013, \$1.4 million and \$1.8 million, respectively, of the exposures related to unrecognized tax benefits would affect the effective tax rate if realized and are included in other long-term obligations on the consolidated balance sheets. These amounts are primarily associated with foreign tax exposures that would, if realized, reduce the amount of net operating losses that would ultimately be utilized. As of February 1, 2014, \$0.4 million of the exposures related to unrecognized tax benefits are expected to decrease in the next 12 months due to the lapse of the statute of limitations.

Adjustments required upon adoption of accounting for uncertainty in income taxes related to deferred tax asset accounts were offset by the related valuation allowance. Future changes to the Company's assessment of the realizability of those deferred tax assets will impact the effective tax rate. The Company accounts for interest and penalties related to exposures as a component of income tax expense. The Company has accrued \$0.3 million and \$0.5 million of interest associated with exposures as of February 1, 2014, and February 2, 2013, respectively.

A significant portion of the Company's unrecognized tax benefits as of the beginning of 2011 was related to an uncertain tax position for advanced payments for the sale of gift cards. The Company filed a request to change its accounting method for advanced payments for the sale of gift cards with the IRS in fiscal 2011 and, during the fourth quarter of fiscal 2011, the IRS approved the Company's request. This approval allowed the Company to increase its tax liability for the impact of the change over a four-year period beginning with its January 28, 2012 tax return. The Company reduced its balance of unrecognized tax benefits by \$6.5 million for the impact of the approval on this uncertain tax position in fiscal 2011.

This Company is subject to tax in the United States, Canada, Shanghai and Hong Kong. The Company could be subject to United States federal and state tax examinations for years 2001 and forward by virtue of net operating loss carryforwards available from those years. There are no United States tax examinations currently in progress. The Company may also be subject to audits in Canada for years 2005 and forward. During fiscal 2012, the Canada Revenue Agency concluded, with no adjustments, its audit of Restoration Hardware Canada, Inc. for the years ended 2006 and 2007 and for the period ended June 16, 2008.

**NOTE 11—EARNINGS PER SHARE**

On November 1, 2012, the Company acquired all of the outstanding shares of capital stock of Restoration Hardware, Inc. and Restoration Hardware, Inc. became a direct, wholly owned subsidiary of the Company. 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. Restoration Hardware, Inc. was a direct, wholly owned subsidiary of Home Holdings prior to the Company's initial public offering. As a result of these transactions, as of November 1, 2012, 32,188,891 shares of the Company's common stock were outstanding.

On November 7, 2012, the Company completed its initial public offering. In connection with its initial public offering, the Company issued and sold 4,782,609 shares of its common stock.

The weighted-average number of shares for fiscal 2011 is calculated by giving effect to the capitalization of Restoration Hardware Holdings, Inc. on September 2, 2011, which resulted in the number of shares outstanding increasing from 100 shares to 1,000 shares.

The weighted-average shares used for earnings per share is as follows (*in thousands*):

	Year Ended		
	February 1, 2014	February 2, 2013	January 28, 2012
Weighted-average shares—basic	38,671,564	9,428,828	468
Effect of dilutive stock-based awards	1,745,066	—	—
Weighted-average shares—diluted	40,416,630	9,428,828	468

For fiscal 2013, options and restricted stock units of 774,745 and 90,988, respectively, were excluded from the calculation of diluted earnings per share because their inclusion would have been anti-dilutive. For fiscal 2012, options of 6,020,152 were excluded from the calculation of diluted earnings per share because their inclusion would have been anti-dilutive. The Company did not have any anti-dilutive securities in fiscal 2011 because all securities granted in those periods were granted by Home Holdings.

**NOTE 12—SHARE REPURCHASES**

Certain options and awards granted under the Company's equity plans contain a repurchase right, which may be exercised at the Company's discretion in the event of the termination of an employee's employment with the Company. During fiscal 2013, the Company repurchased 40,353 shares of common stock from former employees pursuant to such repurchase right. The shares were repurchased for fair value at a weighted-average price of \$67.16 per share and were settled with the issuance of promissory notes bearing interest at 5%, paid annually, with principal due at the end of a 10-year term. As of February 1, 2014, the aggregate unpaid principal amount of the promissory notes was \$2.7 million, which is included in other long-term obligations on the consolidated balance sheets.

**NOTE 13—STOCK-BASED COMPENSATION**

The Company estimates the value of equity grants based upon an option-pricing model 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 a participant will vest, the Company recognizes compensation expense equal to the number of shares which have vested multiplied by the fair value of the related shares measured at the grant date.

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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 \$67.6 million, \$116.2 million and \$1.6 million in fiscal 2013, fiscal 2012 and fiscal 2011, respectively. No stock-based compensation cost has been capitalized in the accompanying consolidated financial statements. Stock-based compensation expense by equity award plan and by equity award type is discussed below.

### *2012 Stock Option Plan and 2012 Stock Incentive Plan*

In connection with the Reorganization, the Board of Directors adopted the Restoration Hardware 2012 Stock Option Plan (the "Option Plan"), pursuant to which 6,829,041 fully vested options were granted in connection with the Reorganization to certain of the Company's employees and advisors, including Mr. Friedman and Mr. Alberini. The options granted under this plan were fully vested upon the completion of the initial public offering and are subject to resale restrictions whereby the holder may not sell the shares for a period of 20 years after the initial public offering, except as follows: (i) with respect to 875,389 of these shares with an exercise price of \$29.00 per share, such resale restrictions lapse over time in accordance with the dates set forth in the applicable award agreement, and (ii) with respect to 5,953,652 shares with an exercise price of \$46.50 per share, such resale restrictions lapse on dates after the initial public offering on which the 10-day average closing price per share of the Company's common stock reaches specified levels ranging from \$50.75 to \$111.25 for at least 10 consecutive trading days. Aside from these options granted in connection with the Reorganization, no other awards will be granted under the Option Plan.

In connection with the Reorganization, the Board of Directors adopted the Restoration Hardware 2012 Stock Incentive Plan (the "Stock Incentive Plan"). 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. In connection with the Reorganization, the Board of Directors granted options to purchase 1,264,036 shares of the Company's common stock to employees of the Company under the Stock Incentive Plan, which options were fully vested upon the completion of the initial public offering, with a weighted-average exercise price equal to \$26.50 per share.

In addition, in connection with the Reorganization, the Board of Directors granted an aggregate of 40,623 restricted stock awards to certain of the Company's directors under the Stock Incentive Plan. Such restricted stock awards vested in full on January 31, 2013.

In connection with the grants under the Option Plan and the Stock Incentive Plan, the Company recorded a non-cash compensation charge at the Reorganization in fiscal 2012 of \$52.0 million related to these awards.

On July 2, 2013, in connection with Mr. Friedman's reappointment as Chairman and Co-Chief Executive Officer, the Company granted a stock option to Mr. Friedman under the 2012 Stock Incentive Plan to purchase 1,000,000 shares of its common stock, with an exercise price of \$75.43, which is equal to the closing price of the Company's common stock on the date of grant. This option is fully vested as of the date of grant but any shares issued upon exercise of the option will be subject to selling restrictions which are scheduled to lapse in three equal installments on the third, fourth and fifth anniversaries of the grant date. The fully vested option resulted in a one-time non-cash stock-based compensation charge of \$33.7 million in fiscal 2013.

Upon adoption, there were a total of 11,900,671 shares issuable under the Option Plan and Stock Incentive Plan. On February 4, 2013, an additional 759,353 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 Option Plan and Stock Incentive Plan as of February 1, 2014 to 12,660,024. 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

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available for future issuance. The number of shares available for future issuance under the Stock Incentive Plan as of February 1, 2014 was 2,857,157. There are no more shares available for issuance under the Option Plan. Shares issued as a result of award exercises under the Option Plan and Stock Incentive Plan will be funded with the issuance of new shares.

On February 3, 2014, an additional 782,495 shares became issuable under the Stock Incentive Plan in accordance with the Stock Incentive Plan evergreen provision.

### 2012 Stock Option Plan and 2012 Stock Incentive Plan – Stock Options

A summary of stock option activity under the Option Plan and the Stock Incentive Plan for fiscal 2013 is as follows:

	<u>Options</u>	<u>Weighted-Average Exercise Price</u>
Outstanding—February 2, 2013	8,159,577	\$ 41.41
Granted	1,417,500	70.32
Exercised	(317,771)	27.26
Forfeited	(95,675)	35.75
Retired	(16,325)	29.00
Outstanding—February 1, 2014	<u>9,147,306</u>	\$ 46.46

The fair value of stock options issued during fiscal 2013 and 2012 was estimated on the date of grant using the following assumptions:

	<u>Fiscal 2013</u>	<u>Fiscal 2012</u>
Expected volatility	39.7%	35.4%
Expected life (years)	6.7	5.3
Risk-free interest rate	1.9%	1.6%
Dividend yield	—	—

A summary of additional information about stock options is as follows:

	<u>Fiscal 2013</u>	<u>Fiscal 2012</u>
Weighted-average fair value per share of stock options granted	\$ 30.49	\$ 6.34
Aggregate intrinsic value of stock options exercised (in thousands)	\$ 11,623	\$ —
Fair value of stock options vested (in thousands)	\$ 33,871	\$ 51,063

Information about stock options outstanding, vested or expected to vest, and exercisable as of February 1, 2014 is as follows:

<u>Range of Exercise Prices</u>	<u>Options Outstanding</u>			<u>Options Exercisable</u>	
	<u>Number of Options</u>	<u>Weighted- Average Remaining Contractual Life (in years)</u>	<u>Weighted- Average Exercise Price</u>	<u>Number of Options</u>	<u>Weighted- Average Exercise Price</u>
\$24.00 - \$29.00	1,736,279	8.50	\$ 27.51	1,736,279	\$ 27.51
\$32.35 - \$39.00	141,875	8.75	33.89	5,000	32.46
\$46.50 - \$46.50	5,953,652	4.54	46.50	5,953,652	46.50
\$58.96 - \$69.64	265,500	9.41	61.54	—	—
\$74.03 - \$76.80	1,050,000	9.41	75.46	1,000,000	75.43
Total	<u>9,147,306</u>	6.06	\$ 46.46	<u>8,694,931</u>	\$ 46.03
Vested or expected to vest as of February 1, 2014	<u>9,113,138</u>	6.05	\$ 46.43		

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The aggregate intrinsic value of options outstanding, options vested or expected to vest, and options exercisable as of February 1, 2014 was \$114.9 million, \$114.7 million, and \$111.8 million, respectively. Stock options exercisable as of February 1, 2014 had a weighted-average remaining contractual life of 8.82 years.

The Company recorded stock-based compensation expense for stock options of \$1.3 million and \$0.1 million in fiscal 2013 and fiscal 2012 (subsequent to expense incurred at the time of the Reorganization), respectively. As of February 1, 2014, the total unrecognized compensation expense related to unvested options was \$7.7 million, which is expected to be recognized on a straight-line basis over a weighted-average period of 3.88 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 under the Stock Incentive Plan for fiscal 2013 is as follows:

	<u>Options</u>	<u>Weighted-Average Grant Date Fair Value</u>	<u>Intrinsic Value</u>
Outstanding—February 2, 2013	—	\$ —	
Granted	316,580	65.37	
Released	(13,333)	57.01	
Cancelled	(13,500)	73.92	
Outstanding—February 1, 2014	<u>289,747</u>	\$ 65.36	\$16,440,000

A summary of additional information about restricted stock awards is as follows:

	<u>Fiscal 2013</u>	<u>Fiscal 2012</u>
Weighted-average fair value per share of awards granted	\$ 65.37	\$ 24.00
Grant date fair value of awards released (in thousands)	\$ 760	\$ 975

The Company recorded stock-based compensation expense for restricted stock awards of \$2.7 million in fiscal 2013. As of February 1, 2014, the total unrecognized compensation expense related to unvested restricted stock awards was \$14.5 million, which is expected to be recognized on a straight-line basis over a weighted-average period of 3.64 years.

### *2012 Equity Replacement Plan*

In connection with the Reorganization, the Board of Directors adopted the Restoration Hardware 2012 Equity Replacement Plan (the “Replacement Plan”), and outstanding units under the Team Resto Ownership Plan were replaced with vested and unvested shares of common stock under the Replacement Plan, in some cases subject to selling restrictions.

A portion of the shares issued under the Replacement Plan, which are fully vested, are subject to resale restrictions whereby the holder may not sell the shares until the earlier of 20 years after the initial public offering, or with respect to 818,209 of these shares, such resale restrictions will lapse over time in accordance with the dates set forth in the applicable award agreement.

The Company recorded a non-cash compensation charge at the Reorganization in fiscal 2012 of \$39.1 million related to the awards granted under the Replacement Plan.

A portion of the shares issued under the Replacement Plan are unvested restricted shares issued to Mr. Friedman and Mr. Alberini in replacement of certain of their performance-based units granted under the



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Team Resto Ownership Plan. With respect to the 1,331,548 shares received by Mr. Friedman and Mr. Alberini in replacement of certain of their performance-based units, such shares began to vest during the period following the initial public offering when the price of the Company's common stock reached a 10-day average closing price per share of \$31.00 for at least 10 consecutive trading days, and such shares fully vested when the price of the Company's common stock reached a 10-day average closing price per share of \$46.50 for at least 10 consecutive trading days. In addition, with respect to the 512,580 shares received by Mr. Friedman and Mr. Alberini in replacement of certain of their performance-based units, such shares began to vest during the period following the initial public offering when the 10-day average closing price of the Company's common stock exceeded the initial public offering price of \$24.00 per share for at least 10 consecutive trading days, and such shares fully vested when the 10-day average closing price of the Company's common stock reached a price per share of \$31.00 for at least 10 consecutive trading days.

In connection with Mr. Friedman's resignation and new role as the Creator and Curator in fiscal 2012 and prior to his reappointment as Chairman and Co-Chief Executive Officer in fiscal 2013, 1,185,511 shares of unvested stock he received in replacement of certain performance-based units were marked to market every period until the required vesting criteria were met in accordance with ASC 718.

During fiscal 2012, all 512,580 shares received by Mr. Friedman and Mr. Alberini in replacement of certain of their performance-based units met the performance objective of \$31.00 per share for at least 10 consecutive trading days. The Company recorded a non-cash compensation charge of \$12.5 million related to these awards in fiscal 2012. During fiscal 2012, 442,932 shares of the 1,331,548 shares received by Mr. Friedman and Mr. Alberini in replacement of certain of their performance-based units had vested in accordance with the performance objective as described above. The Company recorded a non-cash compensation charge of \$10.6 million related to these awards in fiscal 2012.

During fiscal 2013, 888,616 shares of the 1,331,548 shares received by Mr. Friedman and Mr. Alberini in replacement of certain of their performance-based units vested in accordance with the performance objectives described above. The Company recorded a non-cash compensation charge of \$29.9 million related to these awards in fiscal 2013. As all shares received by Mr. Friedman and Mr. Alberini in replacement of certain of their performance-based units had vested as of February 1, 2014, no additional compensation expense will be recorded in future periods related to these awards.

Aside from the awards described above, no other awards will be granted under the Replacement Plan.

### *Team Resto Ownership Plan*

Home Holdings established the Team Resto Ownership Plan in fiscal 2009. Awards under the Team Resto Ownership Plan were granted by the Home Holdings and were made up of the following:

- Time-based units—time-based units vested in annual installments, generally over a five-year graded vesting period.
- Performance-based units—performance-based units vested based on a return on equity investment to the Company's investors between either two times and three times such investment or three times and five times such investment.

All stock-based compensation expense associated with the grants of units by Home Holdings to the Company's directors, executive officers and employees was recorded by the Company. The Company recorded stock-based compensation expense for time-based units of \$1.1 million and \$1.6 million in fiscal 2012 and fiscal 2011, respectively. In connection with its initial public offering, the Company recorded \$0.8 million related to the vested performance-based units in fiscal 2012.

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On November 7, 2012, the Company completed its initial public offering and at the time of the initial public offering, outstanding units under the Team Resto Ownership Plan, were replaced with common stock of the Company.

### **NOTE 14—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 2013, fiscal 2012, or fiscal 2011.

### **NOTE 15—RELATED PARTY TRANSACTIONS**

#### *Reappointment of Gary Friedman as Chairman and Co-Chief Executive Officer*

On July 2, 2013, at the time of Mr. Friedman's reappointment as Chairman of the Company's Board of Directors and Co-Chief Executive Officer, Mr. Friedman and Hierarchy, LLC ("Hierarchy"), a newly formed entity in which Mr. Friedman had a controlling interest, waived all of Home Holdings' obligations to invest in Hierarchy and all of Home Holdings' rights with respect to Hierarchy were canceled, and the Company subsequently acquired all the outstanding interests of Hierarchy. As a result of the acquisition of Hierarchy, in fiscal 2013 the Company wrote off all outstanding receivables in connection with certain consulting services provided to Hierarchy, and recorded a charge of \$0.2 million.

#### *Management Agreement*

Pursuant to the Amended and Restated Management Services Agreement with certain affiliates of Catterton, Tower Three and Glenhill, such affiliated entities were to provide services to the Company for general management, consulting services and other strategic planning functions. The amount of the annual management fee payable to Catterton, Tower Three and Glenhill under the Amended and Restated Management Services Agreement was equal to 1.5% of Catterton's and Tower Three's invested capital in Home Holdings and 1% of Glenhill's invested capital in Home Holdings.

The Amended and Restated Management Services Agreement provided that the term of the agreement ends upon the consummation of an initial public offering, and that additional fees would be payable upon termination in connection with an initial public offering. The Company paid additional fees upon such termination in connection with its initial public offering in fiscal 2012 to Catterton, Tower Three and Glenhill in the amount of \$3.3 million, \$3.1 million and \$0.6 million, respectively.

In addition to the initial public offering termination fees, the Company recorded management fees of \$3.9 million in selling, general and administrative expenses in fiscal 2012 and such management fees were paid by the Company in fiscal 2012.

The Company recorded management fees of \$9.9 million in selling, general and administrative expenses in fiscal 2011, of which \$6.0 million was paid directly by Home Holdings and reflected as a capital contribution from Home Holdings through additional paid-in capital. The remaining \$3.9 million was paid by the Company in fiscal 2011.

#### *Executive Loans with Home Holdings*

In the years prior to the Company's initial public offering in November 2012, certain of the Company's executive officers listed below entered into loans with Home Holdings, a former affiliate of the Company. All of these loans were repaid prior to the completion of the Company's initial public offering.

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In December 2008, Mr. Friedman entered into a \$1.0 million loan with Home Holdings in connection with the purchase of a 0.3% ownership interest in Home Holdings. The full recourse loan initially bore interest at a rate of 8.0% per annum. If the interest was not paid in cash on December 31 of each year, such interest was deemed paid by capitalization and added to the principal amount of the loan. Principal and accrued interest was due the earlier of December 31, 2018, upon the sale of the Company or upon Mr. Friedman's termination of employment. In May 2010, the loan was amended and restated to, among other things, reduce the interest rate to 5.0% per annum, as of the date of the original \$1.0 million loan received in December 2008, modify the maturity date to December 31, 2015, and provide for an additional \$5.0 million loan from Home Holdings in connection with the purchase of an additional 1.7% ownership interest in Home Holdings.

In September 2011, Mr. Friedman repaid the loans owed to Home Holdings, together with accrued interest thereon, through the reclassification by Home Holdings of Mr. Friedman's pre-Reorganization Class A units and Class A-1 units in Home Holdings into an equal number of pre-Reorganization Class A Prime units and Class A-1 Prime units in Home Holdings, respectively. The Class A Prime units and Class A-1 Prime units, which are not subject to any future vesting, do not entitle Mr. Friedman to distributions from Home Holdings until after certain amounts have been distributed to the holders of Class A units, commensurate with the amount of all previously outstanding principal and interest on the loans. On the date of such repayment, the total principal amount of the loans, including all accrued interest thereon, was \$6,559,877. No prior payments of principal or interest were made by Mr. Friedman under the loan agreements. The Company completed a valuation analysis regarding the reclassification of units which resulted in a \$6.4 million compensation charge included in selling, general and administrative expenses on the consolidated statements of operations for fiscal 2011 and reflected as a capital contribution from Home Holdings through additional paid-in capital. Such compensation charge was calculated as the total principal amount of the loans, including all accrued interest thereon, as of the repayment date, less the difference in fair value of the Class A units and Class A-1 units in Home Holdings as compared to the Class A Prime units and Class A-1 Prime units in Home Holdings.

In May 2010, Mr. Alberini entered into a \$4.0 million loan with Home Holdings in connection with the purchase of a 1.4% ownership interest in Home Holdings bearing interest at the rate of 5.0% per annum with a maturity date of ninety days from the original date of such note. The loan to Mr. Alberini was repaid in full on August 25, 2010.

In April 2011, Ken Dunaj, the Company's Chief Operating Officer, entered into a \$600,000 loan with Home Holdings. The full recourse loan bears interest at 5.0% per annum and is secured by Mr. Dunaj's Team Restoration Ownership Plan units. The loan, together with all interest accrued but unpaid, is due and payable on the first to occur of (i) December 31, 2015, (ii) ninety days following termination of employment, (iii) the date of any sale of the Company, (iv) the date of an initial public offering, (v) the date of any acceleration that might occur as a result of a defined default under the note, or (vi) demand for repayment by Home Holdings.

In September 2011, Mr. Dunaj repaid the loan owed to Home Holdings, together with accrued interest thereon, through the reclassification by Home Holdings of Mr. Dunaj's pre-Reorganization Class B units issued under the Team Resto Ownership Plan into an equal number of pre-Reorganization Class B Prime units under the Team Resto Ownership Plan. The Class B Prime units are entitled to a lower distribution amount than Class B units, commensurate with the amount of all previously outstanding principal and interest on the loan. On the date of such repayment, the total principal amount of the loan, including all accrued interest thereon, was \$620,712. No prior payments of principal or interest were made by Mr. Dunaj under the loan agreement. On the date of such repayment, Mr. Dunaj surrendered 300,000 of his unvested Class B performance units under the Team Resto Ownership Plan. The Company undertook a valuation analysis regarding the reclassification of units which resulted in no compensation charge recorded in connection with the reclassification in the Company's consolidated financial statements for fiscal 2011 as it relates to vested awards and over the remaining vesting periods for currently unvested awards.

**NOTE 16—COMMITMENTS AND CONTINGENCIES**

**Leases**

The Company leases certain property consisting of retail and outlet stores, corporate offices, distribution centers and equipment. Leases expire at various dates through 2033. The stores, distribution centers and corporate office leases generally provide that the Company assumes the maintenance and all or a portion of the property tax obligations on the leased property. Most store leases also provide for minimum annual rentals, with provisions for additional rent based on a percentage of sales and for payment of certain expenses.

The aggregate future minimum rental payments under leases in effect as of February 1, 2014, are as follows (*in thousands*):

	Capital Leases (1)	Operating Leases	Other Commitments (2)	Total
2014	\$ 1,844	\$ 68,709	\$ 48,352	\$ 118,905
2015	235	61,396	8,544	70,175
2016	106	57,972	8,966	67,044
2017	50	53,775	9,276	63,101
2018	21	46,824	7,383	54,228
Thereafter	—	323,991	60,480	384,471
Minimum lease commitments	2,256	<u>\$612,667</u>	<u>\$ 143,001</u>	<u>\$ 757,924</u>
Less—amount representing interest	(60)			
Present value of capital lease obligations	2,196			
Less—current capital lease obligations	(1,807)			
Long-term capital lease obligations	<u>\$ 389</u>			

(1) The current and long-term capital lease obligations are included in other current liabilities and other long-term obligations, respectively, on the consolidated balance sheets.

(2) Other commitments include estimated timing and amounts of payments for rent and tenant improvements associated with build-to-suit lease arrangements.

Lease payments that depend on factors that are not measurable at the inception of the lease, such as future sales volume, are contingent rentals and are excluded from minimum lease payments and included in the determination of total rental expense when it is probable that the expense has been incurred and the amount is reasonably estimable. Future payments for insurance, real estate taxes and repair and maintenance to which the Company is obligated are excluded from minimum lease payments. Minimum and contingent rental expense under operating leases is as follows (*in thousands*):

	Year Ended		
	February 1, 2014	February 2, 2013	January 28, 2012
Operating leases			
Minimum rental expense	\$ 66,686	\$ 52,750	\$ 51,665
Contingent rental expense	6,208	3,318	1,456
Total operating leases	<u>\$ 72,894</u>	<u>\$ 56,068</u>	<u>\$ 53,121</u>

**Commitments**

The Company had no off balance sheet commitments as of February 1, 2014.

### 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. As of February 1, 2014, the Company has recorded a liability for the estimated loss related to these disputes. There is a possibility that additional losses may be incurred in excess of the amounts that we have accrued. However, the Company believes that the ultimate resolution of these current matters will not have a material adverse effect on its consolidated financial statements.

### NOTE 17—SEGMENT REPORTING

The Company defines an operating segment on the same basis that it uses to evaluate performance internally by the Chief Operating Decision Maker ("CODM"). The Company has determined that the Chief Executive Officers is its CODM and there is one operating segment. Therefore, the Company reports as a single segment. This includes all sales channels accessed by the Company's customers, including sales through catalogs, sales through the Company's website and sales through the Company's stores.

The Company classifies its sales into furniture and non-furniture product lines. Furniture includes both indoor and outdoor furniture. Non-furniture includes lighting, textiles, accessories and home décor. Net revenues in each category were as follows (*in thousands*):

	Year Ended		
	February 1, 2014	February 2, 2013	January 28, 2012
Furniture	\$ 868,650	\$ 628,092	\$ 477,730
Non-furniture	682,311	564,954	480,354
Total net revenues	<u>\$ 1,550,961</u>	<u>\$ 1,193,046</u>	<u>\$ 958,084</u>

The Company is domiciled in the United States and operates stores in the United States and Canada. Revenues from Canadian operations, and the long-lived assets in Canada, are not material to the Company. Geographic revenues are determined based upon where service is rendered.

No single customer accounted for more than 10% of the Company's revenues in fiscal 2013, fiscal 2012, or fiscal 2011.

### NOTE 18—RETAIL STORE CLOSURES AND OFFICE RESTRUCTURING

#### Shanghai Office Restructuring

In April 2011, the Company restructured its Shanghai office location and terminated employees at that office, as well as terminated employees within the corporate headquarters in Corte Madera, CA. As a result, during fiscal 2011, the Company incurred \$1.6 million in restructuring related costs, including one-time

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employee termination benefits, contract termination fees, loss on disposal of capitalized property and equipment, and other associated costs, which are included in selling, general and administrative expenses on the consolidated statements of operations. During fiscal 2013 and fiscal 2012, the Company did not incur any restructuring related costs. At February 1, 2014, the Company did not have any remaining future liabilities related to this office restructuring. The Company does not expect to incur additional costs associated with this office restructuring in future periods.

### *Retail Store Closures*

In June and July 2011, the Company closed four retail store locations prior to their respective lease termination dates. As a result, during fiscal 2011, the Company incurred \$3.2 million in exit related costs, including contract termination fees, one-time employee termination benefits and other associated costs. During fiscal 2012, the Company recorded income of \$0.4 million related to a change in estimate of liabilities related to closed stores. During fiscal 2013, the Company did not incur any restructuring related costs. At February 1, 2014, the Company did not have any remaining future liabilities existing under these lease agreements. The Company does not expect to incur additional costs associated with these retail store closures in future periods.

### **NOTE 19—SELECTED QUARTERLY FINANCIAL DATA (UNAUDITED)**

Quarterly financial data for fiscal 2013 and fiscal 2012 are set forth below (*in thousands, except share and per share amounts*):

<b>Fiscal 2013</b>	<b>Three Months Ended</b>			
	<b>May 4, 2013</b>	<b>August 3, 2013</b>	<b>November 2, 2013</b>	<b>February 1, 2014</b>
Net revenues	\$ 301,337	\$ 382,098	\$ 395,832	\$ 471,694
Gross profit	101,877	139,226	140,800	174,977
Net income (loss)	(161)	(17,835)	9,549	26,642
Weighted-average shares used in computing basic net income (loss) per share	38,076,026	38,712,000	38,888,208	39,008,383
Basic net income (loss) per share	\$ —	\$ (0.46)	\$ 0.25	\$ 0.68
Weighted-average shares used in computing diluted net income (loss) per share	38,076,026	38,712,000	41,053,211	41,119,175
Diluted net income (loss) per share	\$ —	\$ (0.46)	\$ 0.23	\$ 0.65

<b>Fiscal 2012</b>	<b>Three Months Ended</b>			
	<b>April 28, 2012</b>	<b>July 28, 2012</b>	<b>October 27, 2012</b>	<b>February 2, 2013</b>
Net revenues	\$ 217,914	\$ 292,906	\$ 284,171	\$ 398,055
Gross profit	75,268	114,127	101,880	145,174
Net income (loss)	(3,728)	17,616	1,685	(28,362)
Weighted-average shares used in computing basic and diluted net income (loss) per share	1,000	1,000	1,000	35,692,064
Basic and diluted net income (loss) per share	\$ (3,728)	\$ 17,616	\$ 1,685	\$ (0.79)

The three months ended May 4, 2013 includes (i) a \$3.3 million non-cash compensation charge related to the performance-based vesting of certain shares granted to Mr. Friedman and (ii) \$0.8 million of costs incurred in connection with the Company's follow-on offering in May 2013.

The three months ended August 3, 2013 includes (i) a \$33.7 million non-cash compensation charge related to the one-time, fully vested option granted to Mr. Friedman upon his reappointment as Chairman and Co-Chief

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Executive Officer in July 2013, (ii) a \$26.2 million non-cash compensation charge related to the performance-based vesting of certain shares granted to Mr. Friedman and (iii) \$2.1 million of costs incurred in connection with the Company's follow-on offerings in May 2013 and July 2013.

The three months ended February 2, 2013 includes (i) a \$92.0 million non-cash compensation charge related to equity grants at the time of the Reorganization, (ii) a non-cash compensation charge of \$23.1 million related to the performance-based vesting of certain shares granted to Mr. Alberini and Mr. Friedman, (iii) costs incurred in connection with the initial public offering, including a fee of \$7.0 million to Catterton, Tower Three and Glenhill in accordance with the Company's management services agreement, payments of \$2.2 million to certain former executives and bonus payments to employees of \$1.3 million and (iv) \$3.3 million incurred as a result of increased tariff obligations of one of the Company's foreign suppliers following the U.S. Department of Commerce's review of the anti-dumping duty order on wooden bedroom furniture from China for the period from January 1, 2011 through December 31, 2011. In addition, as of the end of fiscal 2012, the Company's U.S. operations had returned to a position of cumulative profits (adjusted for permanent differences) for the most recent three-year period. The Company concluded that this record of cumulative profitability in recent years, coupled with its business plan for profitability in future periods, provided assurance that the Company's future tax benefits more likely than not would be realized. Accordingly, in the three months ended February 2, 2013, the Company released all of its U.S. valuation allowance of \$57.2 million against net deferred tax assets.

The three months ended July 28, 2012 and October 27, 2012 include \$2.0 million and \$2.8 million, respectively, of legal and other professional fees incurred in connection with the investigation conducted by the special committee of the board of directors relating to Mr. Friedman and its subsequent remedial actions.

### **NOTE 20—SUBSEQUENT EVENTS**

#### *Acquisition of Assets*

On February 3, 2014, the Company completed the acquisition of certain assets for an aggregate purchase price of \$2.5 million. These assets were purchased from a company that is owned by an employee of the Company. The Company will account for this acquisition utilizing the purchase method. In accordance with the purchase method, all assets and liabilities will be recorded at fair value, including goodwill and other intangible assets acquired. The Company has not completed the process of estimating the fair value of goodwill and other intangible assets.

#### *Share Repurchase*

On March 10, 2014, the Company repurchased 238,290 shares of common stock from Carlos Alberini, a former Co-Chief Executive Officer of the Company, pursuant to its repurchase rights under the 2012 Equity Replacement Plan. The shares were repurchased at a purchase price of \$65.06 per share, the closing sale price of the Company's common stock on the New York Stock Exchange on the repurchase date, and were settled with the issuance of an unsecured subordinated promissory note in the aggregate amount of \$15.5 million. The promissory note has a term of eight years and accrues interest annually at a rate of 5%, with accrued interest payable annually by the Company. The principal amount of the promissory note is payable by the Company at maturity on March 10, 2022.

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Board of Directors and Stockholders  
Restoration Hardware Holdings, Inc.

In our opinion, the consolidated financial statements listed in the index appearing under Item 15(a)(1) present fairly, in all material respects, the financial position of Restoration Hardware Holdings, Inc. and its subsidiaries at February 1, 2014 and February 2, 2013, and the results of their operations and their cash flows for each of the three years in the period ended February 1, 2014 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, 2014, based on criteria established in Internal Control—Integrated Framework (1992) issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for these 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 these financial statements and on the Company's internal control over financial reporting based on our audits (which was an integrated audit for fiscal year ended February 1, 2014). We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. 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.

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.

/s/ PricewaterhouseCoopers LLP

San Francisco, California  
March 28, 2014



**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 February 1, 2014 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, 2014 based on the framework established by the Committee of Sponsoring Organizations of the Treadway Commission in *Internal Control—Integrated Framework* (1992). Based on the assessment, management concluded that our internal control over financial reporting was effective as of February 1, 2014. The effectiveness of the Company's internal control over financial reporting as of February 1, 2014 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 was no change in our internal control over financial reporting that occurred during our most recent fiscal quarter that has materially affected, or is 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 Annual Meeting of Shareholders (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:

- Consolidated Balance Sheets as of February 1, 2014 and February 2, 2013
- Consolidated Statements of Operations for the fiscal years ended February 1, 2014, February 2, 2013 and January 28, 2012
- Consolidated Statements of Comprehensive Income (Loss) for the fiscal years ended February 1, 2014, February 2, 2013 and January 28, 2012
- Consolidated Statements of Cash Flows for the fiscal years ended February 1, 2014, February 2, 2013 and January 28, 2012
- Notes to the Consolidated Financial Statements
- Report of Independent Registered Public Accounting Firm on 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 following 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.



**EXHIBIT INDEX**

<b>Exhibit Number</b>	<b>Exhibit Description</b>	<b>Form</b>	<b>Incorporated by Reference</b>		<b>Exhibit Number</b>	<b>Filed Herewith</b>
			<b>File Number</b>	<b>Date of First Filing</b>		
3.1	Amended and Restated Certificate of Incorporation of Restoration Hardware Holdings, Inc.	10-K	001-35720	April 29, 2013	3.1	
3.2	Amended and Restated Bylaws of Restoration Hardware Holdings, Inc.	8-K	001-35720	July 2, 2013	3.1	
4.1	Form of Restoration Hardware Holdings, Inc.'s Common Stock Certificate.	S-1/A	333-176767	October 23, 2012	4.1	
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	First Amendment to Ninth Amended and Restated Credit Agreement dated as of January 6, 2012, by and among Restoration Hardware, Inc., as lead borrower, Restoration Hardware Canada, Inc., as Canadian borrower, the other borrowers party thereto, the guarantors party thereto, the lenders party thereto and Bank of America, N.A., as administrative agent and collateral agent.	S-1	333-176767	June 26, 2012	10.5	

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<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>		
10.3	Second Amendment to Ninth Amended and Restated Credit Agreement, dated as of September 16, 2013 between Restoration Hardware, Inc., as Lead Borrower, the other borrowers party thereto, the guarantors party thereto, the lenders party thereto and Bank of America, N.A., as administrative agent and collateral agent.	8-K	001-35720	September 20, 2013	10.1	
10.4	Ninth Amended and Restated Credit Agreement dated as of August 3, 2011, by and among Restoration Hardware, Inc., as lead borrower, Restoration Hardware Canada, Inc., as Canadian borrower, the other borrowers party thereto, the guarantors party thereto, the lenders from time to time party thereto and Bank of America, N.A., as administrative agent and collateral agent.	S-1	333-176767	June 26, 2012	10.6	
10.5	Stockholders Agreement dated as of November 7, 2012, by and between Restoration Hardware Holdings, Inc., and Home Holdings, LLC.	10-K	001-35720	April 29, 2013	10.4	

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<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>		
10.6	Registration Rights Agreement dated as of November 7, 2012, by and among Restoration Hardware Holdings, Inc., Home Holdings, LLC, CP Home Holdings, LLC, Tower Three Home, LLC, and the other parties thereto.	10-K	001-35720	April 29, 2013	10.5	
10.7	Advisory Services Agreement dated as of October 20, 2012, between Restoration Hardware, Inc. and Gary Friedman.	S-1	333-176767	October 31, 2012	10.18	
10.8	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	
10.9	Employment Agreement dated as of November 1, 2012 by and between Restoration Hardware, Inc. and Carlos Alberini.	10-K	001-35720	April 29, 2013	10.8	
10.10	Amendment to Amended and Restated Employment Agreement, dated as of July 2, 2013, between the Company and Carlos Alberini.	8-K	001-35720	July 3, 2013	10.2	
10.11	Employment Agreement dated as of November 1, 2012, by and between Restoration Hardware, Inc. and Karen Boone.	10-K	001-35720	April 29, 2013	10.9	

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<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>		
10.12	Amended and Restated Offer Letter, between Restoration Hardware, Inc. and Ken Dunaj.	S-1	333-176767	October 23, 2012	10.3	
10.13	2012 Equity Replacement Plan and related documents.	S-8	333-184716	November 2, 2012	4.2	
10.14	2012 Stock Incentive Plan and related documents.	S-8	333-184716	November 2, 2012	4.3	
10.15	2012 Stock Option Plan and related documents.	S-8	333-184716	November 2, 2012	4.4	
10.16	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	
10.17	Form of Notice of Restricted Stock Unit Award and Restricted Stock Unit Agreement under 2012 Stock Incentive Plan.	—	—	—	—	X
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



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<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>		
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
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	—	—	—	—	X
101.SCH	XBRL Taxonomy Extension Schema Document	—	—	—	—	X
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document	—	—	—	—	X
101.DEF	XBRL Extension Definition	—	—	—	—	X
101.LAB	XBRL Taxonomy Extension Label Linkbase Document	—	—	—	—	X
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document	—	—	—	—	X

FORM OF TIME-VESTED RESTRICTED STOCK UNIT AGREEMENT

RESTORATION HARDWARE HOLDINGS, INC. 2012 stock incentive PLAN

NOTICE OF Restricted Stock Unit AWARD

Grantee's Name and Address:

\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

You (the "Grantee") have been granted an award of Restricted Stock Units (the "Award"), subject to the terms and conditions of this Notice of Restricted Stock Unit Award (the "Notice"), the Restoration Hardware Holdings, Inc. 2012 Stock Incentive Plan, as amended from time to time (the "Plan") and the Restricted Stock Unit Agreement (the "Agreement") attached hereto, as follows. Unless otherwise provided herein, the terms in this Notice shall have the same meaning as those defined in the Plan.

Award Number

Date of Award

Vesting Commencement Date

Total Number of Restricted Stock Units Awarded (the "Units")

\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_  
\_\_\_\_\_

Vesting Schedule:

Subject to the Grantee's Continuous Service and other limitations set forth in this Notice, the Agreement and the Plan, the Units will "vest" in accordance with the following schedule (the "Vesting Schedule"):

[Insert Vesting Schedule]

For purposes of this Notice and the Agreement, the term "vest" shall mean, with respect to any Units, that such Units are no longer subject to forfeiture to the Company. If the Grantee would become vested in a fraction of a Unit, such Unit shall not vest until the Grantee becomes vested in the entire Unit.

Vesting shall cease upon the date the Grantee terminates Continuous Service for any reason, including death or Disability. In the event the Grantee terminates Continuous Service for any reason, including death or Disability, any unvested Units held by the Grantee immediately upon such termination of the Grantee's Continuous Service shall be forfeited and deemed reconveyed to the Company and the Company shall thereafter be the legal and beneficial owner of such reconveyed Units and shall have all rights and interest in or related thereto without further action by the Grantee.

IN WITNESS WHEREOF, the Company and the Grantee have executed this Notice and agree that the Award is to be governed by the terms and conditions of this Notice, the Plan, and the Agreement.

**RESTORATION HARDWARE HOLDINGS, INC.**

a Delaware corporation

By: \_\_\_\_\_

Title: \_\_\_\_\_

Date: \_\_\_\_\_

THE GRANTEE ACKNOWLEDGES AND AGREES THAT THE UNITS SHALL VEST, IF AT ALL, ONLY DURING THE PERIOD OF CONTINUOUS SERVICE OR AS OTHERWISE SPECIFICALLY PROVIDED HEREIN (NOT THROUGH THE ACT OF BEING HIRED, BEING GRANTED THIS AWARD OR ACQUIRING SHARES HEREUNDER). THE GRANTEE FURTHER ACKNOWLEDGES AND AGREES THAT NOTHING IN THIS NOTICE, THE AGREEMENT, NOR IN THE PLAN, SHALL CONFER UPON THE GRANTEE ANY RIGHT WITH RESPECT TO CONTINUATION OF THE GRANTEE'S CONTINUOUS SERVICE, NOR SHALL IT INTERFERE IN ANY WAY WITH THE GRANTEE'S RIGHT OR THE COMPANY'S RIGHT TO TERMINATE THE GRANTEE'S CONTINUOUS SERVICE AT ANY TIME, WITH OR WITHOUT CAUSE, AND WITH OR WITHOUT NOTICE. THE GRANTEE ACKNOWLEDGES THAT UNLESS THE GRANTEE HAS A WRITTEN EMPLOYMENT AGREEMENT WITH THE COMPANY TO THE CONTRARY, THE GRANTEE'S STATUS IS AT WILL.

**Grantee Acknowledges and Agrees:**

The Grantee acknowledges receipt of a copy of the Plan and the Agreement and represents that he or she is familiar with the terms and provisions thereof, and hereby accepts the Award subject to all of the terms and provisions hereof and thereof. The Grantee has reviewed this Notice, the Agreement and the Plan in their entirety, has had an opportunity to obtain the advice of counsel prior to executing this Notice and fully understands all provisions of this Notice, the Agreement and the Plan.

The Grantee further acknowledges that, from time to time, the Company may be in a “blackout period” and/or subject to applicable federal securities laws that could subject the Grantee to liability for engaging in any transaction involving the sale of the Company’s Shares. The Grantee further acknowledges and agrees that, prior to the sale of any Shares acquired under this Award, it is the Grantee’s responsibility to determine whether or not such sale of Shares will subject the Grantee to liability under insider trading rules or other applicable federal securities laws.

The Grantee understands that the Award is subject to the Grantee’s consent to access this Notice, the Agreement, the Plan and the Plan prospectus (collectively, the “Plan Documents”) in electronic form on the Company’s intranet or the website of the Company’s designated brokerage firm, if applicable, or by such other method as designated by the Company at the Company’s sole discretion from time to time. By signing below and accepting the grant of the Award, the Grantee: (i) consents to access copies of the Plan Documents by means and methods as designated by the Company from time to time; (ii) if applicable or upon establishment by the Company of an intranet or upon engagement of a brokerage firm for the administration of these Awards, consents to access electronic copies (instead of receiving paper copies) of the Plan Documents via such Company intranet or the website of the Company’s designated brokerage firm; (iii) represents and agrees that the Grantee will comply with reasonable procedures to access the Company’s intranet or the website of the Company’s designated brokerage firm, if applicable; (iv) acknowledges that the Grantee is already in possession of paper copies, of the Plan Documents; and (v) acknowledges that the Grantee is familiar with and accepts the Award subject to the terms and provisions of the Plan Documents.

The Company may, in its sole discretion, decide to deliver any Plan Documents by electronic means or request the Grantee’s consent to participate in the Plan by electronic means. The Grantee hereby consents to receive such documents by electronic delivery and agrees to participate in the Plan through an on-line or electronic system established and maintained by the Company or a third party designated by the Company.

The Grantee hereby agrees that all questions of interpretation and administration relating to this Notice, the Plan and the Agreement shall be resolved by the Administrator in accordance with Section 8 of the Agreement. The Grantee further agrees to the venue and jurisdiction selection in accordance with Section 9 of the Agreement. The Grantee further agrees to notify the Company upon any change in his or her residence address indicated in this Notice.

Date: \_\_\_\_\_

\_\_\_\_\_  
Grantee’s Signature

## RESTORATION HARDWARE HOLDINGS, INC. 2012 STOCK INCENTIVE PLAN

**RESTRICTED STOCK UNIT AGREEMENT**

1. **Issuance of Units.** Restoration Hardware Holdings, Inc., a Delaware corporation (the “Company”), hereby issues to the Grantee (the “Grantee”) named in the Notice of Restricted Stock Unit Award (the “Notice”) an award (the “Award”) of the Total Number of Restricted Stock Units Awarded set forth in the Notice (the “Units”), subject to the Notice, this Restricted Stock Unit Agreement (the “Agreement”) and the terms and provisions of the Restoration Hardware Holdings, Inc. 2012 Stock Incentive Plan, as amended from time to time (the “Plan”), which is incorporated herein by reference. Unless otherwise provided herein, the terms in this Agreement shall have the same meaning as those defined in the Plan.

2. **Transfer Restrictions.** The Units may not be transferred in any manner other than by will or by the laws of descent and distribution.

3. **Conversion of Units and Issuance of Shares.**

(a) **General.** Subject to Sections 3(b) and 3(c), one share of Common Stock shall be issuable for each Unit subject to the Award (the “Shares”) upon vesting. Immediately thereafter, or as soon as administratively feasible, the Company will transfer the appropriate number of Shares to the Grantee after satisfaction of any required tax or other withholding obligations. Any fractional Unit remaining after the Award is fully vested shall be discarded and shall not be converted into a fractional Share. Notwithstanding the foregoing, the relevant number of Shares shall be issued no later than March 15th of the year following the calendar year in which the Award vests. Effective upon the consummation of a Corporate Transaction, the Award shall terminate unless it is Assumed in connection with the Corporate Transaction.

(b) **Delay of Conversion.** The conversion of the Units into the Shares under Section 3(a) above, shall be delayed in the event the Company reasonably anticipates that the issuance of the Shares would constitute a violation of federal securities laws or other Applicable Law. If the conversion of the Units into the Shares is delayed by the provisions of this Section 3(b), the conversion of the Units into the Shares shall occur at the earliest date at which the Company reasonably anticipates issuing the Shares will not cause a violation of federal securities laws or other Applicable Law. For purposes of this Section 3(b), the issuance of Shares that would cause inclusion in gross income or the application of any penalty provision or other provision of the Code is not considered a violation of Applicable Law.

(c) **Delay of Issuance of Shares.** The Company shall delay the issuance of any Shares under this Section 3 to the extent necessary to comply with Section 409A(a)(2)(B)(i) of the Code (relating to payments made to certain “specified employees” of certain publicly-traded companies); in such event, any Shares to which the Grantee would otherwise be entitled during the six (6) month period following the date of the Grantee’s termination of Continuous Service will be issuable on the first business day following the expiration of such six (6) month period.

4. Right to Shares. The Grantee shall not have any right in, to or with respect to any of the Shares (including any voting rights or rights with respect to dividends paid on the Common Stock) issuable under the Award until the Award is settled by the issuance of such Shares to the Grantee.

5. Taxes.

(a) Tax Liability. The Grantee is ultimately liable and responsible for all taxes owed by the Grantee in connection with the Award, regardless of any action the Company or any Related Entity takes with respect to any tax withholding obligations that arise in connection with the Award. Neither the Company nor any Related Entity makes any representation or undertaking regarding the treatment of any tax withholding in connection with any aspect of the Award, including the grant, vesting, assignment, release or cancellation of the Units, the delivery of Shares, the subsequent sale of any Shares acquired upon vesting and the receipt of any dividends or dividend equivalents. The Company does not commit and is under no obligation to structure the Award to reduce or eliminate the Grantee's tax liability.

(b) Payment of Withholding Taxes. Prior to any event in connection with the Award (e.g., vesting) that the Company determines may result in any tax withholding obligation, whether United States federal, state, local or non-U.S., including any social insurance, employment tax, payment on account or other tax-related obligation (the "Tax Withholding Obligation"), the Grantee must arrange for the satisfaction of the minimum amount of such Tax Withholding Obligation in a manner acceptable to the Company.

(i) By Share Withholding. If permissible under Applicable Law, the Grantee authorizes the Company to, upon the exercise of its sole discretion, withhold from those Shares otherwise issuable to the Grantee the whole number of Shares sufficient to satisfy the minimum applicable Tax Withholding Obligation. The Grantee acknowledges that the withheld Shares may not be sufficient to satisfy the Grantee's minimum Tax Withholding Obligation. Accordingly, the Grantee agrees to pay to the Company or any Related Entity as soon as practicable, including through additional payroll withholding, any amount of the Tax Withholding Obligation that is not satisfied by the withholding of Shares described above.

(ii) By Sale of Shares. Unless the Grantee determines to satisfy the Tax Withholding Obligation by some other means in accordance with clause (iii) below, the Grantee's acceptance of this Award constitutes the Grantee's instruction and authorization to the Company and any brokerage firm determined acceptable to the Company for such purpose to, upon the exercise of Company's sole discretion, sell on the Grantee's behalf a whole number of Shares from those Shares issuable to the Grantee as the Company determines to be appropriate to generate cash proceeds sufficient to satisfy the minimum applicable Tax Withholding Obligation. Such Shares will be sold on the day such Tax Withholding Obligation arises (e.g., a vesting date) or as soon thereafter as practicable. The Grantee will be responsible for all broker's fees and other costs of sale, and the Grantee agrees to indemnify and hold the Company harmless from any losses, costs, damages, or expenses relating to any such sale. To the extent the proceeds of such sale exceed the Grantee's minimum Tax Withholding Obligation, the Company agrees to pay such excess in cash to the Grantee. The Grantee acknowledges that the Company or its designee is under no obligation to arrange for such sale at any particular price, and that the proceeds of any such sale may not be sufficient to satisfy the Grantee's minimum Tax Withholding Obligation. Accordingly, the Grantee agrees to pay to the Company or any Related Entity as soon as practicable, including through additional payroll withholding, any amount of the Tax Withholding Obligation that is not satisfied by the sale of Shares described above.

(iii) By Check, Wire Transfer or Other Means. At any time not less than five (5) business days (or such fewer number of business days as determined by the Administrator) before any

Tax Withholding Obligation arises (e.g., a vesting date), the Grantee may elect to satisfy the Grantee's Tax Withholding Obligation by delivering to the Company an amount that the Company determines is sufficient to satisfy the Tax Withholding Obligation by (x) wire transfer to such account as the Company may direct, (y) delivery of a certified check payable to the Company, or (z) such other means as specified from time to time by the Administrator.

Notwithstanding the foregoing, the Company or a Related Entity also may satisfy any Tax Withholding Obligation by offsetting any amounts (including, but not limited to, salary, bonus and severance payments) payable to the Grantee by the Company and/or a Related Entity. Furthermore, in the event of any determination that the Company has failed to withhold a sum sufficient to pay all withholding taxes due in connection with the Award, the Grantee agrees to pay the Company the amount of such deficiency in cash within five (5) days after receiving a written demand from the Company to do so, whether or not the Grantee is an employee of the Company at that time.

6. Entire Agreement; Governing Law. The Notice, the Plan and this Agreement constitute the entire agreement of the parties with respect to the subject matter hereof and supersede in their entirety all prior undertakings and agreements of the Company and the Grantee with respect to the subject matter hereof, and may not be modified adversely to the Grantee's interest except by means of a writing signed by the Company and the Grantee. These agreements are to be construed in accordance with and governed by the internal laws of the State of California without giving effect to any choice of law rule that would cause the application of the laws of any jurisdiction other than the internal laws of the State of California to the rights and duties of the parties. Should any provision of the Notice or this Agreement be determined to be illegal or unenforceable, the other provisions shall nevertheless remain effective and shall remain enforceable.

7. Construction. The captions used in the Notice and this Agreement are inserted for convenience and shall not be deemed a part of the Award for construction or interpretation. Except when otherwise indicated by the context, the singular shall include the plural and the plural shall include the singular. Use of the term "or" is not intended to be exclusive, unless the context clearly requires otherwise.

8. Administration and Interpretation. Any question or dispute regarding the administration or interpretation of the Notice, the Plan or this Agreement shall be submitted by the Grantee or by the Company to the Administrator. The resolution of such question or dispute by the Administrator shall be final and binding on all persons.

9. Venue and Jurisdiction. The parties agree that any suit, action, or proceeding arising out of or relating to the Notice, the Plan or this Agreement shall be brought exclusively in the United States District Court for the Northern District of California (or should such court lack jurisdiction to hear such action, suit or proceeding, in a California state court in the County of San Francisco) and that the parties shall submit to the jurisdiction of such court. The parties irrevocably waive, to the fullest extent permitted by law, any objection the party may have to the laying of venue for any such suit, action or proceeding brought in such court. If any one or more provisions of this Section 9 shall for any reason be held invalid or unenforceable, it is the specific intent of the parties that such provisions shall be modified to the minimum extent necessary to make it or its application valid and enforceable.

10. Notices. Any notice required or permitted hereunder shall be given in writing and shall be deemed effectively given upon personal delivery, upon deposit for delivery by an internationally recognized express mail courier service or upon deposit in the United States mail by certified mail (if the parties are within the United States), with postage and fees prepaid, addressed to the other party at its address as shown in these instruments, or to such other address as such party may designate in writing from time to time to the other party.

11. Data Privacy. The Grantee hereby explicitly and unambiguously consents to the collection, use and transfer, in electronic or other form, of the Grantee's personal data as described in the Notice and this Agreement by and among, as applicable, the Grantee's employer, the Company and any Related Entity for the exclusive purpose of implementing, administering and managing the Grantee's participation in the Plan. The Grantee understands that the Company and the Grantee's employer may hold certain personal information about the Grantee, including, but not limited to, the Grantee's name, home address and telephone number, date of birth, social insurance or other identification number, salary, nationality, job title, any Shares or directorships held in the Company, details of all Units or any other entitlement to Shares awarded, canceled, vested, unvested or outstanding in the Grantee's favor, for the exclusive purpose of implementing, administering and managing the Plan ("Data"). The Grantee understands that Data will be transferred to any third party assisting the Company with the implementation, administration and management of the Plan. The Grantee understands that the recipients of the Data may be located in the Grantee's country, or elsewhere, and that the recipients' country may have different data privacy laws and protections than the Grantee's country. The Grantee understands that the Grantee may request a list with the names and addresses of any potential recipients of the Data by contacting the Grantee's local human resources representative. The Grantee authorizes the Company and any other possible recipients which may assist the Company (presently or in the future) with implementing, administering and managing the Plan to receive, possess, use, retain and transfer the Data, in electronic or other form, for the sole purpose of implementing, administering and managing the Grantee's participation in the Plan. The Grantee understands that Data will be held only as long as is necessary to implement, administer and manage the Grantee's participation in the Plan. The Grantee understands that the Grantee may, at any time, view Data, request additional information about the storage and processing of Data, require any necessary amendments to Data or refuse or withdraw the consents herein, in any case without cost, by contacting in writing the Grantee's local human resources representative. The Grantee understands, however, that refusal or withdrawal of consent may affect the Grantee's ability to participate in the Plan. For more information on the consequences of the Grantee's refusal to consent or withdrawal of consent, the Grantee understands that the Grantee may contact the Grantee's local human resources representative.

12. Language. If the Grantee has received this Agreement or any other document related to the Plan translated into a language other than English and if the translated version is different than the English version, the English version will control, unless otherwise prescribed by Applicable Law.

13. Amendment and Delay to Meet the Requirements of Section 409A. The Grantee acknowledges that the Company, in the exercise of its sole discretion and without the consent of the Grantee, may amend or modify this Agreement in any manner and delay the issuance of any Shares issuable pursuant to this Agreement to the minimum extent necessary to meet the requirements of Section 409A of the Code as amplified by any Treasury regulations or guidance from the Internal Revenue Service as the Company deems appropriate or advisable. In addition, the Company makes no representation that the Award will comply with Section 409A of the Code and makes no undertaking to prevent Section 409A of the Code from applying to the Award or to mitigate its effects on any deferrals or payments made in respect of the Units. The Grantee is encouraged to consult a tax adviser regarding the potential impact of Section 409A of the Code.

14. Imposition of Other Requirements. The Company reserves the right to impose other requirements on the Grantee's participation in the Plan, on the Award and on any Shares acquired under the Plan, to the extent the Company determines it is necessary or advisable in order to comply with local law or facilitate the administration of the Plan, and to require the Grantee to sign any additional agreements or undertakings that may be necessary to accomplish the foregoing.

**END OF AGREEMENT**



List of Direct and Indirect Subsidiaries of Restoration Hardware Holdings, Inc.

Name	Jurisdiction of Incorporation
Restoration Hardware, Inc.	Delaware
Hierarchy, LLC	Delaware
RH Yountville, Inc.	Delaware
Restoration Hardware Canada, Inc.	British Columbia, Canada
Restoration Hardware International Limited	Hong Kong
Restoration Hardware (Shanghai) Consulting Limited	People's Republic of China
RHG Management, LLC	Maryland
The Michaels Furniture Company, Inc.	California

**CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

We hereby consent to the incorporation by reference in the Registration Statement on Form S-8 (No. 333-191194) of Restoration Hardware Holdings, Inc. of our report dated March 28, 2014 relating to the financial statements and the effectiveness of internal control over financial reporting, which appears in this Form 10-K.

/s/ PricewaterhouseCoopers LLP

San Francisco, California  
March 28, 2014

**CERTIFICATION OF PERIODIC REPORT UNDER SECTION 302 OF  
THE SARBANES-OXLEY ACT OF 2002**

I, Gary Friedman, certify that:

1. I have reviewed this Annual Report on Form 10-K of Restoration Hardware Holdings, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b. Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, 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
  - c. Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 28, 2014

/s/ Gary Friedman

Gary Friedman  
Chairman and Chief Executive Officer

**CERTIFICATION OF PERIODIC REPORT UNDER SECTION 302 OF  
THE SARBANES-OXLEY ACT OF 2002**

I, Karen Boone, certify that:

1. I have reviewed this Annual Report on Form 10-K of Restoration Hardware Holdings, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - a. Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b. Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, 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
  - c. Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d. Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a. All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b. Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 28, 2014

/s/ Karen Boone

Karen Boone

Chief Financial Officer

**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**

I, Gary Friedman, Chief Executive Officer of Restoration Hardware Holdings, Inc. (the "Company"), do hereby certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that to the best of my knowledge:

- the Annual Report of the Company on Form 10-K for the fiscal year ended February 1, 2014 fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- the information contained in such Annual Report on Form 10-K fairly presents, in all material respects, the financial condition and results of operations of the Company for the periods presented therein.

Date: March 28, 2014

By: /s/ Gary Friedman  
Name: Gary Friedman  
Title: Chairman and Chief Executive Officer

This certification accompanies this Annual Report on Form 10-K pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 and shall not be deemed filed by the Company for purposes of Section 18 of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Such certification will not be deemed to be incorporated by reference into any filing under the Securities Act of 1933, as amended, or the Exchange Act, except to the extent that the Company specifically incorporates it by reference.

## 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

I, Karen Boone, Chief Financial Officer of Restoration Hardware Holdings, Inc. (the "Company"), do hereby certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that to the best of my knowledge:

- the Annual Report of the Company on Form 10-K for the fiscal year ended February 1, 2014 fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- the information contained in such Annual Report of the Company on Form 10-K fairly presents, in all material respects, the financial condition and results of operations of the Company for the periods presented therein.

Date: March 28, 2014

By: /s/ Karen Boone

Name: Karen Boone

Title: Chief Financial Officer

This certification accompanies this Annual Report on Form 10-K pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 and shall not be deemed filed by the Company for purposes of Section 18 of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). Such certification will not be deemed to be incorporated by reference into any filing under the Securities Act of 1933, as amended, or the Exchange Act, except to the extent that the Company specifically incorporates it by reference.