RH
Form 10-K
March 29, 2018

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 3, 2018

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

(Exact name of registrant as specified in its charter)

Delaware	45-3052669
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)
15 Koch Road, Suite K Corte Madera, CA	94925 (Zip Code)

(Address of principal executive offices)
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	New York Stock Exchange, Inc.
(Title of class)	(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, a smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act. (Check one):

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

Emerging growth company

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

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

As of July 28, 2017, 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 $1,303,469,078. 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 23, 2018, 21,518,618 shares of registrant’s common stock were outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant’s Proxy Statement for its 2018 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 3, 2018.

RH

INDEX TO FORM 10-K

SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS AND MARKET DATA

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

RH (the "Company") is a leading luxury retailer in the home furnishings marketplace. Our curated and fully-integrated assortments are presented consistently across our sales channels in sophisticated and unique lifestyle settings that we believe are on par with world-class interior designers. We offer dominant merchandise assortments across a growing number of categories, including furniture, lighting, textiles, bathware, décor, outdoor and garden, tableware, and child and teen furnishings. We position our Galleries as showrooms for our brand, while our Source Books and websites act as virtual extensions of our stores.

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

On May 27, 2016, we acquired a controlling interest in Design Investors WW Acquisition Company, LLC, which owns the business operating under the name "Waterworks." After the transaction, and giving effect to equity interests acquired by management in the business, we own in excess of 90% of the total equity interests in Waterworks.

Our business is fully integrated across our multiple channels of distribution, consisting of our stores, Source Books, and websites. As of February 3, 2018, we operated a total of 83 retail Galleries consisting of 16 Design Galleries (10 next generation Design Galleries and 6 larger format Design Galleries), 47 legacy Galleries, 1 RH Modern Gallery and 4 RH Baby & Child Galleries throughout the United States and Canada, and 15 Waterworks Showrooms in the United States and in the U.K. In addition, as of February 3, 2018, we operated 32 outlet stores throughout the United States and Canada.

Products and Product Development

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

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

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

1

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 2017, sales of products originating in our stores represented 56% of our net revenues, while sales from our direct business represented 44% 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. We believe the key advantage of our multiple sales channels is our ability to leverage the unique attributes of each channel in our approach to the market.

Stores

Retail Galleries

Our retail Galleries are located primarily in upscale malls and street locations, as well as in iconic locations. We believe situating our Galleries in desirable locations is critical to the success of our business, and we identify Gallery locations based on a variety of factors, including timing of legacy Gallery lease expiration, deal economics, and availability of suitable new site locations based on several store specific aspects including geographic location, demographics, and proximity to affluent consumers. We pursue a market-based sales strategy, whereby we assess each market's overall sales potential and how best to approach the market across all of our channels. We customize square footage, as well as catalog circulation, to maximize each market's sales potential and increase our return on invested capital.

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

We operate the following distinct store types as of February 3, 2018:

1) Design Galleries, which average approximately 33,000 leased selling square feet (inclusive of next generation Design Galleries which average 42,000 leased selling square feet and larger format Design Galleries which average 19,000 leased selling square feet);
2) Legacy Galleries, which average approximately 8,000 leased selling square feet;
3) The RH Modern Gallery, which is located in Los Angeles and is approximately 13,000 leased selling square feet;
4) RH Baby & Child Galleries, which average approximately 4,000 leased selling square feet; and
5) Waterworks Showrooms, which average approximately 4,000 leased selling square feet.

We have identified key learnings from our real estate transformation efforts during 2016 and 2017 that have supported our development of a new prototype Design Gallery that will enable us to escalate our new store opening cadence beginning in 2019. The new prototype will range in size from 33,000 square feet inclusive of our integrated hospitality experience to 29,000 square feet without, and will represent our assortments from RH Interiors, RH Modern, RH Baby

& Child, RH TEEN and RH Outdoor. Due to the reduced square footage and efficient design, these new Galleries should be significantly more capital efficient and should have lower risk in the real estate development process both with respect to costs and time required for completion. We anticipate these new Galleries will represent approximately two thirds of our target markets and enable us to ramp from three to five new Galleries per year to a pace of five to seven. We will continue to develop and open larger more customized Bespoke Design Galleries in the top metropolitan markets, and indigenous smaller format Bespoke Galleries in second home markets that have attractive customer demographics. As an example of the smaller Bespoke Gallery format, in 2018 we expect to open RH Yountville, the Gallery in the Napa Valley.

We continue to evaluate potential opportunities for standalone RH Baby & Child, RH TEEN and RH Modern Galleries in key markets.

In fiscal 2015, RH unveiled its initial foray into hospitality at RH Chicago, The Gallery at the Three Arts Club. This first of its kind retail concept provides a seamlessly integrated culinary offering, including the 3Arts Club Café, the 3Arts Club Wine Vault &

Tasting Room, and the 3Arts Club Pantry & Espresso Bar. Building on the success in Chicago, RH introduced an integrated hospitality experience in each of the Design Galleries it opened in 2017, RH Toronto and RH West Palm. RH plans to include an integrated hospitality experience in many of the Galleries that will open in fiscal 2018.

Retail Gallery Metrics [1]

	Year Ended February 3, 2018		January 28, 2017	
	Store Count	Total Leased Selling Square Footage [2] (in thousands)	Store Count	Total Leased Selling Square Footage [2] (in thousands)
Beginning of period	85	912	69	725
Waterworks Showrooms acquired	—	—	15	51.0
Retail Galleries opened:				
Toronto (Yorkdale) Design Gallery	1	43.3	—	—
West Palm Design Gallery	1	46.5	—	—
Waterworks Boston Showroom	1	5.0	—	—
Leawood Design Gallery	—	—	1	33.5
Austin Design Gallery	—	—	1	39.6
Las Vegas Design Gallery	—	—	1	47.6
Seattle Design Gallery	—	—	1	35.7
Pittsburgh Gallery	—	—	1	6.0
Waterworks San Francisco Showroom	—	—	1	5.8
Retail Galleries closed:				
Toronto (Bayview) legacy Gallery	(1)	(6.0)	—	—
Toronto (Yonge Street) legacy Gallery	(1)	(8.6)	—	—
West Palm legacy Gallery	(1)	(7.1)	—	—
West Palm Baby & Child Gallery	(1)	(2.5)	—	—
Waterworks Boston Showroom	(1)	(2.1)	—	—
Kansas City legacy Gallery	—	—	(1)	(9.9)
Austin legacy Gallery	—	—	(1)	(6.2)
Seattle legacy Gallery	—	—	(1)	(8.1)
Pittsburgh legacy Gallery	—	—	(1)	(5.7)
Waterworks San Francisco (Kansas Street) Showroom	—	—	(1)	(2.0)
End of period	83	981	85	912
Total leased square footage at end of period [3]		1,318		1,242
Weighted-average leased square footage [4]		1,248		1,108

Weighted-average leased selling square footage [4]	916	802
Retail sales per leased selling square foot [5]	$ 1,270	$ 1,285

(1) Retail data has been calculated based upon retail stores, which includes our RH Baby & Child and RH Modern Galleries, and excludes outlet stores.

(2) 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, food preparation, kitchen space or similar purpose, as well as exterior sales space located outside a store, such as courtyards, gardens and rooftops. Leased selling square footage for fiscal 2017 includes approximately 4,800 square feet related to one owned store location. Leased selling square footage for fiscal 2016 includes approximately 13,000 square feet related to two owned store locations.

(3) Total leased square footage for fiscal 2017 includes approximately 5,400 square feet related to one owned store location. Total leased square footage for fiscal 2016 includes approximately 24,000 square feet related to two owned store locations.

(4) Weighted-average leased selling and total square footage is calculated based on the number of days a Gallery location was opened during the period divided by the total number of days in the period.

(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 weighted-average leased selling square footage for the period.

As of February 3, 2018, we operated a total of 83 retail Galleries consisting of 16 Design Galleries (10 next generation Design Galleries and 6 larger format Design Galleries), 47 legacy Galleries, 1 RH Modern Gallery and 4 RH Baby & Child Galleries throughout the United States and Canada, and 15 Waterworks Showrooms in the United States and in the U.K. The following list shows the number of retail Galleries and Showrooms in each U.S. state, each Canadian province and in the U.K. where we operate as of February 3, 2018:

Location	Store	Location	Store	Location	Store
Alabama	1	Massachusetts	2	Tennessee	1
Arizona	2	Michigan	1	Texas	7
California	19	Minnesota	1	Utah	1
Colorado	2	Missouri	1	Virginia	2
Connecticut	4	Nevada	1	Washington	1
Florida	5	New Jersey	2	District of Columbia	2
Georgia	2	New York	5	Alberta	2
Illinois	3	North Carolina	2	British Columbia	1
Indiana	1	Ohio	3	Ontario	1
Kansas	1	Oklahoma	1	London	1
Louisiana	1	Oregon	1		
Maryland	1	Pennsylvania	2	Total	83

We continually analyze opportunities to selectively consolidate stores in connection with openings of our Design Galleries or close stores that 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.

Outlet Stores

As of February 3, 2018, we operated 32 outlet stores in 19 states in the United States and Canada. Our outlet stores are branded as Restoration Hardware Outlet or RH Outlet and are typically located in large outlet malls. Our outlet stores serve as an efficient means to sell second quality, discontinued and overstock inventory outside of our core sales channels. In addition, we periodically hold warehouse and sample sales to liquidate inventory. These net revenues are included in our outlet channel.

E-Commerce

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

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

The RH websites also offer room-based navigation, which allows the customer to envision and shop items by room or by product, expanding on the richness of the online experience. 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.

Source Books

We produce a series of catalogs, which we refer to as Source Books, to showcase our merchandise assortment. In fiscal 2017, our mailed Source Books included Interiors, Outdoor, RH Modern, RH TEEN, RH Baby & Child and Holiday. Our Source Books are one of our primary branding and advertising vehicles. We have found that merchandise assortments displayed in our Source Books contribute to increased sales of those products across all of our channels. As in our retail stores, our Source Books present our merchandise in lifestyle settings that reflect our unique design aesthetic. Our Source Books also feature profiles of select artisan vendors and other compelling editorial content regarding home décor. All creative work on our Source Books is coordinated in-house in our RH Center of Innovation & Product Leadership, providing us greater control over the brand image presented to our customers, while also reducing our Source Book production costs.

Our Source Book mailings serve as a key driver of sales through both our websites and retail stores. 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. We continue to evaluate and optimize our Source Book strategy based on our experience.

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

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

Trade and Contract

In addition to our core channels, we continue to expand into 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." Our Contract business services hospitality, real estate development and other business clients. These channels offer additional avenues for reaching new customers, including both businesses and individuals.

Phone Orders

In addition to making purchases in our stores or online, customers, including those from our Trade and Contract businesses, can place orders over the phone by calling our customer service associates.

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 Source Book circulation, promotional mailings, email communications, online and print advertisements, and public relations activities and events. We maintain a database of customers, which includes sales patterns, detailed purchasing information, certain demographic information, geographic locations and mailing and email addresses. We use our customer database to tailor our programs and increase productivity of our marketing and promotion initiatives. We leverage our marketing and advertising expenses across all our channels as we seek to optimize the efficiency of our investment.

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, Veranda, Town and Country, T Magazine, WSJ and others, and deliver marketing messages to customers via online advertising. We believe that these efforts will drive increased brand awareness, leading to higher sales in our stores and our direct business over time.

RH Members Program

The RH Members Program is an exclusive membership program that reimagines and simplifies the shopping experience. For an annual fee, the RH Members Program provides a set discount every day across all RH brands in addition to other benefits including complimentary interior design services through the RH Interior Design program and eligibility for preferred financing plans on the RH Credit Card, among other benefits. We have introduced the RH Members Program as an alternative to prior practices involving numerous event-driven promotions, which has changed the promotional cadence of our business from historical norms. Our business has evolved from a product based business to a project based business. The RH Members Program allows our customers to shop for what they want, when they want, and receive the greatest value. We believe that our shift from a promotional event model to a membership model has enhanced the customer experience, rendered our brand more valuable, improved operational execution and reduced costs.

Sourcing

We primarily contract with third-party vendors 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. Our products are generally made from readily available raw materials. We seek to ensure the consistent quality of our manufacturers' products by selectively inspecting pre-production samples, conducting periodic site visits to certain of our vendors' production facilities and selectively inspecting inbound shipments at our distribution facilities. In fiscal 2017, we sourced approximately 75% of our purchase dollar volume from approximately 26 vendors. In fiscal 2017, one vendor accounted for approximately 11% of our purchase dollar volume. Based on total dollar volume of purchases for fiscal 2017, approximately 77% of our products were sourced in Asia, the majority of which originated from China, 14% from the United States and the remainder from other regions.

RH is committed to offering safe, legal, high quality products, made consistently with our values. RH has a Compliance and Social Responsibility team dedicated to ensuring we keep these commitments through product testing, audits and other verification methods. Product testing is a core process for our organization. RH Baby & Child has received GREENGUARD Gold Certification of nursery furniture, which demonstrates that these products are low-emitting, thus contributing to better indoor air quality. GREENGUARD Gold Certified products aid in the creation of healthier indoor environments, by emitting fewer airborne compounds that can contribute to health issues including asthma and other respiratory conditions. We are in the process of obtaining GREENGUARD Gold Certification for all of our furniture products.

We believe that we generally have strong relationships with our product vendors. We have a limited number of long-term merchandise supply contracts. Although we transact business primarily on an order-by-order basis, we typically work with many of our vendors over extended periods of time, and many vendors are making long-term capacity investments to serve our increasing demands.

Distribution and Delivery

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

In fiscal 2017, we completed the closure of our furniture fulfillment centers in Los Angeles and Dallas. In total, we eliminated 1.75 million square feet of distribution center space, resulting in savings in excess of $20 million annually. Moving forward, we believe servicing our business from two coastal distribution centers will result in improved in-stock availability and significantly faster inventory turns.

We operate portions of our home delivery services in 11 key markets to leverage operating costs and improve our customers' delivery experience, while reducing returns and damage to our products. We plan to continue to in-source these services in additional markets over time. We offer a white glove home delivery service for our larger merchandise and furniture categories, where third-party delivery personnel assist our customers by delivering fully assembled items to the location of their choice. We believe there is an opportunity to improve the customer experience by taking greater control of the home delivery experience over time. We believe that many third-party furniture delivery providers are designed to support mass and mid-market companies and that significant opportunity exists for developing improved solutions for the luxury market. We have achieved significant scale such that we can now explore and test alternative solutions in many markets, including the use of our own trucks and drivers, and believe we can dramatically enhance the customer experience while driving down return rates, damages, and deliveries per order.

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

In fiscal 2017, we began architecting a new operating platform in order to simplify our business, enhance the customer experience, and amplify decision quality and speed. Our initial efforts focused on our distribution center network and the home delivery experience. As a result of our work to redesign our distribution network and optimize inventory, we were able to forego building a fifth furniture distribution center planned to open in fiscal 2017, and close two furniture distribution centers. We intend to continue to strengthen our supply chain operations through a number of key initiatives in fiscal 2018 as we work to design an operating platform that aligns with and amplifies our luxury positioning, inclusive of continued work on our distribution center network redesign, reverse logistics and outlet redesign, and the reconceptualization of home delivery.

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 are superior quality, highly distinctive design styles and a sophisticated lifestyle presentation in our product offering.

We also believe that our success depends in substantial part on our ability to originate and define product trends, as well as to timely anticipate, gauge and react to changing consumer demands. Certain 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. We believe we are effectively positioned between these two market segments to gain market share and drive growth.

Employees

As of February 3, 2018, we had approximately 5,200 employees, of which approximately 900 were part-time employees. As of that date, approximately 2,200 of our employees were based in our stores. None of our employees are represented by a union, and we have had no labor-related work stoppages. We believe our relations with our employees are good.

Intellectual Property

The “RH,” “Restoration Hardware,” “RH Baby & Child,” “RH Modern,” “RH TEEN,” “Waterworks,” and “Waterworks Studi 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,” “rhbabyandchild.com,” “rhmodern.com,” “rhteen.com,” and “waterworks.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 our website and for several of our Source Books. 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 the timing of Source Book releases, the timing and extent of our realization of the costs and benefits of our numerous strategic initiatives, among other things. As a result of these factors, our working capital requirements and demands on our product distribution and delivery network may fluctuate during the year. Unique factors in any given quarter may affect period-to-period comparisons between the quarters being compared, and the results for any quarter are not necessarily indicative of the results that we may achieve for a full fiscal year. In addition, the introduction of the RH Members Program may influence the seasonality of our business, which previously fluctuated based on the timing of our promotional events.

Regulation and Legislation

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

Where You Can Find More Information

We are required to file annual, quarterly and current reports, proxy statements and other information required by the Securities Exchange Act of 1934, as amended, 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 and www.rh.com and make available, free of charge, through these sites our Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, Proxy Statements and Forms 3, 4 and 5 filed on behalf of directors and executive officers, as well as any amendments to those reports filed or furnished pursuant to the Exchange Act as soon as reasonably practicable after we electronically file such material with, or furnish it to, the SEC. We also put on our websites the charters for our Board of Directors' Audit Committee, Compensation Committee, and Nominating and Corporate Governance Committee, as well as our Code of Business Conduct, our Corporate Governance Guidelines and Code of Ethics governing our chief executive and senior financial officers and other related materials. The information on our websites is not part of this annual report.

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

Item 1A. Risk Factors
Certain factors may have a material adverse effect on our business, financial condition, and results of operations. You should consider carefully the risks and uncertainties described below, in addition to other information contained in this Annual Report on Form 10-K, including our consolidated financial statements and related notes. If any of the following risks actually occurs, our business, financial condition, results of operations, and future prospects could be materially and adversely affected. In that event, the trading price of our common stock could decline, and you could lose part or all of your investment. The risks and uncertainties described below are not the only ones we face. Additional risks and uncertainties that we are unaware of, or that we currently believe are not material, may also become important factors that adversely affect our business.

Risks Related to Our Business

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

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

There can be no assurance that these efforts will be successful or that we will not encounter other operational difficulties that may have a negative impact on growth and profitability. In addition, these initiatives may have near-term negative impacts on growth and profitability as we incur costs or pursue strategies that may not contribute to our profits and margins until future periods, if at all. For example, in fiscal 2017, net revenues increased 14%, of which 2.9 points of growth was related to higher outlet and warehouse sales stemming from our accelerated inventory optimization efforts. While our higher outlet revenues and inventory optimization efforts had a positive impact on revenues and working capital, they had a negative impact on margins and earnings.

Some factors affecting our business, including macroeconomic conditions, are not within our control. In prior periods, our results of operations have been adversely affected by weakness in the overall economic environment such as periods of economic recession as well as slowdowns in the housing market. Our business performance is also linked to the overall strength of luxury consumer spending in markets in which we operate. Economic conditions affecting selected markets in which we operate can have an impact on the strength of our business in those local markets. As an example, during periods in which the price for oil declined rapidly, we experienced a slowing in our business in some regions where the economy is linked to energy exploration and production, including Texas and Canada.

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

- the overall economic and general retail sales environment, including the effects of uncertainty or stock market volatility on consumer spending;
- consumer preferences and demand;
- the number, size and location of stores we open, close, remodel or expand in any period;
- changes in Source Book circulation, and the number of pages in our Source Books and timing of mailing;
- our ability to efficiently source and distribute products;
- changes in our product offerings and the introduction and timing of introduction of new products and new product categories;
- promotional events;

9

- our competitors introducing similar products or merchandise formats;
- the timing of various holidays, including holidays with potentially heavy retail impact; and
- the success of our marketing programs.

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

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

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

We are undertaking a large number of new business initiatives in order to support our future growth. For example, we have developed and continue to refine and enhance our Gallery format, which involves larger store square footage. We also continue to add new product categories and to expand product assortments. For example, in fiscal 2015 we introduced our new RH Modern and RH TEEN categories. We are currently contemplating other new product lines and extensions and complementary brand-enhancing businesses, such as the expansion of our product sales to international markets and providing brand-enhancing offerings in hospitality including an integrated food and beverage experience. For example, in fiscal 2015 we unveiled our initial foray into hospitality at RH Chicago, The Gallery at the Three Arts Club, and in fiscal 2017, we opened RH Toronto and RH West Palm, each with integrated food and beverage offerings. The majority of our new Design Galleries under development include an RH Hospitality offering including restaurants, wine vaults, and pantries as we continue to develop and refine our integrated hospitality experience. However, there can be no assurance that we will be successful in launching future hospitality offerings or in providing hospitality offerings that are and remain attractive to consumers in our market. If we are not successful in managing the large number of new initiatives that are underway, we might experience an adverse impact on our financial performance and results of operations.

Furthermore, we can provide no assurances that customers will respond favorably to our new product offerings, Galleries or complementary businesses or that we will successfully execute on such business initiatives. Such new business opportunities may not achieve market acceptance or may only achieve market acceptance in limited geographic areas or at certain Design Galleries. In addition, developing and testing new and multiple business opportunities and strategies often requires knowledge in areas of expertise that may be new to our organization and may require significant time of our management and resources. For example, the brand-enhancing offerings in hospitality that we are pursuing represent areas where we have limited historical operating and management experience. We can provide no assurances that we will be successful in expanding our operations into any new businesses and product lines.

Any new businesses we enter may also expose us to additional laws, regulations and risks, including the risk that we may incur ongoing operating expenses in such businesses in excess of revenues, which could harm our 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. For example, new hospitality concepts that we are pursuing could expose us to new risks related to consumer litigation and longer lease terms.

We often have in the past, and may in the future, incur significant costs for any new initiative before we realize any corresponding revenue with respect to such initiative. In addition, we may incur costs as we revise, restructure or discontinue existing product categories or business offerings in favor of pursuing new initiatives or retail concepts. For example, as we continue to open larger format Design Galleries in select major metropolitan markets, we expect to close a number of legacy Galleries and replace them with our Design Gallery format. The introduction of integrated food and beverage offerings at our new Gallery locations often requires significant investments by us before the location is open to customers and able to generate revenues, and we anticipate that a number of Galleries to be opened during the next several years will require this form of upfront investment before they generate revenue from the food and beverage offerings. In addition, during the fourth quarter of fiscal 2016, we initiated and executed a plan to integrate the RH Contemporary Art ("RHCA") product line into the broader RH platform and we no longer operate RHCA as a separate division, and as a result we incurred restructuring related costs. To the extent that these new business opportunities do not generate sufficient revenue to recoup the cost of developing and operating such new concepts, our results of operations could be materially adversely affected.

In addition, we are continuing a number of new initiatives to improve the operations of our business, including elevating the customer experience which includes architecting a new fully integrated back-end operating platform, inclusive of the supply chain network, the home delivery experience as well as a new metric-driven quality system and company-wide decision data, transitioning from a promotional to a membership model, rationalizing our SKU count and optimizing inventory which includes selling slower moving, discontinued and other inventory through markdowns and our outlet channel, enhancing and optimizing our product sourcing capabilities, improving our distribution and delivery of products to our customers, including architecting a new fully integrated back-end operating platform, and adding new management information systems. For example, in the early part of fiscal 2016, we introduced the RH Members Program, which provides a range of benefits to our customers in return for payment of an annual membership fee. We introduced the RH Members Program as an alternative to prior practices involving numerous event-driven promotional programs. Although we are extremely satisfied with the results of the RH Members Program to date, this program is still new to our business, and there can be no certainty as to exactly how our customers may react to this program over time or how the RH Members Program will affect our financial results from quarter to quarter.

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

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

As part of exploring growth opportunities, we may acquire from time to time value-creating, add-on businesses that broaden our existing position and market reach. For example, in fiscal 2016, we acquired a controlling interest in Waterworks. In the fourth quarter of fiscal 2017, we recorded a goodwill impairment charge of $33.7 million with respect to Waterworks due to indicators identified in the fourth quarter of fiscal 2017 that there could be an impairment of the Waterworks reporting unit. These indicators included (i) an updated long-range financial plan provided by the Waterworks segment management that indicated a reduction of revenues and EBITDA as compared to prior long-range financial plans, (ii) a review of the strategic initiatives of the Waterworks segment and (iii) the Waterworks segment not achieving revenue and operating income objectives compared to plans. There can be no assurance that the Waterworks business will meet its future operating or financial objectives and if its results do not improve we may recognize additional chargers related to this business and our financial results of operation may be adversely affected.

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

In addition, we face the risk that an acquired business may not be successful on the RH platform and may underperform relative to expectations. We may be unable to achieve synergies originally anticipated, we may be exposed to unexpected liabilities or we may be unable to sufficiently integrate completed acquisitions into our current business model and platform. The success of any completed acquisition will depend on our ability to effectively manage the business after the acquisition. The process of maintaining the right incentives for management of acquired businesses and integrating the acquired businesses may involve unforeseen difficulties and may require a disproportionate amount of our managerial and financial resources. Our failure to incorporate acquired businesses into our existing operations successfully or to minimize any unforeseen operational difficulties could have a material adverse effect on our financial condition and results of operations. Further, if we fail to allocate our capital appropriately, in respect of either our acquisitions or organic growth in our operations, we could be overexposed in certain markets and geographies and unable to expand into adjacent products or markets.

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

We target consumers of high-end home furnishings as customers for our products. As a result, we believe that our sales are sensitive to a number of factors that influence consumer spending generally, but are particularly affected by the health of the higher end customer and demand levels from that customer demographic. In addition, not all macroeconomic factors are highly correlated in their impact on lower end housing versus the higher end customer. Demand for lower priced homes and first time home buying may be influenced by factors such as employment levels, interest rates, demographics of new household formation and the affordability of homes for the first time home buyer. The higher end of the housing market may be disproportionately influenced by other factors including the number of foreign buyers in higher end real estate markets in the U.S., the number of second and third homes being sold, stock market prices and volatility and the perceived prospect for capital appreciation in higher end real estate. Although employment levels in the U.S. were reasonably strong at the beginning of 2018, the stock market has experienced significant volatility and there can be no assurance that some of the other macroeconomic factors described above will not adversely affect the higher end consumer that we believe makes up the bulk of our customer demand.

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

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

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

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

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

Source Book mailings are an important component of our business. We continue to adjust and refine our Source Book mailing strategy and we expect to do so in the future. For example, in fiscal 2014 and fiscal 2015, we reduced the number of Source Books circulated, and in fiscal 2016, we decided to move the mailing of our annual Source Books to the Fall, whereas our Source Books were circulated in the Spring in the prior years. We intend to continue adjusting our Source Book circulation strategy based on a variety of factors, including the success of the various changes that we adopt. We can provide no assurances as to the success of any Source Book strategy we pursue. Increased expenditures on our catalog strategy may result in the production of too many Source Books, which could negatively affect our operating margins. Reducing expenditures on our catalog strategy, however, could overly restrict catalog circulation and have a negative effect on our revenues. Additionally, due to the size of our Source Books we have in the past received negative publicity from environmental groups. If we fail to adequately adjust our catalog strategy to meet our goals, or if our catalog strategy is unsuccessful, our results of operations could be negatively impacted.

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

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

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

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

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

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

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

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

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

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

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

Based on total volume dollar purchases, in fiscal 2017 we sourced approximately 86% of our merchandise from outside the United States, including 77% 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, particularly Asia. Our future success will depend in large part upon our ability to maintain our existing foreign vendor relationships and to develop new ones as well as the ability of our vendors to scale their operations commensurate with demand from our customers, which in some cases will require substantial ongoing investments to support additional capacity. 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.

Substantial regulatory uncertainty exists regarding international trade and trade policy, both in the United States and abroad. For example, recently President Trump has introduced tariffs on certain goods imported from China. President Trump and members of the U.S. Congress have at various times called for the possible implementation of a border tax. The Trump administration has also raised the possibility of other initiatives that may affect importation of goods including renegotiation of trade agreements with other countries and the possible introduction of further import duties or tariffs. 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 that we import into the United States. While we are continuing to assess the recently announced pending tariffs on Chinese imports, such tariffs, and the possible implementation of a border tax or additional tariffs, could materially increase our cost of goods sold with respect to merchandise that we purchase from vendors who manufacture products in China or other countries outside the United States, which could in turn require us to increase our prices and, in the event consumer demand declines as a result, negatively impact our financial performance. Furthermore, certain of our competitors may be better positioned than us to withstand or react to border taxes, tariffs or other restrictions on global trade and as a result we may lose market share to such competitors. Due to broad uncertainty regarding the timing, content and extent of any regulatory changes in the U.S. or abroad, we cannot predict the impact, if any, that these changes could have to our business, financial condition and results of operations.

Our dependence on foreign imports also makes us vulnerable to risks associated with products manufactured abroad, including, among other things, risks of damage, destruction or confiscation of products while in transit to our distribution centers located in the United States, 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. Any resulting penalty or enforcement action could delay future imports/exports or otherwise negatively impact our business. In addition, there can be no assurance that our vendors outside the United States will adhere to applicable legal requirements or our global compliance standards such as fair labor standards, prohibitions on child labor and other product safety or manufacturing safety standards. 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 results of operations.

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

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

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

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

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

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

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

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

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

We are engaged in a number of initiatives to enhance the quality of our customers' experience, which we expect will require significant expenditures in the near term and which are expected to include increasingly significant operational and other changes in the near term, such as increased attention to the quality of the products that we sell. From time to time we have recalled products from the market due to quality or other issues including during fiscal 2017. Despite our ongoing efforts to improve customers' satisfaction with their experience at RH, we may fail to maintain the necessary level of quality for some of our products in order to satisfy our customers. For example, our vendors may not be able to continuously adhere to our quality control standards, and we might not identify a quality deficiency before merchandise ships to our stores or customers. Our failure to supply high quality merchandise in a timely and effective manner to our customers could damage our reputation and brand image, and could lead to an increase in product returns or exchanges or customer litigation against us and a corresponding increase in our routine and non-routine litigation costs. Further, any merchandise that does not meet our quality standards or applicable government requirements could trigger high rates of customer complaints or returns or could become subject to a product recall, which could in turn damage our reputation and brand image, result in consumer litigation (including class-action lawsuits), and harm our business.

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

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

Increases in the prices of the components and raw materials used in our products could negatively affect the sales of our merchandise and our product margins. Alternatively, the strength of the U.S. dollar may negatively impact the ability of some of our customers to purchase our goods. We believe some portion of our business depends on non-U.S. consumers, including sales in our stores in Canada and Waterworks Showrooms in the U.K., as well as sales in some of our U.S.-based stores which have a high number of visitors from other countries who purchase goods from us while visiting the United States.

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

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

We are subject to risks associated with occupying substantial amounts of space, including future increases in occupancy costs. We own certain properties, and we may choose in the future to acquire further properties, including store locations, which 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 other storage and office space, and our 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 anywhere from ten to twenty-five years. The initial lease term for one of our Design Galleries is forty-one years, and contains renewal options for five years. Most leases for our retail stores provide for a minimum rent, typically including escalating rent amounts, plus a percentage rent based upon sales after certain minimum thresholds are achieved, as well as common area maintenance charges, real property insurance and real estate taxes. We purchased the building and land for our store in San Francisco and one of our Toronto store locations, and we own two properties in Yountville, California, one is the location of our wine tasting room and the other is expected to become the location of a Design Gallery in the future. We previously entered into a real estate joint venture transaction related to the development of our Patterson distribution center. As we develop new stores, new store formats and other new strategic initiatives in the future, we may explore other models for our real estate, which could include further purchases of, or joint ventures or other forms of equity ownership in, real estate interests associated with new sites and buildings. These approaches might include complicated real estate transactions and require additional capital investment and could present different risks related to the ownership and developments of real estate compared to those risks associated with a traditional store lease with a landlord, including greater financial exposure if our plans for the relevant real estate are not as successful as we originally anticipate or if the value of the real estate we acquire subsequently decreases. Such strategy could also expose us to further risks associated with increases or fluctuations in real estate development costs, including due to increasing costs of building materials such as steel or other factors causing increased building and construction costs.

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

A number of factors that affect our ability to successfully open new stores within the time frames we initially target or optimize our store footprint are beyond our control, and these factors may harm our ability to execute our strategy 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 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 or being without presence or "out of the market."

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

- identify suitable locations, the availability of which is largely outside of our control;
- size the store locations to the market opportunity;

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

We have experienced delays in opening some new stores within the time frames we initially targeted, and may experience such delays again in the future. Any of the above challenges or other similar challenges could delay or prevent us from completing store openings or the additional remodeling of existing stores or hinder the operations of stores we open or remodel. If any of these challenges delays the opening of a store, our results of operations will be negatively affected as we will incur leasing and other costs during the delay without associated store revenue at such location. New or remodeled stores may also 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. Changes in regulation or increases in building or construction costs including with respect to the cost of building materials could result in unanticipated increases in real estate development costs or delays in the completion of our real estate projects. Our failure to effectively address challenges such as those listed above could adversely affect our ability to successfully open new stores or change our store footprint in a timely and cost-effective manner and could have a material adverse effect on our business, results of operations and financial condition.

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

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

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

If we are unable to successfully optimize and operate our distribution centers, furniture home delivery hubs and customer service centers, as well as fulfill orders and deliver our merchandise to our customers in a timely manner, our business and results of operations will be harmed.

Our business depends upon the successful operation of our distribution centers, furniture home delivery hubs and customer service centers, as well as upon 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.

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

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

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

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

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

We have historically relied on the availability of some amount of debt financing to fund our operations. We have also incurred indebtedness to finance other strategic initiatives, such as the aggregate $1 billion in stock repurchase programs authorized by our Board of Directors, which program was fully completed during fiscal 2017. We completed debt financings in fiscal 2014 and fiscal 2015 through the issuance of two series of convertible senior notes for an aggregate principal amount of $650 million. As of February 3, 2018, we had $200.0 million in outstanding borrowings and $186.4 million of availability under our revolving line of credit, net of $33.8 million in outstanding letters of credit. As a result of the consolidated fixed charge coverage ratio restriction that limits the last 10% of borrowing availability, actual incremental borrowing available to us and the other affiliated parties under the revolving line of credit was approximately $136.4 million as of February 3, 2018. In addition, as of February 3, 2018, we had $80.0 million outstanding borrowings under our term loan facility.

While we believe that we currently have sufficient capital for the operation of our business in the near term, we may expend some significant portion of our capital on investments in our business, the purchase of our equity securities, the acquisition of new businesses and our significant number of concurrent initiatives. In addition, our capital needs may change in the future due to changes in our business or new opportunities that we choose to pursue. We have invested significant capital expenditures in remodeling and opening new Galleries, and these capital expenditures have increased in the past and may continue to increase in future periods as we open additional Design Galleries, which may require us to undertake upgrades to historical buildings or construction of new buildings. During fiscal 2017, we spent $112.5 million for capital expenditures which was offset by proceeds from sales of assets of approximately $15.1 million. Additionally, we made payments of $14.4 million in fiscal 2017 to escrow accounts for future construction of Design Galleries. We anticipate our gross capital expenditures to be approximately $100 million to $110 million in fiscal 2018, primarily related to our efforts to continue our growth and expansion, including construction of new Design Galleries and infrastructure investments. Our fiscal 2018 capital expenditures will be partially offset by proceeds from anticipated sales of assets of $25 million. We plan to continue opening 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, as well as the location of our wine tasting room in Yountville, California, which is expected to be the location of a Design Gallery in the future, but to date we have principally relied upon leases with landlords for our other locations. As we develop new Galleries, as well as potentially other strategic initiatives in the future like our integrated hospitality experience, we may explore other models for our real estate, which could include longer lease terms or further purchases of, or joint ventures or other forms of equity ownership in, real estate interests associated with new sites and buildings. These approaches might require greater capital investment than a traditional store lease with a landlord. In the event that such capital and other expenditures require us to pursue additional funding sources, we can provide no assurances that we will be successful in securing additional funding on attractive terms or at all.

While we seek to target capital toward investments that we believe will achieve favorable returns for our shareholders, these decisions involve a significant amount of judgment regarding the availability of capital and the anticipated growth of the business in both revenue and earnings in future periods. For example, the use of capital to repurchase shares may yield beneficial impact on earnings per share but may divert capital from other purposes including other investments that we might undertake with respect to the business. We can provide no assurances of the exact impact of any share repurchases on our business. Although our previous stock repurchase programs were intended to enhance long-term stockholder value by representing an attractive investment and use of capital by the Company, there can be no assurance that the stock repurchases under the program will in fact enhance stockholder value. For example, the market price of our common stock may subsequently decline below the levels at which repurchases were made. Furthermore, any strategy of this kind regarding capital allocation may have unanticipated effects on our business and financial results. We may also decide to pursue additional repurchase programs in the future. We may incur debt in connection with our business in the event that we use other cash resources to purchase shares, which may affect the financial performance of our business during future periods or our liquidity and the availability of capital for other needs of the business.

In addition, while we anticipate that we will be able to repay our debt maturities as they come due, there can be no assurance that we will have sufficient financial resources or be able to arrange financing to repay these obligations, or that we will be able to extend their maturities or otherwise refinance our obligations as needed. For example, in certain circumstances, we may be required to repay the two series of convertible senior notes that we issued in fiscal 2014 and fiscal 2015 with cash payments. See Item 7—Management's Discussion and Analysis of Financial Condition and Results of Operations—Liquidity and Capital Resources—Convertible Senior Notes. Additionally, at the time the notes become due, the trading price of our common stock may be such that we may find it necessary to settle the notes in cash. There can be no assurance that we will be able to pay the amount of cash due if holders surrender their notes for conversion. In addition, agreements governing any debt may restrict our ability to make each of the required cash payments even if we have sufficient funds to make them. Furthermore, our ability to purchase the notes or to pay cash upon the conversion of the notes may be limited by law or regulatory authority. In addition, if we fail to purchase the notes, to pay special interest, if any, due on the notes, or to pay the amount of cash due upon conversion, we will be in default under the respective indentures governing the notes, which in turn may result in the acceleration of other indebtedness we may then have. If the repayment of the other indebtedness were to be accelerated, we may not have sufficient funds to repay that indebtedness and to purchase the notes or to pay the amount of cash due upon conversion.

The need to repay our convertible senior notes or other debt obligations could cause us to incur additional borrowings or sell additional notes to investors. We may also experience cash flow shortfalls in the future, and we may otherwise require additional external funding, or we may need to raise funds to take advantage of unanticipated opportunities, to make acquisitions of other businesses or companies or to respond to changing business conditions or unanticipated competitive pressures. Any weakening of, or other adverse developments in, the U.S. or global credit markets could affect our ability to manage our debt obligations and our ability to access future debt. We cannot assure you that we will be able to raise necessary funds on favorable terms, if at all, or that future financing requirements would not 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.

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, as well as other members of our senior management responsible for merchandise assortment and other business operations. The loss of the services of our key personnel could make it more difficult to successfully operate our business and achieve our business goals. Our key officers and directors periodically travel together while on company business. We do not have a policy that prohibits key officers and directors from flying together, whether flying commercially or in our corporate aircraft. 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.

Competition for qualified employees and personnel in the retail industry is intense, particularly in the San Francisco Bay Area where our headquarters are located, and we may be unable to retain personnel that are important to our business or hire additional qualified personnel. The process of identifying personnel with the combination of skills and attributes required to carry out our goals is often lengthy. Our success depends to a significant degree upon our ability to attract, retain and motivate qualified management, marketing and sales personnel, and store managers, and upon the continued contributions of these people. In addition, our complex operations require the services of qualified and experience management personnel, with expertise in the areas including information technology and supply chain management. We cannot assure you that we will be successful in attracting and retaining qualified executives and personnel.

In addition, 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 and food and beverage industry is generally high. Excessive employee turnover will result in higher employee costs associated with finding, hiring and training new store employees. If we are unable to hire and retain store personnel capable of consistently providing a high level of customer service, our ability to open new stores and to expand our food and beverage business may be impaired, the performance of our existing and new stores could be materially adversely affected and our brand image may be negatively impacted.

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

We depend largely upon our information technology systems in the conduct of all aspects of our operations, many of which we have only adopted and implemented within the past several years or are in the midst of implementing in connection with rebuilding our supply chain and infrastructure. Our operations are also dependent on the information technology systems of our third party vendors. Such systems are subject to damage or interruption from power outages, computer and telecommunications failures, computer viruses, security breaches and natural disasters. In addition, damage or interruption can also occur as a result of non-technical issues, including vandalism, catastrophic events, and human error. If a computer hacker or other third party is able to circumvent our security measures, he or she could destroy or steal valuable information or disrupt our operations. 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. Damage or interruption to our information systems may require a significant investment to fix or replace the affected system, and we may suffer interruptions in our operations in the interim. Any material interruptions or failures in our systems or the systems of our third party vendors may have a material adverse effect on our business or results of operations.

Additionally, in order for our business to function successfully, we and other market participants must be able to handle and transmit confidential and personal information securely, including in customer orders placed through our website. That information may include data about our customers, including personally identifiable information and credit card information, as well as sensitive information about our vendors and workforce, including social security numbers and bank account information. If our systems are damaged, interrupted or subject to unauthorized access, information about our customers, vendors or workforce could be stolen or misused. Any security breach could expose us to risks of data loss, fines, litigation and liability and could seriously disrupt our operations and harm our reputation, any of which could adversely affect our business. We may be subject to one or more claims or lawsuits related to the intentional or unintentional release of confidential or personal information, including personally identifiable information about our customers, vendors or workforce. In addition to the possibility of fines, lawsuits and other claims, we could be required to expend significant resources to change our business practices or modify our service offerings in connection with the protection of personally identifiable information, which could have a material adverse effect on our business. Any breach could also cause consumers to lose confidence in the security of our website and choose not to purchase from us.

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

States and the federal government have enacted additional laws and regulations to protect consumers against identity theft, including laws governing treatment of personally identifiable information. These laws have increased the costs of doing business and, if we fail to implement appropriate safeguards or we fail to detect and provide prompt notice of unauthorized access as required by some of these laws, we could be subject to potential claims for damages and other remedies. If we were required to pay any significant amount in satisfaction of claims under these laws, or if we were forced to cease our business operations for any length of time as a result of our inability to comply fully with any such law, our business, results of operations and financial condition could be adversely affected. We may also incur legal costs if we are required to defend our methods of collection, processing and storage of personal data. Investigations, lawsuits, or adverse publicity relating to our methods of handling personal data could result in increased costs and negative market reaction.

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

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

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

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

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

We maintain a product safety and compliance program to help ensure our products are safe, legal and made consistently in compliance with our values. Nevertheless, our products have, from time to time, been subject to recall for product safety and compliance reasons including during fiscal 2017. Concerns of product safety and compliance could result in future voluntary or involuntary removal of products, product recalls, other actions by applicable government authorities or product liability, personal injury or property damage claims.

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

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 with respect to our collection and sale of reproduction products, consumer class action claims relating to our consumer practices including the collection of zip code or other information from customers, and claims alleging securities fraud. 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 our management or us could result in unexpected expenses and liability and could also materially adversely affect our operations and our reputation.

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

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

We currently rely on a combination of copyright, trademark, patent, trade dress and unfair competition laws, as well as confidentiality procedures and licensing arrangements, to establish and protect our intellectual property rights. We believe that our trademarks and other proprietary rights have significant value and are important to identifying and differentiating certain of our products and brand from those of our competitors and creating and sustaining demand for certain of our products. We have from time to time encountered other retailers selling products substantially similar to our products or misrepresenting that the products such retailers were selling were our products. We cannot assure you that the steps taken by us to protect our intellectual property rights will be adequate to prevent infringement of our rights by others, including imitation of our products and misappropriation of our brand. The costs of defending and enforcing our intellectual property assets may incur significant time and legal expense, and we may not be entirely successful in protecting our assets and enforcing our rights. If we are unable to protect and maintain our intellectual property rights, the value of our brand could be diminished and our competitive position could suffer.

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

We are subject to numerous regulations, including labor and employment, customs, truth-in-advertising, consumer protection, e-commerce, privacy, safety, real estate, environmental and zoning and occupancy laws, and other laws and 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, changes to United States health care laws, or potential global and domestic greenhouse gas emission requirements and other environmental legislation and regulations, could result in increased direct compliance costs for us (or may cause our vendors to raise the prices they charge us in order to maintain profitable operations because of increased compliance costs), increased transportation costs or reduced availability of raw materials.

In fiscal 2017 we sourced 86% of our products from outside the United States, and we are increasing the level of our international sourcing activities in an effort to obtain more of our products directly from vendors located outside the

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

Labor organizing and other activities could negatively impact us.

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

In addition, several of our retail stores are currently under construction. If the contractors we hire to perform the construction work do not employ union labor, our locations may be subject to picketing and other labor actions that could discourage our customers from entering our stores, which could adversely affect our business at those locations and our results of operations, including our same-store sales metrics.

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

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

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

The United States enacted the Tax Cuts and Jobs Act (the “Tax Act”) on December 22, 2017, which had a significant impact to our provision for income taxes as of February 3, 2018. The Tax Act includes a number of changes to existing U.S. tax laws that impact us, including the reduction of the U.S. corporate income tax rate from 35% to 21% effective January 1, 2018. The Tax Act also provides for a one-time transition tax on accumulated foreign earnings and the acceleration of depreciation for certain assets, as well as prospective changes beginning in 2018, including limitations on the deductibility of executive compensation and interest, the elimination of certain domestic deductions and credits, the elimination of the Alternative Minimum Tax regime, and modifications to the deductibility and carryforward period of net operating losses. The Tax Act transitions U.S. international taxation from a worldwide system to a modified territorial system and includes base erosion prevention measures on non-U.S. earnings, which may have the effect of subjecting certain earnings of our foreign subsidiaries to U.S. taxation.

The Tax Act requires complex computations to be performed that were not previously required under U.S. tax law, significant judgments to be made in interpretation of the provisions of the Tax Act and significant estimates in calculations, and the preparation and analysis of information not previously relevant or regularly produced. The U.S. Treasury Department, the Internal Revenue Service, and other standard-setting bodies could interpret or issue guidance on how provisions of the Tax Act will be applied or otherwise administered that is different from our interpretation. As we complete our analysis of the Tax Act, review all information, collect and prepare necessary data, and interpret any additional guidance, we may make adjustments to provisional amounts that we have recorded, which could have a material adverse effect on our business, results of operations or financial condition.

Provisions of the Tax Act may also impact our customers and the high end housing market. For example, the Tax Act changes the availability of deductions for mortgage interest and state income and property taxes. The reduction of such deductions may adversely impact the high-end housing market or consumption patterns by our customers. The full impact of the Tax Act on us as a taxpayer, our customers, the housing market, the luxury retail market and the U.S. economy in general is unknown and may not become fully clear for some time. Our business and results of operations may be adversely impacted by changes in consumer and market behavior in response to the Tax Act and its evolving interpretation.

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, we will adopt Accounting Standards Update 2014-09—Revenue from Contracts with Customers (Topic 606) in the first quarter of fiscal 2018, the adoption of which will materially impact the timing of recognizing advertising expense related to direct response advertising, including costs associated with our Source Books. In addition, Accounting Standards Update 2016-02—Leases will be effective for public companies for fiscal years beginning after December 15, 2018, and while we are still evaluating the effects of the adoption of this standard, we anticipate it will significantly impact our consolidated financial statements given that we have a significant number of leases. For information regarding recently issued accounting pronouncements, refer to Note 3—Significant Accounting Polices in our consolidated financial statements within Part II of this Annual Report on Form 10-K.

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 results of operations that are lower than our current estimates at certain store locations, may cause us to incur impairment charges that could adversely affect our results of operations.

Our total assets include intangible assets with an indefinite life, goodwill and trademarks, and substantial amounts of property and equipment. We evaluate these long-lived assets for possible impairment annually or earlier if impairment indicators exist and make certain estimates and projections in connection with the impairment analyses for these long-lived assets. We also review the carrying value of these assets for impairment whenever events or changes in circumstances indicate that the carrying value of the asset may not be recoverable. We will record an impairment loss when the carrying value of the underlying asset, asset group or reporting unit exceeds its fair value. These calculations require us to make a number of estimates and projections of future results. If these estimates or projections change, we may be required to record additional impairment charges on certain of these assets. If these impairment charges were significant, our results of operations would be adversely affected.

In fiscal 2017, we recorded goodwill impairment related to the Waterworks reporting unit of $33.7 million. Additionally, in fiscal 2017, we recorded impairment charges on long-lived assets of $4.5 million due to the closure of two distribution centers. In fiscal 2016, we recorded impairment charges on long-lived assets of $5.5 million due to the decisions made to integrate the RHCA product line into the broader RH platform and of $4.8 million due to the decision to sell an aircraft. There can be no assurance that we will not experience further impairment charges with respect to the Waterworks reporting unit or impairment charges with respect to other assets in future periods.

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

We are subject to Section 404 of the Sarbanes-Oxley Act of 2002, as amended (the “Sarbanes-Oxley Act”), which requires us to maintain internal control over financial reporting and to report any material weaknesses in such internal control. We have in the past periodically experienced deficiencies in our internal controls that have been identified during the audit process or at other times. Management has concluded that our internal control over financial reporting was effective as of February 3, 2018. 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. 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 produce reliable financial reports. Our failure to achieve and maintain effective internal control over financial reporting could prevent us from filing our periodic reports on a timely basis, which could result in the loss of investor confidence in the reliability of our financial statements, harm our business, and negatively impact the trading price of our common stock.

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

Our business operations depend on our ability to maintain and protect our facilities, computer systems and personnel. Our operations and consumer spending may be affected by natural 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 are located in Northern and Southern California, each of which is vulnerable to the effects of disasters, including fires and earthquakes that could disrupt our operations and affect our results of operations. 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 results of operations, revenue and costs.

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

Risks Related to Ownership of Our Common Stock

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

The market price for our common stock has in the past been, and may in the future 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 results of operations compared to market expectations;
- changes in preferences of our customers;
- announcements of new products or significant price reductions by us or our competitors;
- size of our public float;
- stock price performance of our competitors;
- fluctuations in stock market prices and volumes;
- default on our indebtedness;
- actions by competitors or other shopping center tenants;
- changes in senior management or key personnel;
- changes in financial estimates by securities analysts or failure to meet their expectations;
- actual or anticipated negative earnings or other announcements by us or other retail companies;
- downgrades in our credit ratings or the credit ratings of our competitors;
- natural 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. Stockholders can institute securities class action litigation following periods of market volatility, and we are currently subject to such a class action securities lawsuit. Such securities litigation can incur substantial costs and our resources and the attention of management could be diverted from our business.

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

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

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

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

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

- establish a classified board of directors so that not all members of our board of directors are elected at one time;
- authorize the issuance of undesignated preferred stock, the terms of which may be established and the shares of which may be issued without stockholder approval, and which may include super voting, special approval, dividend or other rights or preferences superior to the rights of the holders of common stock;
- prohibit stockholder action by written consent, which requires all stockholder actions to be taken at a meeting of our stockholders;
- provide that our board of directors is expressly authorized to make, alter or repeal our bylaws; and
- establish advance notice requirements for nominations for elections to our board of directors or for proposing matters that can be acted upon by stockholders at stockholder meetings.

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

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

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

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

In June 2015, we issued $250 million of 0.00% convertible senior notes due 2020 and, on July 2, 2015, we issued an additional $50 million pursuant to the exercise of the over-allotment option granted to the initial purchasers as part of the June 2015 offering (collectively, the “2020 Notes”). In June 2014, we issued $300 million of 0.00% convertible senior notes due 2019 and, on June 24, 2014, we issued an additional $50 million pursuant to the exercise of the over-allotment option granted to the initial purchasers as part of the June 2014 offering (the “2019 Notes” and, together with the 2020 Notes, the “Notes”). In connection with each offering of the Notes, we entered into convertible note hedge transactions with certain counterparties (the “Bond Hedge”) and warrant transactions (the “Warrants” and together with the Notes and the Bond Hedge, the “Convertible Notes Financings”) with the same counterparties (the “hedge counterparties”).

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

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

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

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

Taken together, the Bond Hedge and Warrants are intended, but not guaranteed, to offset any actual earnings dilution that could occur upon delivery of shares of common stock to satisfy to our conversion obligation under the Notes. For the 2020 Notes, the corresponding Bond Hedge and Warrants are intended to limit the earnings dilution that our stockholders would experience until the Company's common stock is above approximately $189.00 per share, the strike price of the 2020 Notes warrant transactions, which represented a 100% premium over the closing price of our common stock at the time we entered into the Bond Hedge and Warrants related to the 2020 Notes. For the 2019 Notes, the corresponding Bond Hedge and Warrants are intended to limit the earnings dilution that our stockholders would experience until the Company's common stock is above approximately $171.98 per share, the strike price of the 2019 Notes warrant transactions, which represented a 100% premium over the closing price of our common stock at the time we entered into the Bond Hedge and Warrants related to the 2019 Notes. However, these transactions are complex, and there can be no assurance that they will operate as planned.

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

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

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

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

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

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

Item 1B. Unresolved Staff Comments

None.

Item 2. Properties

We have approximately 1,318,000 leased gross square feet for 16 Design Galleries (10 next generation Design Galleries and 6 larger format Design Galleries), 47 legacy Galleries, 1 RH Modern Gallery, 4 RH Baby & Child Galleries, and 15 Waterworks Showrooms. The initial lease term of our retail Galleries generally ranges from 10 to 15 years, and certain leases contain renewal options for up to an additional 25 years. We have approximately 1,025,000 leased gross square feet for 32 outlet stores that were open as of February 3, 2018.

Most leases for our retail Galleries and outlets 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, repair and maintenance expenses, and common area maintenance.

Leased Properties

The following table summarizes the location and size of our leased distribution centers and corporate facilities occupied as of February 3, 2018:

Location	Leased Square Footage (Approximate)
RH Furniture Fulfillment Centers	
Patterson, California	1,501,000
Baltimore (North East), Maryland	1,195,000
Baltimore (Essex), Maryland (1)	508,000
Home delivery locations (2)	987,000
RH Small Parcel Fulfillment Center	
West Jefferson, Ohio (3)	1,224,000
Waterworks Fulfillment Center	
Brookfield, Connecticut	160,000
Customer Service Center	

Grand Prairie, Texas	20,000
Corporate Facilities	
Corte Madera, California (4)	257,000
Richmond, California (5)	200,000
Danbury, Connecticut (6)	26,000
Other	18,000

(1) Home delivery operations are also performed at this location.
(2) Represents square footage of ten of our eleven home delivery locations. The other home delivery location is located at our Baltimore (Essex), Maryland fulfillment center.
(3) Customer service center operations are also performed at this location.
(4) Location of RH Headquarters. Includes approximately 8,000 square feet of warehouse space.
(5) Represents warehouse space.
(6) Location of Waterworks Headquarters.

Owned Properties

We currently own one approximately 9,000 square foot property, which is the location of our Gallery in San Francisco’s Design District. Additionally, we own properties in Yountville, California, including the building occupying our wine tasting room and the adjacent parcel of land, which is expected to be the location of a future Design Gallery. All such owned properties are part of our RH Segment.

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

Item 3. Legal Proceedings

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

For additional information, refer to Note 19—Commitments and Contingencies in our consolidated financial statements within Part II of this Annual Report on Form 10-K.

Item 4. Mine Safety Disclosures

Not applicable.

PART II

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

Market Information and Dividend Policy

Our common stock trades under the symbol "RH" on the NYSE. The following table sets forth the highest and lowest closing prices for our common stock on the NYSE for the periods indicated.

	Highest	Lowest
Fiscal 2016		
First Quarter	$59.49	$36.65
Second Quarter	$42.77	$25.39
Third Quarter	$36.38	$28.13
Fourth Quarter	$38.99	$26.09
Fiscal 2017		
First Quarter	$48.75	$25.08
Second Quarter	$77.40	$42.54
Third Quarter	$86.88	$45.16
Fourth Quarter	$105.78	$82.11

The number of stockholders of record of our common stock as of February 3, 2018 was 26. This number excludes stockholders whose stock is held in nominee or street name by brokers.

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

Stock Performance Graph

This performance graph shall not be deemed “soliciting material” or to be “filed” with the SEC for purposes of Section 18 of the 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 RH under the Securities Act of 1933, as amended, or the Exchange Act.

The following graph and table compare the cumulative total stockholder return for our common stock during the period from November 2, 2012 (the date our common stock commenced trading on the NYSE) through February 3, 2018 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 RH, the NYSE Composite Index and the S&P Retailing Select Index. Data for the NYSE Composite Index and the S&P Retailing Select Index assumes reinvestments of dividends. The comparisons in the graph and table are required by the SEC and are not intended to be indicative of possible future performance of our common stock.

	11/2/2012	2/1/2013	1/31/2014	1/30/2015	1/29/2016	1/27/2017	2/2/2018
RH	100.00	116.50	182.44	281.45	198.14	83.89	295.95
NYSE Composite Index	100.00	108.87	121.04	127.96	116.97	137.02	158.90
S&P Retailing Select Index	100.00	107.88	128.22	149.53	132.53	137.97	146.98

Repurchases of Common Stock during the Three Months Ended February 3, 2018

During the three months ended February 3, 2018, we repurchased the following shares of our common stock:

	Number of Shares (1)	Average Purchase Price Per Share	Total Number of shares Repurchased as Part of Publicly Announced Plans or Programs	Approximate Dollar Value of Shares That May Yet Be Purchased Under the Plans or Programs (in millions)
October 29, 2017 to November 25, 2017	—	$ —	—	$ —
November 26, 2017 to December 30, 2017	8,810	$ 99.63	—	$ —
December 31, 2017 to February 3, 2018	—	$ —	—	$ —
Total	8,810	$ 99.63	—	

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

Item 6. Selected Consolidated Financial Data

The following tables present RH's consolidated financial and operating data as of the dates and for the periods indicated. The selected consolidated financial data as of February 3, 2018 and January 28, 2017 and for the fiscal years ended February 3, 2018, January 28, 2017, and January 30, 2016 were derived from consolidated financial statements included in Item 8—Financial Statements and Supplementary Data. The selected consolidated financial data as of January 30, 2016 and as of and for the periods ended January 31, 2015 and February 1, 2014 were derived from consolidated financial statements for such years not included herein.

The fiscal year ended February 3, 2018 consisted of 53 weeks. The fiscal years ended January 28, 2017, January 30, 2016, January 31, 2015 and February 1, 2014 each consisted of 52 weeks.

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

	Year Ended February 3, 2018	January 28, 2017	January 30, 2016	January 31, 2015	February 1, 2014
	(dollars in thousands, except per share amounts)				
Consolidated Statements of Income:					
Net revenues	$2,440,174	$2,134,871	$2,109,006	$1,867,422	$1,550,961
Cost of goods sold	1,591,107	1,455,084	1,356,314	1,176,648	994,081
Gross profit	849,067	679,787	752,692	690,774	556,880
Selling, general and administrative expenses	717,766	626,751	567,131	525,048	502,029
Income from operations	131,301	53,036	185,561	165,726	54,851
Other expenses					
Interest expense—net	62,570	44,482	35,677	17,551	5,733
Goodwill impairment	33,700	—	—	—	—
Loss on extinguishment of debt	4,880	—	—	—	—
Total other expenses	101,150	44,482	35,677	17,551	5,733
Income before income taxes	30,151	8,554	149,884	148,175	49,118
Income tax expense	27,971	3,153	58,781	57,173	30,923
Net income	$2,180	$5,401	$91,103	$91,002	$18,195
Weighted-average shares used in computing basic net income per share	27,053,616	40,691,483	40,190,448	39,457,491	38,671,564
Basic net income per share	$0.08	$0.13	$2.27	$2.31	$0.47
Weighted-average shares used in computing diluted net income per share	29,253,208	40,926,840	42,256,559	41,378,210	40,416,630
Diluted net income per share	$0.07	$0.13	$2.16	$2.20	$0.45
Other Financial and Operating Data:					
Direct as a percentage of net revenues [(1)]	44 %	45 %	49 %	50 %	47 %
Growth in net revenues:					
Stores [(2)]	16 %	9 %	16 %	14 %	27 %
Direct [(1)]	12 %	(7)%	10 %	28 %	33 %
Total	14 %	1 %	13 %	20 %	30 %
Comparable brand revenue growth [(3)]	6 %	(7)%	11 %	20 %	31 %
Adjusted net income [(4)]	$89,200	$51,789	$114,772	$97,636	$69,101
Capital:					
Capital expenditures [(5)]	$112,455	$157,644	$133,460	$110,359	$93,868
Construction related deposits [(6)]	14,387	23,380	20,049	9,250	—
Total capital	$126,842	$181,024	$153,509	$119,609	$93,868

	February 3, 2018 (in thousands)	January 28, 2017	January 30, 2016	January 31, 2015	February 1, 2014
Balance Sheet Data:					
Cash and cash equivalents	$17,907	$87,023	$331,467	$145,686	$13,389
Short-term and long-term investments [7]	—	175,889	152,855	80,506	—
Working capital [8]	132,098	722,355	861,304	540,299	276,919
Total assets	1,732,866	2,192,520	2,067,944	1,522,036	1,025,103
Financing obligations under build-to-suit lease transactions	229,323	203,015	146,621	124,770	33,165
Convertible senior notes due 2019—net [9]	329,012	314,543	300,711	287,487	—
Convertible senior notes due 2020—net [9]	255,865	239,876	224,887	—	—
Term loan	80,000	—	—	—	—
Equipment security notes	18,497	—	—	—	—
Promissory note	13,183	—	—	—	—
Asset based credit facility	199,970	—	—	—	85,425
Notes payable for share repurchases	19,390	19,390	19,523	19,523	2,710
Total debt (including current portion) [10]	923,896	581,318	552,702	314,514	90,331
Total stockholders' equity (deficit)	(7,336)	919,869	886,160	702,916	545,272

(1) Direct net revenues include sales through our Source Books, websites, and phone orders, including our Contract business and a portion of our Trade business.

(2) Stores data represents retail stores, including Waterworks Showrooms, plus outlet stores. Net revenues for outlet stores, which include warehouse sales, for fiscal 2017, fiscal 2016, fiscal 2015, fiscal 2014 and fiscal 2013 were $205.7 million, $144.6 million, $142.8 million, $121.6 million and $89.6 million, respectively.

(3) Comparable brand revenue growth includes direct net revenues and retail comparable store sales, including RH Baby & Child, RH Modern Galleries and Hospitality. Comparable brand revenue growth excludes retail non-comparable store sales, closed store sales and outlet net revenues. Comparable store sales have been calculated based upon retail stores, excluding outlet 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. Membership revenue was included in comparable brand revenue growth beginning April 2017, which is the first full month following the one-year anniversary of the program launch. Waterworks revenue was included in comparable brand revenue growth beginning June 2017, which is the first full month following the one-year anniversary of the acquisition. The impact on net revenues related to the product recalls in fiscal 2017 and fiscal 2016 has been excluded from comparable brand revenue growth. Because fiscal 2017 was a 53-week year, comparable brand revenue growth percentage for fiscal 2017 excludes the extra week of revenue.

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

	Year Ended				
	February 3, 2018	January 28, 2017	January 30, 2016	January 31, 2015	February 1, 2014
	(in thousands)				
Net income	$2,180	$5,401	$91,103	$91,002	$18,195
Adjustments pre-tax:					
Goodwill impairment [(a)]	33,700	—	—	—	—
Amortization of debt discount [(b)]	27,926	26,404	19,803	6,852	—
Non-cash compensation [(c)]	23,872	3,672	—	—	63,155
Recall accrual [(d)]	7,707	4,615	—	—	—
Distribution center closures [(e)]	5,795	—	—	—	—
Loss on extinguishment of debt [(f)]	4,880	—	—	—	—
Asset impairment and lease losses [(g)]	4,417	12,743	—	—	—
Impact of inventory step-up [(h)]	2,527	6,835	—	—	—
Anti-dumping exposure [(i)]	(2,202)	—	—	—	—
Gain on sale of building and land [(j)]	(2,119)	—	—	—	—
Legal claim [(k)]	—	8,701	19,046	7,700	—
Reorganization related costs [(l)]	—	5,698	—	—	—
Aircraft impairment [(m)]	—	4,767	—	—	—
Acquisition related costs [(n)]	—	2,847	—	—	—
Follow-on offering fees [(o)]	—	—	—	—	2,895
Subtotal adjusted items	106,503	76,282	38,849	14,552	66,050
Impact of income tax items [(p)]	(19,483)	(29,894)	(15,180)	(7,918)	(15,144)
Adjusted net income	$89,200	$51,789	$114,772	$97,636	$69,101

(a) Represents goodwill impairment related to the Waterworks reporting unit. Refer to "Impairment" within Note 3—Significant Accounting Policies in our consolidated financial statements.

(b) Under GAAP, certain convertible debt instruments that may be settled in cash on conversion are required to be separately accounted for as liability and equity components of the instrument in a manner that reflects the issuer's non-convertible debt borrowing rate. Accordingly, in accounting for GAAP purposes for the $350 million aggregate principal amount of convertible senior notes that were issued in June 2014 (the "2019 Notes") and for the $300 million aggregate principal amount of convertible senior notes that were issued in June and July 2015 (the "2020 Notes"), we separated the 2019 Notes and 2020 Notes into liability (debt) and equity (conversion option) components and we are amortizing as debt discount an amount equal to the fair value of the equity components as interest expense on the 2019 Notes and 2020 Notes over their respective terms. The equity components represent the difference between the proceeds from the issuance of the 2019 Notes and 2020 Notes and the fair value of the liability components of the 2019 Notes and 2020 Notes, respectively. Amounts are presented net of interest capitalized for capital projects of $2.5 million, $2.4 million, $2.3 million and $1.1 million during fiscal 2017, fiscal 2016, fiscal 2015 and fiscal 2014, respectively.

(c) The adjustment for fiscal 2017 represents a non-cash compensation charge related to a fully vested option grant made to Mr. Friedman in May 2017. The adjustment for fiscal 2016 represents a non-cash compensation charge related to the fully vested option grants made in connection with our acquisition of Waterworks. Fiscal 2013 includes a $33.7 million non-cash compensation charge related to the fully vested option grant made 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.

(d) Represents a reduction in net revenues, increase in cost of goods sold and inventory charges associated with product recalls initiated in the fourth quarter of fiscal 2016 and second quarter of fiscal 2017, as well as adjustments in fiscal 2017 of the accrual related to the recalls. The recall adjustments, which affected our results for fiscal 2017 and fiscal 2016, had the following effect on our income before taxes:

	Year Ended	
	February 3, 2018	January 28, 2017
	(in thousands)	
Reduction of net revenues	$3,207	$3,441
Incremental cost of goods sold and inventory charges	4,315	535
Impact on gross profit	7,522	3,976
Incremental selling, general and administrative expenses	185	639
Impact on income before income taxes	$7,707	$4,615

(e) Represents property and equipment disposals, lease related charges, inventory transfer costs, severance expense and other costs associated with two distribution center closures, which were completed in November 2017 and January 2018.

(f) Represents the loss on extinguishment of debt related to the second lien term loan which was repaid in full in October 2017.

(g) Represents the impairments associated with RH Contemporary Art and RH Kitchen. The impairment related to RH Kitchen is a result of the alignment with the Waterworks Kitchen product line strategy. This resulted in cost of goods sold of $1.0 million which represented impairment of inventory in fiscal 2016. RH Contemporary Art was integrated into the broader RH platform and no longer operates as a separate division. In fiscal 2016, this resulted in cost of goods sold of $1.1 million which represented impairment of inventory, and selling, general and administrative expenses of $10.6 million which represents lease related charges, property and equipment disposals, and donations. In fiscal 2017, an additional lease related charge of $4.4 million was recorded due to the remeasurement of the liability for lease losses for RH Contemporary Art resulting from an update to both the timing and the amount of future estimated lease related cash inflows.

(h) Represents the non-cash amortization of the inventory fair value adjustment recorded in connection with our acquisition of Waterworks.

(i) Represents the release of the remaining reserve for potential claims regarding anti-dumping duties which we believe have lapsed. The reserve related to potential tariff obligations of one of our foreign suppliers following the U.S. Department of Commerce’s review on the anti-dumping duty order on wooden bedroom furniture from China for the period from January 1, 2011 through December 31, 2011.

(j) Represents the gain on the sale of building and land of one of our owned retail Galleries.

(k) Represents charges incurred or the estimated cumulative impact of coupons redeemed in connection with a legal claim alleging that the Company violated California’s Song-Beverly Credit Card Act of 1971 by requesting and recording ZIP codes from customers paying with credit cards.

(l) Represents costs associated with a reorganization, which include severance costs and related taxes, partially offset by a reversal of stock-based compensation expense related to unvested equity awards.

(m) Represents the impairment recorded upon reclassification of aircraft as asset held for sale.

(n) Represents costs incurred in connection with our acquisition of Waterworks including professional fees.

(o) Represents legal and other professional fees incurred in connection with our follow-on offerings in May 2013 and July 2013.

(p)

The adjustment for fiscal 2017 is based on an adjusted tax rate of 34.7%, which is calculated based on the weighted-average fiscal 2017 quarterly adjusted pro forma tax rates and excludes the impact of tax reform, including the $6.0 million revaluation of the net deferred tax assets and $1.0 million transitional tax, as well as the $5.9 million tax impact associated with the Waterworks reporting unit goodwill impairment. Fiscal 2016 assumes a normalized tax rate of 39%. The adjustment for fiscal 2015 represents the tax effect of the adjusted items based on our effective tax rate of 39.2%. Fiscal 2014 and fiscal 2013 assume a normalized tax rate of 40%.

(5) Capital expenditures include the acquisition of buildings and land of $14.0 million in fiscal 2015.

(6) Construction related deposits relate to payments to escrow accounts for future construction of Design Galleries.

(7) As of the year ended fiscal 2016, fiscal 2015 and fiscal 2014, $142.7 million, $130.8 million and $62.2 million, respectively, of our investments were due within one year. As of the year ended fiscal 2016, fiscal 2015 and fiscal 2014, $33.2 million, $22.1 million and $18.3 million, respectively, of our investments were due within two years. The Company held no investments as of fiscal 2017.

(8) Working capital is defined as current assets, less current liabilities, excluding the current portion of long-term debt.

(9) Represents our obligations, net of debt discount, related to the 2019 Notes and 2020 Notes. The aggregate principal amounts due under the 2019 Notes and 2020 Notes are $350 million and $300 million, respectively.

(10) Total debt (including current portion) includes the 2019 Notes and 2020 Notes, net of debt discount, asset based credit facility, term loan, notes payable for share repurchases, equipment security notes, aircraft promissory note 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 curated and fully-integrated assortments are presented consistently across our sales channels in sophisticated and unique lifestyle settings that we believe are on par with world-class interior designers. We offer dominant merchandise assortments across a growing number of categories, including furniture, lighting, textiles, bathware, décor, outdoor and garden, tableware, and child and teen furnishings. We position our Galleries as showrooms for our brand, while our Source Books and websites act as virtual extensions of our stores.

Our business is fully integrated across our multiple channels of distribution, consisting of our stores, Source Books and websites. As of February 3, 2018, we operated a total of 83 retail Galleries consisting of 16 Design Galleries (10 next generation Design Galleries and 6 larger format Design Galleries), 47 legacy Galleries, 1 RH Modern Gallery and 4 RH Baby & Child Galleries throughout the United States and Canada, and 15 Waterworks Showrooms in the United States and in the U.K. In addition, as of February 3, 2018, we operated 32 outlet stores throughout the United States and Canada.

We lowered our new Gallery opening cadence in 2016 to three to five Galleries per year. We made this decision in order to focus on a slower store opening cadence that was designed to decrease the execution risk over the course of our real estate transformation and to lower our capital requirements. This slower opening cadence also was designed to put less pressure on our infrastructure, enabling greater capital discipline throughout the organization while we continued to focus on other initiatives to improve our operating model. We believe this effort has been successful in yielding the benefits that we have been seeking from this initiative. At the same time, we have identified key learnings from our real estate transformation efforts during 2016 and 2017 that have supported our development of a new prototype Design Gallery that will enable us to escalate our new store opening cadence beginning in 2019. The new prototype will range in size from 33,000 square feet inclusive of our integrated hospitality experience to 29,000 square feet without, and will represent our assortments from RH Interiors, RH Modern, RH Baby & Child, RH TEEN and RH Outdoor. Due to the reduced square footage and efficient design, these new Galleries should be significantly more capital efficient and should have lower risk in the real estate development process both with respect to costs and time required for completion. We anticipate these new Galleries will represent approximately two thirds of our target markets and enable us to ramp from three to five new Galleries per year to a pace of five to seven. We will continue to develop and open larger more customized Bespoke Design Galleries in the top metropolitan markets, and indigenous smaller format Bespoke Galleries in second home markets that have attractive customer demographics. As an example of the smaller Bespoke Gallery format, in 2018 we expect to open RH Yountville, the Gallery in the Napa Valley.

Key Value Driving Strategies

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

- Transform Our Real Estate Platform. We believe we have an opportunity to significantly increase our sales by transforming our real estate platform from our existing legacy retail footprint to a portfolio of Design Galleries that are sized to the potential of each market and the size of our assortment. In 2016, we lowered our new Gallery opening cadence to three to five Galleries per year. We made this decision in order to focus on a slower store opening cadence that was designed to decrease the execution risk over the course of our real estate transformation and to lower our capital requirements. This slower opening cadence also was designed to put less pressure on our infrastructure, enabling greater capital discipline throughout the organization while we continued to focus on other initiatives to improve our operating model. We believe this effort has been successful in yielding the benefits that we have been seeking from this initiative.

We opened RH Toronto in October 2017 and RH West Palm in November 2017, both with integrated food and beverage offerings. We expect to open three Design Galleries in Portland, Nashville and New York, in addition to one smaller Gallery in Yountville, California in the Napa Valley, in fiscal 2018, the latter three with integrated cafés, wine vaults and barista bars.

New Design Gallery sites are identified based on a variety of factors, including timing of legacy Gallery lease expiration, availability of suitable new site locations based on several store specific aspects including geographic location, demographics, and proximity to affluent consumers, and the negotiation of favorable economic terms to the Company for the new location, as well as satisfactory and timely completion of real estate development including procurement of permits and completion of construction. The number of Design Galleries we open in any fiscal year is highly dependent upon these variables and individual new Design Galleries may be subject to delay or postponement depending on the circumstances of specific projects.

Based on our analysis, we believe we have the opportunity to operate Design Galleries in 60 to 70 locations in the United States and Canada. Landlords continue to offer us leases that accommodate our space requirements and that have favorable terms.

We have identified key learnings from our real estate transformation efforts during 2016 and 2017 that have supported our development of a new prototype Design Gallery that will enable us to escalate our new store opening cadence beginning in 2019. The new prototype will range in size from 33,000 square feet inclusive of our integrated hospitality experience to 29,000 square feet without, and will represent our assortments from RH Interiors, RH Modern, RH Baby & Child, RH TEEN and RH Outdoor. Due to the reduced square footage and efficient design, these new Galleries should be significantly more capital efficient and should have lower risk in the real estate development process both with respect to costs and time required for completion. We anticipate these new Galleries will represent approximately two thirds of our target markets and enable us to ramp from three to five new Galleries per year to a pace of five to seven. We will continue to develop and open larger more customized Bespoke Design Galleries in the top metropolitan markets, and indigenous smaller format Bespoke Galleries in second home markets that have attractive customer demographics. As an example of the smaller Bespoke Gallery format, in 2018 we expect to open RH Yountville, the Gallery in the Napa Valley.

Our rate of revenue growth across fiscal 2016 and fiscal 2017 slowed as compared to prior years in part due to the slower cadence of our new Design Gallery openings during those years. We expect to open four new Galleries in 2018 and then shift the cadence of openings beginning in 2019 to five to seven new locations per year. The increased cadence should support an increase in the rate of our revenue growth as new Gallery openings are one of the key drivers of our revenue.

We also believe there is an opportunity to transition our real estate strategy from a leasing model to a development model, where we potentially buy and develop our Design Galleries then recoup the investments through a sale-leaseback arrangement resulting in lower capital investment and lower rent. We currently have two projects, RH Yountville, California, and Edina, Minnesota, under construction using this new model and have an additional five projects in the development process.

- 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, including design services and cafes, wine vaults and coffee bars at our Design Galleries;
- exploring and testing new business opportunities complementary to our core business; and
- increasing our brand awareness and customer loyalty through our Source Book circulation strategy, membership program, our digital marketing initiatives and our advertising and public relations activities and events.

During 2017 and 2018 we have deferred the introduction of major new product category expansions other than the ongoing development of RH hospitality in conjunction with new Design Galleries. We plan a return to our product and business expansion strategy in 2019, which has been on hold as we focused on the architecture of a new operating platform and our move to a membership model.

- Architect New Operating Platform. Our goal is to architect a new operating platform that we believe will simplify our business, enhance the customer experience, and amplify decision quality and speed. As part of architecting a new operating platform, we have focused on redesigning our supply chain network, rationalizing our product offerings, and transitioning inventory into fewer facilities, creating a more capital efficient model. Our initial efforts in fiscal 2016 and 2017 focused on our distribution center network, decision data, and the home delivery experience, including:
- Introduction of New Membership Model—In March 2016, we introduced the RH Members Program, an exclusive new membership program that reimagines and simplifies the shopping experience. For an annual fee, the RH Members Program provides a set discount every day across all RH brands in addition to other benefits including complimentary interior design services through the RH Interior Design program and eligibility for preferred

financing plans on the RH Credit Card, among others. We believe that transitioning our business from a promotional to membership model has enhanced our brand, simplified and streamlined our business as well as allowed us to develop deeper connections with our customers. We believe that the transition to a membership model has had a favorable impact on our business and financial performance including through a reduction in our return rate, exchange rate and cancel rate resulting in higher conversion of demand into revenues.

- For the year ended February 3, 2018, our members drove 95% of sales in our core RH business, and we had approximately 405,000 members at year end. Our core RH business does not include sales generated via Outlet, Contract or Waterworks.
- We believe that the shift to a membership model has positively affected the financial results of our business. Specifically, we believe some of the benefits include:

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

Lower cancellations and returns. We believe the shift to a membership model has also resulted in positive trends, including lower rates of cancelled orders and returns.

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

- Distribution Center Network Redesign—As a result of our work to redesign our distribution network and optimize inventory, we were able to forego building a fifth furniture distribution center planned to open in fiscal 2017, consolidate our current furniture distribution center network from four to two locations in fiscal 2017, and believe we can operate our business with even fewer facilities. In fiscal 2017, we completed the closure of our furniture distribution centers in Los Angeles and Dallas, eliminating 1.75 million square feet of distribution center space, resulting in savings in excess of $20 million annually. We believe managing our business in fewer facilities will reduce inventory risk, increase turns, and should result in higher gross margins over time.
- Reconceptualize Reverse Logistics Business—In fiscal 2017, we implemented initiatives to re-conceptualized our Outlet and reverse logistics business. Previously, furniture product returns would go from a customer's home and be returned to a furniture distribution center, then eventually transferred to one of our Outlet locations. We believe by rerouting customer returns away from our distribution centers, in favor of in-market alternatives and direct to Outlet transfers, we will reduce transportation and handling costs, plus improve selling margins across our Outlet network. Our early tests indicate that this initiative could yield substantial savings and margin enhancement opportunity of approximately $20 million annually.
- Luxury In-Home Furniture Delivery Experience—We believe there is an opportunity to improve the customer experience by taking greater control of the final mile in-home delivery. We have in-sourced the majority of our home delivery hubs, but continue to use third-party providers for furniture delivery into our customer's home. We believe that many third-party furniture delivery providers are designed to support mass and mid-market companies and that significant opportunity exists for developing improved solutions for the luxury market. We have achieved significant scale such that we can now explore and test alternative solutions in certain markets, including the use of our own trucks and drivers, and believe we can dramatically enhance the customer experience while driving down return rates, damages, and deliveries per order.
- Elevate the Customer Experience. We are focused on improving the end-to-end customer experience. As we have elevated our brand, especially at retail, we are also working to enhance the brand experience in other aspects of our business. We are making changes in many aspects of our business processes that affect our customers, including the in-home delivery experience, improvements in product quality and enhancements in sourcing, product availability, and all aspects of customer care and service. We also believe that the introduction of experiential brand-enhancing products and services, such as expanded design ateliers, the RH Interior Design program and the launch of an integrated food and beverage experience in a number of our new Galleries, will further enhance our customers' in-store experience, in addition to allowing us to further disrupt the highly fragmented home furnishings landscape

and achieve market share gains.

- Increase Operating Margins. We have the opportunity to continue to improve our operating margins by focusing on optimizing the profitability of our new platform and leveraging our fixed occupancy, advertising and corporate general and administrative costs and scalable infrastructure. We anticipate improved operating margins through the benefits of our SKU rationalization and inventory reduction efforts, cycling the significant start-up costs from our integrated hospitality experience, neutralizing the earnings drag from Waterworks, benefitting from the continued cost savings of our new operating platform, and leveraging the gain we expect from our real estate transformation. In addition, we believe the operating efficiencies of our membership model are helping to drive a number of efficiencies across our business that are contributing to our improving operating margins.
- Optimize the Allocation of Capital in the Business and Maximize Cash Flow. We believe that our operations and current initiatives present a significant opportunity to optimize the allocation of capital in our business, including generating free cash flow and optimizing cash on our balance sheet as well as deploying capital to repay debt and repurchase shares of our

common stock, which we believe creates a long term benefit to our shareholders. During fiscal 2017, we repurchased approximately 20.2 million shares of our common stock under two separate repurchase programs for an aggregate repurchase amount of approximately $1 billion, which represented 49.5% of the shares outstanding as of the end of fiscal 2016. We incurred additional debt to fund a portion of our share repurchase programs and we believe that was a good capital allocation given favorable interest rates on debt and the ability of our business to generate cash in light of current business initiatives in order to paydown and service such debt. Our focus on cash during 2017 also resulted in the Company generating $433 million in free cash flow in 2017 which further supported our share repurchase programs. We expect to continue to focus on generating additional free cash flow during 2018.

We believe many of our current business initiatives support our capital allocation and cash flow goals. For example, during fiscal 2017, one of our initiatives has been to generate additional cash flow through the optimization of inventory, including through rationalizing our SKU count and reducing overall levels of inventory, which involves selling slower moving, discontinued and other inventory through markdowns and through our outlet channel. We have also undertaken initiatives to optimize our distribution network and make significant improvements in the way that we handle merchandise in the distribution and delivery part of our business. We expect that these improvements will result in operational efficiencies in the handling and transportation of merchandise and will enable us to achieve greater efficiency and lower requirements for carrying inventory to meet customer demand. We also believe that our Gallery opening cadence of three to five Galleries per year will result in improved deal economics, lower build out costs and higher returns, will lower our capital requirements and execution risk over the course of our real estate transformation and will put less pressure on our infrastructure, enabling greater capital discipline throughout the organization. In addition, we have a number of assets that can be sold to third parties in order to generate cash. We expect to transition from a lease to a development model and may enter into sale leaseback transactions with respect to certain real estate that we own, for example, and may enter into capital or operating leases in lieu of purchasing or holding certain assets that are used in our business. We intend to continue to seek out and evaluate opportunities for effectively managing and deploying capital in ways that support and enhance our business initiatives and strategies.

- Pursue International Expansion. We plan to strategically expand our business into select countries outside of the United States, Canada and the U.K. in the future. We also continue to explore opportunities to open our first RH Gallery in London. We believe that our luxury brand positioning and unique aesthetic will have strong international appeal.

We continue to pursue and test numerous initiatives to improve many aspects of our business including through efforts to optimize inventory, elevate the home delivery experience and simplify our distribution network, as well as to expand our product offering and transform our real estate. There can be no assurance as to the timing and extent of the operational benefits and financial contributions of these strategic efforts. In addition, our pursuit of multiple initiatives with respect to our business in any given period may result in period-to-period changes in, and increased fluctuation in, our results of operations. For example, our efforts to optimize our distribution network could cause us to incur costs and expenses in the short term with respect to changes in the way in which we operate our business such as charges related to closure of distribution centers. The above factors and other current and future operational initiatives of the Company may create additional uncertainty with respect to our consolidated net revenues and profit in the near term.

Factors Affecting Our Results of Operations

Various factors affected our results for the periods presented in this "Management's Discussion and Analysis of Financial Condition and Results of Operations," and such discussion generally lists the factors in order of magnitude based on their impact. The below are certain factors that affect our results of operations:

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

- the introduction and expansion of new product categories and services;
- efforts to reduce inventories and rationalize our SKU count;
- the transition from a promotional to a membership model;
- changes in our Source Book circulation strategy including the depth, frequency and timing of mailings as well as the scope of product offerings displayed in our Source Books;
- changes in the overall opening cadence for new Galleries;
- the timing and progress of the opening of new Design Galleries that are under development;
- the optimization of our store sizes to better fit anticipated demand in a given market;

- the redesign of our distribution center network;
- changes in handling of customer returns and reverse logistics model in favor of a direct to outlet model;
- efforts to elevate the customer experience including architecting a new fully integrated back-end operating platform, inclusive of the supply chain network, the home delivery experience as well as a new metric driven quality system and company-wide decision data, vendor product initiatives and changes to the way we operate our distribution centers, home delivery hubs and customer service centers;
- the introduction of an integrated hospitality experience, including the roll out of an integrated food and beverage experience in a number of our new Design Galleries; and
- leveraging the above strategic initiatives across both our RH Segment and Waterworks to drive the performance of each business.

As a result of the number of current business initiatives we are pursuing, we have experienced in the past, and may experience in the future, significant period-to-period variability in our financial performance and results of operations.

Certain of our strategic initiatives were initiated to address temporal factors that negatively impacted the business in fiscal 2016. The factors negatively impacting the business in 2016 included: (1) costs related to the launch of RH Modern, including substantial customer accommodations and related expenses incurred in part in response to initial difficulties in ramping up production in response to customer demand; (2) the timing and recognition of RH Member Program revenue, as the RH Members Program fee is amortized on a monthly basis over the annual membership period and therefore at the time of launching the program these fees negatively impact margin in the short-term; (3) efforts to reduce inventories and rationalize SKU count; and (4) the decision to move the Spring 2016 Source Book mailing to Fall 2016. In fiscal 2017, our financial results were positively impacted by the anniversary of many of these temporal factors as well as the continued strong demand for our product offering and growth from our real estate strategy. In addition to cycling many of the temporal drags from fiscal 2016, our efforts to optimize our supply chain network, including the closure of two furniture fulfillment centers, changes to the customer return and reverse logistics process, among other supply chain improvements, contributed to the strong margin improvement and earnings growth in fiscal 2017. Our continued efforts to optimize inventory and rationalize our SKU count into fiscal 2017 did have a negative impact, however, on our margin and earnings, particularly in the first half of fiscal 2017.

Our Ability to Source and Distribute Products Effectively. Our net revenues and gross profit are affected by our ability to purchase our merchandise in sufficient quantities at competitive prices. Our current and anticipated demand, our level of net revenues have been adversely affected in prior periods by constraints in our supply chain, including the inability of our vendors to produce sufficient quantities of some merchandise in a manner that was able to match market demand from our customers, leading to higher levels of customer back orders and lost sales. For example, some of our vendors experienced difficulty in producing goods in sufficient quantity to meet initial customer demand for RH Modern.

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 results of operations. We also acquired Waterworks in fiscal 2016 and have added Waterworks product offerings to our platform. Periods in which our products have achieved strong customer acceptance generally have had more favorable results. If we misjudge the market for our products or the product lines that we acquire, we may be faced with excess inventories for some products and may be required to become more promotional in our selling activities, which would impact our net revenues and gross profit.

Overall Economic Trends. The industry in which we operate is cyclical, and consequently our net revenues are affected by general economic conditions including conditions that affect the housing market. We target consumers of high-end home furnishings. As a result, we believe that our sales are sensitive to a number of macroeconomic factors that influence consumer spending generally, but that our sales are particularly affected by the health of the higher end customer and demand levels from that customer demographic. While the overall home furnishings market may be influenced by factors such as employment levels, interest rates, demographics of new household formation and the affordability of homes for the first time home buyer, the higher end of the housing market may be disproportionately influenced by other factors including the number of foreign buyers in higher end real estate markets in the U.S., the number of second and third homes being bought and sold, stock market prices, tax policies and interest rates, and the perceived prospect for capital appreciation in higher end real estate. We have in the past experienced volatility in our sales trends related to many of these factors and believe our sales may be impacted by these economic factors in future periods. Additionally, we have seen a weakness in consumer spending at the luxury end of the retail market. These headwinds tied to macroeconomic factors may continue in future quarters. For more information, refer to Item 1A—Risk Factors—Changes in consumer spending and factors that influence spending of the specific consumers we target, including the health of the high-end housing market, may significantly impact our revenue and results of operations.

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

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

How We Assess the Performance of Our Business

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

Net Revenues. Net revenues reflect our sale of merchandise plus shipping and handling revenue collected from our customers, less returns and discounts. Revenues are recognized upon receipt of product by our customers. We collect annual membership fees related to the RH Members Program, which are recorded as deferred revenue and recognized as revenue on a straight-line basis over the membership period, or one year.

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 and our supply chain, such as rent and common area maintenance for our leases; depreciation and amortization of leasehold improvements, equipment and other assets in our stores and distribution centers. In addition, cost of goods sold include all logistics costs associated with shipping product to our customers, which are partially offset by shipping income collected from customers (recorded in net revenues). We expect gross profit to increase to the extent that we successfully grow our net revenues and leverage the fixed portion of cost of goods sold.

Our gross profit can be favorably impacted by sales volume increases, as occupancy and certain other costs that are largely fixed do not necessarily increase proportionally with volume increases. Changes in the mix of our products may also impact our gross profit. We review our inventory levels on an ongoing basis in order to identify slow-moving merchandise and use product markdowns and our outlet stores to efficiently sell these products. The timing and level of markdowns are driven primarily by customer acceptance of our merchandise. The primary drivers of the costs of individual goods are raw materials costs, which fluctuate based on a number of factors beyond our control, including commodity prices, changes in supply and demand, general economic conditions, competition, import duties, tariffs and government regulation, logistics costs (which may increase in the event of, for example, expansions of or interruptions in the operation of our distribution centers, furniture home delivery 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. In addition, certain of our store leases are accounted for as build-to-suit lease transactions which result in our recording a portion of our rent payments under these agreements in interest expense on the consolidated statements of income.

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

In recent periods we have experienced increased selling, general and administrative expenses, excluding certain non-cash compensation and costs associated with distribution center closures, and asset impairments and lease losses, as discussed in “Basis of Presentation and Results of Operations” below. The most significant components of these increases are employment costs due to company growth and expansion, an increase in advertising and marketing costs, an increase in credit card fees due to increased revenues, as well as an increase in professional fees and other corporate costs. We expect certain of these expenses to continue to increase as we continue to open new stores, develop new product categories and otherwise pursue our current business initiatives.

Adjusted Net Income. We believe that adjusted net income is a useful measure 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 net income 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.

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

Comparable Brand Revenue. We believe that comparable brand revenue is a meaningful metric to evaluate period-to-period changes in net revenue performance given the integrated multi-channel nature of our business, the synergies between our retail stores, websites and Source Books, and the fact that customers shop across all of these channels.

Comparable brand revenue growth includes direct net revenues and retail comparable store sales, including RH Baby & Child, RH Modern Galleries and Hospitality. Comparable brand revenue growth excludes retail non-comparable store sales, closed store sales and outlet store net revenues. Comparable store sales have been calculated based upon retail stores, excluding outlet 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. Membership revenue was included in comparable brand revenue growth beginning April 2017, which is the first full month following the one-year anniversary of the program launch. Waterworks revenue was included in comparable brand revenue growth beginning June 2017, which is the first full month following the one-year anniversary of the acquisition. The impact on net revenues related to the product recalls in fiscal 2017 and fiscal 2016 has been excluded from comparable brand revenue growth. Because fiscal 2017 was a 53-week year, comparable brand revenue growth percentage for fiscal 2017 excludes the extra week of revenue.

As the comparable brand revenue metric includes changes in retail store net revenues (i.e. comparable store sales) on a period-to-period basis and also incorporates changes in net revenues resulting from Source Book and websites sales, we believe this metric provides better information to investors in terms of evaluating our business performance and a better basis to compare performance to that of key competitors.

Basis of Presentation and Results of Operations

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

	Year Ended February 3, 2018	January 28, 2017	January 30, 2016
	(dollars in thousands)		
Consolidated Statements of Income:			
Net revenues	$2,440,174	$2,134,871	$2,109,006
Cost of goods sold	1,591,107	1,455,084	1,356,314
Gross profit	849,067	679,787	752,692
Selling, general and administrative expenses	717,766	626,751	567,131
Income from operations	131,301	53,036	185,561
Other expenses			
Interest expense—net	62,570	44,482	35,677
Goodwill impairment	33,700	—	—
Loss on extinguishment of debt	4,880	—	—
Total other expenses	101,150	44,482	35,677
Income before income taxes	30,151	8,554	149,884
Income tax expense	27,971	3,153	58,781
Net income	$2,180	$5,401	$91,103
Other Financial and Operating Data:			
Net revenues:			
Stores (1)	$1,371,342	$1,178,860	$1,083,600
Direct (2)	$1,068,832	$956,011	$1,025,406
Direct as a percentage of net revenues (2)	44 %	45 %	49 %
Growth in net revenues:			
Stores (1)	16 %	9 %	16 %
Direct (2)	12 %	(7)%	10 %
Total	14 %	1 %	13 %
Comparable brand revenue growth (3)	6 %	(7)%	11 %
Capital:			
Capital expenditures (4)	$112,455	$157,644	$133,460
Construction related deposits (5)	14,387	23,380	20,049
Total capital	$126,842	$181,024	$153,509

(1) Stores data represents retail stores, including Waterworks Showrooms, plus outlet stores. Net revenues for outlet stores, which include warehouse sales, for fiscal 2017, fiscal 2016 and fiscal 2015 were $205.7 million, $144.6 million and $142.8 million, respectively.

(2) Direct net revenues include sales through our Source Books, websites, and phone orders, including our Contract business and a portion of our Trade business.

(3) Comparable brand revenue growth includes direct net revenues and retail comparable store sales, including RH Baby & Child, RH Modern Galleries and Hospitality. Comparable brand revenue growth excludes retail non-comparable store sales, closed store sales and outlet net revenues. Comparable store sales have been calculated based upon retail stores, excluding outlet 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. Membership revenue was included in comparable brand revenue growth beginning April 2017, which is the first full month following the one-year anniversary of the program launch. Waterworks revenue was included in comparable brand revenue growth beginning June 2017, which is the first full month following the one-year anniversary of the acquisition. The impact on net revenues related to the product recalls in fiscal 2017 and fiscal 2016 has been excluded from comparable brand revenue growth. Because fiscal 2017 was a 53-week year, comparable brand revenue growth percentage for fiscal 2017 excludes the extra week of revenue.

(4) Capital expenditures include the acquisition of buildings and land of $14.0 million in fiscal 2015.

(5) Construction related deposits relate to payments to escrow accounts for future construction of Design Galleries.

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

	Year Ended February 3, 2018	January 28, 2017	January 30, 2016
Consolidated Statements of Income:			
Net revenues	100.0 %	100.0 %	100.0 %
Cost of goods sold	65.2	68.2	64.3
Gross profit	34.8	31.8	35.7
Selling, general and administrative expenses	29.4	29.3	26.9
Income from operations	5.4	2.5	8.8
Other expenses			
Interest expense—net	2.6	2.1	1.7
Goodwill impairment	1.4	—	—
Loss on extinguishment of debt	0.2	—	—
Total other expenses	4.2	2.1	1.7
Income before income taxes	1.2	0.4	7.1
Income tax expense	1.1	0.1	2.8
Net income	0.1 %	0.3 %	4.3 %

Fiscal 2017 Compared to Fiscal 2016

Prior to the Waterworks acquisition on May 27, 2016, we had one reportable segment. As we acquired the Waterworks business on May 27, 2016, reportable segment information presented below for Waterworks includes results for thirty-five weeks during fiscal 2016 and includes results for fifty-three weeks during fiscal 2017. The RH Segment includes results for fifty-two weeks during fiscal 2016 and fifty-three weeks during fiscal 2017.

	Year Ended February 3, 2018			January 28, 2017		
	RH Segment	Waterworks (1)	Total	RH Segment	Waterworks (1)	Total
	(in thousands)					
Net revenues	$2,319,332	$ 120,842	$2,440,174	$2,060,044	$ 74,827	$2,134,871
Cost of goods sold	1,517,333	73,774	1,591,107	1,403,853	51,231	1,455,084
Gross profit	801,999	47,068	849,067	656,191	23,596	679,787
Selling, general and administrative expenses	666,055	51,711	717,766	590,288	36,463	626,751
Income (loss) from operations	$135,944	$ (4,643)	$131,301	$65,903	$ (12,867)	$53,036

(1) Waterworks results include non-cash amortization of $2.5 million and $6.8 million related to the inventory fair value adjustment recorded in connection with our acquisition of Waterworks during fiscal 2017 and fiscal 2016, respectively. Waterworks results for fiscal 2016 also include a non-cash compensation charge of $3.7 million related to the fully vested option grants made in connection with our acquisition of Waterworks.

Net revenues

Consolidated net revenues increased $305.3 million, or 14.3%, to $2,440.2 million in fiscal 2017 compared to $2,134.9 million in fiscal 2016. We had 83 and 85 retail stores open at February 3, 2018 and January 28, 2017, respectively. Stores net revenues increased $192.5 million, or 16.3%, to $1,371.3 million in fiscal 2017 compared to $1,178.9 million in fiscal 2016. Direct net revenues increased $112.8 million, or 11.8%, to $1,068.8 million in fiscal 2017 compared to $956.0 million in fiscal 2016. Comparable brand revenue growth was 6% for fiscal 2017.

RH Segment net revenues

RH Segment net revenues increased $259.3 million, or 12.6%, to $2,319.3 million in fiscal 2017 compared to $2,060.0 million in fiscal 2016. The below discussion highlights several significant factors that resulted in increased RH Segment net revenues, which are listed in order of magnitude.

RH Segment core net revenues increased due to the performance of our new Design Galleries and an increase in retail weighted-average leased selling square footage, as well as our decision to move the mailing of our 2016 Interiors Source Book to the fall of 2016. The 2016 Interiors Source Book mailing was complete in mid-December and therefore was a contributor to net revenues in fiscal 2017, whereas fiscal 2016 did not benefit from a similarly timed mailing.

Outlet sales, which include sales via warehouse locations, increased $61.1 million in fiscal 2017 compared to fiscal 2016, representing 23.5% of the RH Segment net revenues growth. Increased outlet sales occurred primarily as a result of our inventory optimization efforts as we increased our outlet promotional activity and offered higher discounts, including through warehouse sales. We also increased outlet selling square footage by approximately 33% compared to the prior period.

In addition, RH Segment net revenues increased approximately $34 million due to fiscal 2017 representing fifty-three weeks of results, whereas fiscal 2016 only included fifty-two weeks of results.

We introduced our membership program in March 2016, which provided a greater level of discount to our customers in most instances, but our recognition of membership fee revenue did not coincide with the timing of a customer order since the membership fee is recognized ratably over the 12 month period of membership. In fiscal 2017, we passed the first year anniversary of the launch of RH membership and as a result we were able to recognize a larger amount of Membership revenue versus 2016 and therefore we had an increase in Membership revenue recognized of $21.4 million.

During fiscal 2016, RH Segment net revenues were reduced by an estimated $16 million due to customer accommodation and related expenses as a result of our initiative to elevate the customer experience, including in response to production delays related to RH Modern. We did not experience similar production delays during fiscal 2017. Additionally, RH Segment net revenues for fiscal 2017 and fiscal 2016 were negatively impacted by $3.2 million and $3.4 million, respectively, related to the reduction of revenue associated with product recalls.

Waterworks net revenues

On May 27, 2016, we acquired a controlling interest in Waterworks. As a result of this acquisition, we acquired 15 Waterworks Showrooms and included such additional retail stores in our weighted-average leased selling square footage for both fiscal 2017 and part of fiscal 2016. Waterworks net revenues increased $46.0 million, or 61.5%, to $120.8 million in fiscal 2017 compared to $74.8 million in fiscal 2016. Waterworks net revenues represented 5.0% and 3.5% of our net revenues for fiscal 2017 and fiscal 2016, respectively. The increase in Waterworks net revenues is primarily due to fiscal 2017 representing fifty-three weeks of results, whereas fiscal 2016 only included thirty-five weeks of results as Waterworks was acquired on May 27, 2016.

Gross profit

Consolidated gross profit increased $169.3 million, or 24.9%, to $849.1 million in fiscal 2017 from $679.8 million in fiscal 2016. As a percentage of net revenues, gross margin increased 3.0% to 34.8% of net revenues in fiscal 2017 from 31.8% of net revenues in fiscal 2016.

RH Segment gross profit for fiscal 2017 was positively impacted by $2.2 million related to the release of the remaining reserve for potential claims regarding anti-dumping duties which we believe have lapsed. RH Segment gross profit for fiscal 2016 was negatively impacted by $7.7 million related to the estimated cumulative impact of coupons redeemed in connection with a legal claim alleging that the Company violated California’s Song-Beverly Credit Card Act of 1971 by requesting and recording ZIP codes from customers paying with credit cards. The coupons expired in March 2016. RH Segment gross profit for fiscal 2016 was also negatively impacted by $4.0 million related to the reduction of revenue and costs associated with product recalls and $2.2 million due to inventory impairments related to RH Contemporary Art and RH Kitchen. RH Segment gross profit for fiscal 2017 was negatively impacted by $7.5 million related to the reduction of revenue, incremental costs and inventory charges associated with product recalls and $1.7 million related to costs associated with distribution center closures.

Waterworks gross profit for fiscal 2017 and fiscal 2016 was negatively impacted by $2.5 million and $6.8 million, respectively, of amortization related to the inventory fair value adjustment recorded in connection with the acquisition.

Excluding the release of the anti-dumping duty reserve, impact of the coupons redeemed in connection with the legal claim, product recall costs, RH Contemporary Art and RH Kitchen impairments, costs associated with the distribution center closures and amortization related to the inventory fair value adjustment mentioned above, consolidated gross margin would have increased 2.3% to 35.1% of net revenues in fiscal 2017 from 32.8% of net revenues in fiscal 2016.

RH Segment gross profit

RH Segment gross profit increased $145.8 million, or 22.2%, to $802.0 million in fiscal 2017 from $656.2 million in fiscal 2016. As a percentage of net revenues, RH Segment gross margin increased 2.7% to 34.6% of net revenues in fiscal 2017 from 31.9% of net revenues in fiscal 2016. Excluding the release of the anti-dumping duty reserve, impact of the coupons redeemed in connection with the legal claim, product recall costs, RH Contemporary Art and RH Kitchen impairments, and costs associated with distribution center closures mentioned above, RH Segment gross margin would have increased 2.3% to 34.8% of net revenues in fiscal 2017 from 32.5% of net revenues in fiscal 2016.

Merchandise margins were impacted by our SKU rationalization efforts that had a reduced impact on our margins this year compared to last year, partially offset by higher outlet and warehouse sales driven by increased promotions and higher discounts. In addition, gross margin increased due to leverage in our fiscal 2017 shipping expense, as well as incremental shipping charges incurred during fiscal 2016 related to RH Modern production delays and our investment to elevate the customer experience. We also experienced cost leverage due to savings related to our newly introduced reverse logistics strategy. During fiscal 2017, we experienced leverage in our fixed distribution occupancy costs, partially offset by increased outlet occupancy costs.

Waterworks gross profit

Waterworks gross profit increased $23.5 million, or 99.5%, to $47.1 million in fiscal 2017 from $23.6 million in fiscal 2016. The increase in Waterworks gross profit is primarily due to fiscal 2017 representing fifty-three weeks of results, whereas fiscal 2016 included thirty-five weeks of results as Waterworks was acquired on May 27, 2016. As a percentage of net revenues, Waterworks gross margin increased 7.5% to 39.0% of net revenues in fiscal 2017 from 31.5% of net revenues in fiscal 2016. Excluding the impact of the amortization related to the inventory fair value adjustment mentioned above, Waterworks gross margin would have increased 0.3% to 41.0% of net revenues in fiscal 2017 from 40.7% of net revenues in fiscal 2016. The increase in gross margin is primarily due to a decline in product related reserves year over year, partially offset by deleverage in occupancy costs.

Selling, general and administrative expenses

Consolidated selling, general and administrative expenses increased $91.0 million, or 14.5%, to $717.8 million in fiscal 2017 compared to $626.8 million in fiscal 2016.

RH Segment selling, general and administrative expenses

RH Segment selling, general and administrative expenses increased $75.8 million, or 12.8%, to $666.1 million in fiscal 2017 compared $590.3 million in fiscal 2016. Employment and employment related costs increased $47.5 million in fiscal 2017 compared to fiscal 2016, which includes the fully vested option grant made to Mr. Friedman and severance expense associated with the distribution center closures and reorganization discussed below. Excluding the fully vested option grant and severance expense, the remaining increase in employment costs is primarily related to incentive compensation due to the Company achieving certain internal performance targets in fiscal 2017. In addition, advertising and marketing costs increased $26.3 million in fiscal 2017 as compared to fiscal 2016, primarily due to the timing of our Source Book mailings. In fiscal 2017 we amortized costs related to our 2016 Interiors Source Book which was circulated in the fall of 2016. The 2016 Interiors Source Book mailing was complete in mid-December and therefore resulted in amortized costs in fiscal 2017, whereas fiscal 2016 did not incur similarly timed expenses.

RH Segment selling, general and administrative expenses for fiscal 2017 included $23.9 million related to a fully vested option grant made to Mr. Friedman in May 2017, $4.4 million related to remeasurement of RH Contemporary Art lease loss liability, $4.1 million costs associated with distribution center closures, $0.2 million incremental costs associated with product recalls and a gain of $2.1 million related to the sale of building and land.

RH Segment selling, general and administrative expenses for fiscal 2016 included a $10.6 million impairment associated with RH Contemporary Art, $5.7 million associated with a reorganization, including severance and related taxes, $4.8 million related to the impairment recorded due to the decision to sell an aircraft, $2.8 million related to charges and expenses incurred as a result of the Waterworks transaction, $1.0 million related to the estimated cumulative impact of coupons redeemed in connection with a legal claim alleging that the Company violated California's Song-Beverly Credit Card Act of 1971 by requesting and recording ZIP codes from customers paying with credit cards, and $0.6 million in costs associated with product recalls.

RH Segment selling, general and administrative expenses were 27.4% of net revenues for both fiscal 2017 and fiscal 2016, respectively, excluding the fully vested option grant made to Mr. Friedman in May 2017, costs associated with distribution center closures, impairment and subsequent remeasurement of the lease liability associated with RH Contemporary Art, the product recall costs, the gain related to the sale of building and land, the reorganization costs, the impairment recorded due to the decisions to sell an aircraft, the charges and expenses incurred as a result of the Waterworks transaction, and the impact of coupons redeemed in connection with the legal claim mentioned above. Selling, general and administrative expenses as a percentage of net revenues decreased due to leverage in our employment and corporate occupancy costs, which was offset by an increase in advertising and marketing costs, as well as increased incentive compensation costs.

Waterworks selling, general and administrative expenses

Waterworks selling, general and administrative expenses increased $15.2 million, or 41.8%, to $51.7 million in fiscal 2017 compared $36.5 million in fiscal 2016.

The increase in Waterworks selling, general and administrative expenses is primarily due to fiscal 2017 representing fifty-three weeks of results, whereas fiscal 2016 only includes thirty-five weeks of results as Waterworks was acquired on May 27, 2016. This increase is partially offset by stock-based compensation of $3.7 million related to the fully vested option grants made in connection with our acquisition of Waterworks in fiscal 2016.

Excluding the fully vested option grants made in connection with our acquisition of Waterworks, Waterworks selling, general and administrative expenses would have been 42.8% and 43.8% of net revenues in fiscal 2017 and fiscal 2016, respectively, with such decrease driven by leverage in corporate costs and advertising expenses partially offset by deleverage in employment and employment related costs.

Interest expense—net

Interest expense increased $18.1 million to $62.6 million in fiscal 2017 compared to $44.5 million in fiscal 2016. Interest expense consisted of the following:

	Year Ended	
	February 3, 2018	January 28, 2017
	(in thousands)	
Amortization of convertible senior notes debt discount	$30,457	$28,822
Build-to-suit lease transactions	16,781	13,447
Asset based credit facility	7,042	1,827
Amortization of debt issuance costs and deferred financing fees	4,705	2,525
Term loans	4,526	—
Other interest expense	2,877	3,268
Capitalized interest for capital projects	(3,304)	(2,418)
Interest income	(514)	(2,989)
Total interest expense—net	$62,570	$44,482

Goodwill impairment

We incurred a $33.7 million goodwill impairment in fiscal 2017 for our Waterworks reporting unit. Refer to “Impairment” within Note 3—Significant Accounting Policies in our consolidated financial statements for details regarding the goodwill impairment.

Loss on extinguishment of debt

We incurred a $4.9 million loss on extinguishment of debt in fiscal 2017 due to the repayment in full of the second lien term loan in October 2017, which includes a prepayment penalty of $3.0 million and acceleration of amortization of debt issuance costs of $1.9 million.

Income tax expense

Income tax expense was $28.0 million in fiscal 2017 compared to $3.2 million in fiscal 2016. Our effective tax rate was 92.8% in fiscal 2017 compared to 36.9% in fiscal 2016. The effective tax rate in fiscal 2017 was significantly impacted by non-deductible stock-based compensation related to the May 2017 grant to Mr. Friedman of an option to purchase 1,000,000 shares of the Company's common stock. Refer to Note 16—Stock-Based Compensation in our consolidated financial statements for a description of the option grant to Mr. Friedman. In addition, the effective tax rate in fiscal 2017 was impacted by tax reform and the Waterworks reporting unit goodwill impairment. The effective tax rate was favorably impacted by net excess tax benefits from stock-based compensation of $7.0 million resulting from the Company's adoption of ASU 2016-09 in the first quarter of fiscal 2017.

The United States enacted the Tax Cuts and Jobs Act (the "Tax Act") on December 22, 2017. The new legislation contains several key tax provisions that affect us and, as required, we have included reasonable estimates of the income tax effects of the changes in tax law and tax rate in our fiscal 2017 financial results. Since the Tax Act was passed in the fourth quarter of fiscal 2017, we consider the accounting for the transition tax, deferred tax re-measurements, and other items to be provisional as the charge may be adjusted due to changes in interpretations and assumptions we have made, guidance that may be issued, and actions we may take as a result of the tax legislation. We expect to finalize our estimates within the one-year measurement period allowed by the SEC.

Our provision for income taxes in fiscal 2017 included $7.0 million of income tax expense as a result of the Tax Act, including $6.0 million for the provisional re-measurement of our net deferred tax assets for the reduction in the U.S. corporate income tax rate from 35% to 21% and a $1.0 million charge for our provisional estimate of the transition tax.

Fiscal 2016 Compared to Fiscal 2015

Prior to the Waterworks acquisition on May 27, 2016, we had one reportable segment. As we acquired the Waterworks business on May 27, 2016, reportable segment information presented below for Waterworks includes results for thirty-five weeks during fiscal 2016. The RH Segment includes results for fifty-two weeks during fiscal 2016.

	Year Ended January 28, 2017		
	RH Segment	Waterworks (1)	Total
	(in thousands)		
Net revenues	$2,060,044	$ 74,827	$2,134,871
Cost of goods sold	1,403,853	51,231	1,455,084
Gross profit	656,191	23,596	679,787
Selling, general and administrative expenses	590,288	36,463	626,751
Income (loss) from operations	$65,903	$ (12,867)	$53,036

(1) Waterworks results for fiscal 2016 include non-cash amortization of $6.8 million related to the inventory fair value adjustment recorded in connection with our acquisition of Waterworks, as well as a non-cash compensation charge of $3.7 million related to the fully vested option grants made in connection with our acquisition of Waterworks.

Net revenues

Consolidated net revenues increased $25.9 million, or 1.2%, to $2,134.9 million in fiscal 2016 compared to $2,109.0 million in fiscal 2015. We had 85 and 69 retail stores open at January 28, 2017 and January 30, 2016, respectively. Stores net revenues increased $95.3 million, or 8.8%, to $1,178.9 million in fiscal 2016 compared to $1,083.6 million in fiscal 2015. Direct net revenues decreased $69.4 million, or 6.8%, to $956.0 million in fiscal 2016 compared to $1,025.4 million in fiscal 2015. While we recorded an increase in our net revenues in fiscal 2016 as compared to fiscal 2015, we experienced a decline in our comparable brand revenue of 7% for fiscal 2016 which was primarily driven by the decline in direct net revenues resulting from the change in timing of the Source Book circulation.

On May 27, 2016, we acquired a controlling interest in Waterworks. As a result of this acquisition, we acquired 15 Waterworks Showrooms and included such additional retail stores in our weighted-average leased selling square footage for fiscal 2016. Waterworks net revenues were $74.8 million, which represented 3.5% of our net revenues for fiscal 2016.

RH Segment net revenues decreased $49.0 million, or 2.3%, to $2,060.0 million in fiscal 2016 compared to $2,109.0 million in fiscal 2015. Factors that adversely affected net revenues during fiscal 2016 included our decision to move the mailing of our annual Source Books to the fall, whereas our Source Books were circulated in the spring in the prior year. The Fall 2016 mailing was not complete until mid-December and therefore was not as meaningful a contributor to net revenues in fiscal 2016 as in fiscal 2015 where sales benefited from a longer build of the Spring 2015 Source Books. The change in the timing of the Source Book circulation also contributed to the decline in direct net revenues.

In addition, our transition from a promotional model to the RH Members Program had some negative impact on revenue year over year in the year we launched the RH Members Program as customers transitioned from our previous promotional sales model to purchasing our products under the RH Members Program. As a result of the launch of the RH Members Program, we experienced an increase in the time period of our sales cycles as customers were not under the short-term pressure to accelerate purchases in time to qualify for a promotional event. In addition, membership fee revenue is recognized ratably over a one year period from the date a membership is purchased, while the merchandise discount associated with the first product purchases of a new membership is recognized up front at the time of sale.

Net revenues were also reduced by an estimated $16 million due to customer accommodations related to RH Modern production delays and our investment to elevate the customer experience and $3.4 million due to product recalls in fiscal 2016.

A number of positive factors contributed to our fiscal 2016 net revenues, including the increase in our store count and weighted average leased selling square footage which includes our non-comparable Design Galleries and our standalone RH Modern Gallery that opened in the fall of 2015. Other factors that contributed to our fiscal 2016 net revenues include the launch of RH Modern and RH TEEN in the second half of 2015, the introduction of new products and new product categories and the expansion of existing product assortments.

Concurrently with the above, we have experienced unfavorable macroeconomic factors during fiscal 2016 including weakness in consumer spending at the luxury end of the retail market. These factors may continue to negatively impact net revenues in future quarters.

Gross profit

Consolidated gross profit decreased $72.9 million, or 9.7%, to $679.8 million in fiscal 2016 from $752.7 million in fiscal 2015. As a percentage of net revenues, gross margin decreased 3.9% to 31.8% of net revenues in fiscal 2016 from 35.7% of net revenues in fiscal 2015.

Waterworks gross profit was $23.6 million for fiscal 2016, which was negatively impacted by $6.8 million of amortization related to the inventory fair value adjustment recorded in connection with the acquisition.

RH Segment gross profit decreased $96.5 million, or 12.8%, to $656.2 million in fiscal 2016 from $752.7 million in fiscal 2015. As a percentage of net revenues, gross margin decreased 3.8% to 31.9% of net revenues in fiscal 2016 from 35.7% of net revenues in fiscal 2015.

RH Segment gross profit for fiscal 2016 was negatively impacted by $4.0 million related to the reduction of revenue and costs associated with product recalls and $2.2 million due to inventory impairments related to RH Contemporary Art and RH Kitchen.

RH Segment gross profit for fiscal 2016 and fiscal 2015 were also negatively impacted by $7.7 million and $17.2 million, respectively, related to the estimated cumulative impact of coupons redeemed in connection with a legal claim alleging that the Company violated California's Song-Beverly Credit Card Act of 1971 by requesting and recording ZIP codes from customers paying with credit cards. The coupons expired in March 2016.

51

Excluding the inventory impairments, product recalls and impact of the coupons redeemed in connection with the legal claim mentioned above, RH Segment gross margin would have decreased 4.0% to 32.5% of net revenues in fiscal 2016 from 36.5% of net revenues in fiscal 2015. This decrease is primarily due to a decline in our product margins related to the higher discount rate offered through the RH Members Program versus our promotional cadence in fiscal 2015. We experienced deleverage in our gross margins related to rationalizing our SKU count and reducing inventories through markdowns and our outlet channel. We also had lower gross margins and higher shipping costs due to customer accommodations and related expenses as a result of our initiative to elevate the customer experience, including production delays related to RH Modern. In addition, we also experienced higher shipping costs, including transportation related to floorset changes. Further, we experienced deleverage in occupancy costs due to the addition of a new distribution center in the third fiscal quarter of 2015 for which the rent expense was primarily recorded in interest expense through January 2016 based on requirements under Accounting Standards Codification (“ASC”) 840—Leases.

Selling, general and administrative expenses

Consolidated selling, general and administrative expenses increased $59.7 million, or 10.5%, to $626.8 million in fiscal 2016 compared to $567.1 million in fiscal 2015, $36.5 million of which was directly related to our acquisition of Waterworks.

RH Segment selling, general and administrative expenses increased $23.2 million, or 4.1%, to $590.3 million in fiscal 2016 compared to $567.1 million in fiscal 2015. The increase was primarily related to an increase in employment and employment related costs of $14.0 million due to Company growth, an increase in corporate occupancy costs of $11.5 million primarily due to increased depreciation associated with upgrades in our technology infrastructure, and an increase in professional fees and other corporate costs. In addition, during fiscal 2016 we incurred a $10.6 million impairment associated with RH Contemporary Art and RH Kitchen, $5.7 million associated with a reorganization, including severance costs and related taxes, $4.8 million related to the impairment recorded due to the decision to sell an aircraft, $2.8 million related to charges and expenses incurred as a result of the Waterworks transaction, $1.0 million related to the estimated cumulative impact of coupons redeemed in connection with the legal claim mentioned above and $0.6 million in costs associated with product recalls. These increases were partially offset by a $1.8 million charge incurred in connection with the legal claim included in selling, general and administrative expenses for fiscal 2015.

These increases were partially offset by a decrease in advertising and marketing costs of $30.1 million related to our decision to move the mailing of our annual Source Books from the spring to the fall.

Excluding the impairment associated with RH Contemporary Art and RH Kitchen, reorganization charges, including severance costs and related taxes, impairment recorded due to the decision to sell an aircraft, charges and expenses incurred as a result of the Waterworks transaction, the estimated cumulative impact of coupons redeemed in connection with a legal claim and the product recall costs, RH Segment selling, general and administrative expenses were 27.4% and 26.8% of net revenues in fiscal 2016 and fiscal 2015, respectively. The increase in selling, general and administrative expenses as a percentage of net revenues was primarily driven by increased employment and employment related costs, an increase in corporate occupancy costs primarily related to depreciation associated with upgrades in our technology infrastructure and an increase in professional fees and other corporate costs. These increases were partially offset by decreases in advertising and marketing costs.

Interest expense—net

Interest expense increased $8.8 million to $44.5 million in fiscal 2016 compared to $35.7 million in fiscal 2015. Interest expense consisted of the following:

	Year Ended	
	January 28, 2017	January 30, 2016
	(in thousands)	
Amortization of convertible senior notes debt discount	$28,822	$22,114
Build-to-suit lease transactions	13,447	10,766
Amortization of debt issuance costs and deferred financing fees	2,525	2,091
Other interest expense	5,095	4,961
Capitalized interest for capital projects	(2,418)	(2,311)
Interest income	(2,989)	(1,944)
Total interest expense—net	$44,482	$35,677

Income tax expense

Income tax expense was $3.2 million in fiscal 2016 compared to $58.8 million in fiscal 2015. Our effective tax rate was 36.9% in fiscal 2016 compared to 39.2% in fiscal 2015. Refer to Note 13—Income Taxes in our consolidated financial statements.

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 3, 2018. This quarterly information has been prepared on the same basis as our annual audited financial statements and includes all adjustments that we consider necessary to fairly state the financial information for the fiscal quarters presented. The quarterly data should be read in conjunction with our consolidated financial statements and the related notes included in Item 8—Financial Statements and Supplementary Data.

Our quarterly results have historically varied depending upon a variety of factors, including our product offerings, promotional events, store openings, shifts in the timing of holidays and the timing of Source Book 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 and results of a period shorter than a full year may not be indicative of results expected for the entire year.

	Fiscal 2016				Fiscal 2017			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
	(dollars in thousands)							
Net revenues	$455,456	$543,381	$549,328	$586,706	$562,080	$615,326	$592,473	$670,295
Cost of goods sold	327,981	363,542	373,509	390,052	391,824	409,513	378,148	411,622
Gross profit	127,475	179,839	175,819	196,654	170,256	205,813	214,325	258,673
Selling, general, and administrative expenses	138,950	157,824	160,433	169,544	163,360	193,690	171,163	189,553
Income (loss) from operations	(11,475)	22,015	15,386	27,110	6,896	12,123	43,162	69,120
Other expenses								
Interest expense—net	10,528	10,909	11,091	11,954	12,179	14,402	18,915	17,074
Goodwill impairment	—	—	—	—	—	—	—	33,700
Loss on extinguishment of debt	—	—	—	—	—	—	4,880	—
Total other expenses	10,528	10,909	11,091	11,954	12,179	14,402	23,795	50,774
Income (loss) before income	(22,003)	11,106	4,295	15,156	(5,283)	(2,279)	19,367	18,346

taxes								
Income tax expense (benefit)	(8,533)	4,188	1,778	5,720	(1,913)	5,583	6,216	18,085
Net income (loss)	$(13,470)	$6,918	$2,517	$9,436	$(3,370)	$(7,862)	$13,151	$261
Adjusted net income (loss) (1)	$(2,066)	$17,908	$8,019	$27,928	$1,794	$19,701	$24,424	$43,281
Comparable brand revenue growth (2)	4 %	(3)%	(6)%	(18)%	9 %	7 %	6 %	2 %

(1) 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 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.

53

	Fiscal 2016				Fiscal 2017			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
	(in thousands)							
Net income (loss)	$(13,470)	$6,918	$2,517	$9,436	$(3,370)	$(7,862)	$13,151	$261
Adjustments pre-tax:								
Goodwill impairment [(a)]	—	—	—	—	—	—	—	33,700
Amortization of debt discount [(b)]	6,442	6,479	6,629	6,854	6,715	6,790	6,879	7,542
Asset impairments and lease losses [(c)]	—	—	—	12,743	—	—	—	4,417
Distribution center closures [(d)]	—	—	—	—	—	—	1,862	3,933
Impact of inventory step-up [(e)]	—	3,401	1,786	1,648	1,380	480	248	419
Anti-dumping exposure [(f)]	—	—	—	—	—	—	—	(2,202)
Recall accrual [(g)]	—	—	—	4,615	—	4,733	3,552	(578)
Loss on extinguishment of debt [(h)]	—	—	—	—	—	—	4,880	—
Gain on sale of building and land [(i)]	—	—	—	—	—	(1,300)	(819)	—
Non-cash compensation [(j)]	—	3,672	—	—	—	23,872	—	—
Aircraft impairment [(k)]	—	—	—	4,767	—	—	—	—
Reorganization related costs [(l)]	1,415	3,309	974	—	—	—	—	—
Acquisition related costs [(m)]	2,069	778	—	—	—	—	—	—
Legal claim [(n)]	8,701	—	—	—	—	—	—	—
Subtotal adjusted items	18,627	17,639	9,389	30,627	8,095	34,575	16,602	47,231
Impact of income tax items [(o)]	(7,223)	(6,649)	(3,887)	(12,135)	(2,931)	(7,012)	(5,329)	(4,211)
Adjusted net income (loss)	$(2,066)	$17,908	$8,019	$27,928	$1,794	$19,701	$24,424	$43,281

(a) Represents goodwill impairment related to the Waterworks reporting unit. Refer to "Impairment" within Note 3—Significant Accounting Policies in our consolidated financial statements.

(b) Under GAAP, certain convertible debt instruments that may be settled in cash on conversion are required to be separately accounted for as liability and equity components of the instrument in a manner that reflects the issuer's non-convertible debt borrowing rate. Accordingly, in accounting for GAAP purposes for the $350 million aggregate principal amount of convertible senior notes that were issued in June 2014 (the "2019 Notes") and for the $300 million aggregate principal amount of convertible senior notes that were issued in June and July 2015 (the "2020 Notes"), we separated the 2019 Notes and 2020 Notes into liability (debt) and equity (conversion option) components and we are amortizing as debt discount an amount equal to the fair value of the equity components as interest expense on the 2019 Notes and 2020 Notes over their respective terms. The equity components represent the difference between the proceeds from the issuance of the 2019 Notes and 2020 Notes and the fair value of the liability components of the 2019 Notes and 2020 Notes, respectively. Amounts are presented net of interest capitalized for capital projects of $0.6 million, $0.7 million, $0.6 million and $0.5 million during the first, second, third and fourth quarters of fiscal 2016, respectively. Amounts are presented net of interest capitalized for capital projects of $0.7 million, $0.8 million, $0.8 million and $0.2 million during the first, second, third and fourth quarters of fiscal 2017, respectively.

(c) The adjustment for the fourth quarter of fiscal 2016 represents the impairments associated with RH Contemporary Art and RH Kitchen. The impairment related to RH Kitchen is a result of the alignment with the Waterworks

Kitchen product line strategy. This resulted in cost of goods sold of $1.0 million which represented impairment of inventory in the fourth quarter of fiscal 2016. RH Contemporary Art was integrated into the broader RH platform and no longer operates as a separate division. In the fourth quarter of fiscal 2016, this resulted in cost of goods sold of $1.1 million which represented impairment of inventory, and selling, general and administrative expenses of $10.6 million which represents lease related charges, property and equipment disposals, and donations. In the fourth quarter of fiscal 2017, an additional lease related charge of $4.4 million was recorded due to the remeasurement of the liability for lease losses for RH Contemporary Art resulting from an update to both the timing and the amount of future estimated lease related cash inflows.

(d) The adjustments represent property and equipment disposals, lease related charges, inventory transfer costs, severance expense and other costs associated with two distribution center closures, which were completed in November 2017 and January 2018.

(e) The adjustments represent the non-cash amortization of the inventory fair value adjustment recorded in connection with our acquisition of Waterworks.

(f) Represents the release of the remaining reserve for potential claims regarding anti-dumping duties which we believe have lapsed. The reserve related to potential tariff obligations of one of our foreign suppliers following the U.S. Department of Commerce’s review on the anti-dumping duty order on wooden bedroom furniture from China for the period from January 1, 2011 through December 31, 2011.

(g) The adjustments represent the reduction of net revenues and costs associated with product recalls.

(h) The adjustment represents the loss on extinguishment of debt related to the second lien term loan which was repaid in full in October 2017.
(i) The adjustment represents the gain on the sale of building and land of one of our owned retail Galleries. As we entered into a short-term lease agreement to lease the property subsequent to the sale, the total gain associated with the sale of this property was amortized over a five month period.
(j) The adjustment for the second quarter of fiscal 2016 represents a non-cash compensation charge related to fully vested option grants made in connection with our acquisition of Waterworks. The adjustment for the second quarter of fiscal 2017 represents a non-cash compensation charge related to a fully vested option grant made to Mr. Friedman in May 2017.
(k) The adjustment represents the impairment recorded upon reclassification of aircraft as asset held for sale.
(l) The adjustments represent costs associated with a reorganization, which include severance costs and related taxes, partially offset by a reversal of stock-based compensation expense related to unvested equity awards.
(m) The adjustments represent costs incurred in connection with our acquisition of Waterworks including professional fees.
(n) The adjustment represents the estimated cumulative impact of coupons redeemed in connection with a legal claim alleging that the Company violated California's Song-Beverly Credit Card Act of 1971 by requesting and recording ZIP codes from customers paying with credit cards.
(o) The adjustments to calculate income tax expense for the first, second and third quarters of fiscal 2016 represent the tax effect of the adjusted items based on our effective tax rates of 38.8%, 37.7% and 41.4%, respectively. The fourth quarter of fiscal 2016 assumes a normalized tax rate of 39%. The adjustments to calculate income tax expense for the first and third quarters of fiscal 2017 represent the tax effect of the adjusted items based on our effective tax rates of 36.2% and 32.1%, respectively. The adjustment for the second quarter of fiscal 2017 assumes a normalized tax rate of 39%. The adjustment for the fourth quarter of fiscal 2017 is based on an adjusted tax rate of 34.0% which excludes the impact of tax reform, including the $6.0 million revaluation of the net deferred tax assets and $1.0 million transitional tax, as well as the $5.9 million tax impact associated with the Waterworks reporting unit goodwill impairment.

(2) Comparable brand revenue growth includes direct net revenues and retail comparable store sales, including RH Baby & Child, RH Modern Galleries and Hospitality. Comparable brand revenue growth excludes retail non-comparable store sales, closed store sales and outlet store net revenues. Comparable store sales have been calculated based upon retail stores, excluding outlet 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. Membership revenue was included in comparable brand revenue growth beginning April 2017, which is the first full month following the one-year anniversary of the program launch. Waterworks revenue was included in comparable brand revenue growth beginning June 2017, which is the first full month following the one-year anniversary of the acquisition. The impact on net revenues related to the product recalls in the second, third and fourth quarters of fiscal 2017 and the fourth quarter of fiscal 2016 has been excluded from comparable brand revenue growth. Because fiscal 2017 was a 53-week year, comparable brand revenue growth percentage for the fourth quarter of fiscal 2017 excludes the extra week of revenue.

Liquidity and Capital Resources

General

The primary cash needs of our business have historically been for merchandise inventories, payroll, Source Books, store rent, capital expenditures associated with opening new stores and updating existing stores, as well as the development of our infrastructure and information technology. We seek out and evaluate opportunities for effectively managing and deploying capital in ways that improve working capital and support and enhance our business initiatives and strategies. In fiscal 2017, we completed two share repurchase programs in an aggregate amount of $1 billion. A $300 million share repurchase was completed during the first quarter of fiscal 2017 and a $700 million share repurchase was completed during the second quarter of fiscal 2017 (refer to “Share Repurchase Programs” below). We intend to evaluate our capital allocation from time to time and may engage in future share repurchases in circumstances where buying shares of our common stock represents a good value and provides a favorable return for our shareholders.

We have $650 million in aggregate principal amount of convertible notes outstanding, of which $350 million mature in June 2019 and $300 million mature in June 2020. While we anticipate using free cash flow to repay the convertible notes in cash to minimize dilution, we may need to pursue additional sources of liquidity to repay such convertible notes in cash at their respective maturity dates. There can be no assurance as to the availability of capital to fund such repayments, or that if capital is available through additional debt issuances or refinancing of the convertible notes, that such capital will be available on terms that are favorable to us.

We extended and amended our revolving line of credit in June 2017, which has a total availability of $600.0 million, of which $10.0 million is available to Restoration Hardware Canada, Inc., and includes a $200.0 million accordion feature under which the revolving line of credit may be expanded by agreement of the parties from $600.0 million to up to $800.0 million if and to the extent the lenders revise their credit commitments to encompass a larger facility. In addition, we have an $80.0 million last out, delayed draw term loan ("LILO term loan") facility. The revolving line of credit and LILO term loan facility have a maturity date of June 28, 2022.

In July 2017, Restoration Hardware, Inc. entered into a credit agreement (the "second lien credit agreement") with respect to an initial term loan in an aggregate principal amount equal to $100.0 million with a maturity date of January 7, 2023 (the "second lien term loan"). Refer to Second Lien Credit Agreement below. The proceeds of the second lien term loan were used to support our share repurchase program. We repaid this debt in full in October 2017.

We believe that cash expected to be generated from operations, net cash proceeds from the issuance of the convertible senior notes, borrowing availability under the revolving line of credit, borrowings under our term loan and other financing arrangements will be sufficient to meet working capital requirements, anticipated capital expenditures and other capital needs for the next 12 months.

Our business has relied on cash flows from operations, net cash proceeds from the issuance of the convertible senior notes, as well as borrowings under our credit facilities as our primary sources of liquidity. We have pursued in the past, and may pursue in the future, additional strategies to generate liquidity for our operations, including through the strategic sale of assets, utilization of our credit facilities, and entry into new debt financing arrangements that present attractive terms.

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

In addition, our capital needs may change in the future due to changes in our business or new opportunities that we choose to pursue. We have invested significant capital expenditures in remodeling and opening new Design Galleries, and these capital expenditures have increased in the past and may continue to increase in future periods as we open additional Design Galleries, which may require us to undertake upgrades to historical buildings or construction of new buildings. During fiscal 2017, our investments in capital expenditures totaled $112.5 million and were offset by proceeds from sales of assets of $15.1 million. We made payments of $14.4 million in fiscal 2017 to escrow accounts for future construction of Design Galleries.

We anticipate our gross capital expenditures to be approximately $100 million to $110 million in fiscal 2018, primarily related to our efforts to continue our growth and expansion, including construction of new Design Galleries and infrastructure investments. We anticipate that our fiscal 2018 capital expenditures will be partially offset by proceeds from sales of assets of approximately $25 million.

The majority of the current lease arrangements for our new Design Galleries require the landlord to fund a portion of the construction related costs directly to third parties, rather than through traditional construction allowances and accordingly, we do not expect to receive significant contributions directly from our landlords related to the building of our Design Galleries in fiscal 2018. As we develop new Galleries, as well as potentially other strategic initiatives in the future like our integrated hospitality experience, we may explore other models for our real estate, which could include longer lease terms or further purchases of, or joint ventures or other forms of equity ownership in, real estate interests associated with new sites and buildings. These approaches might require greater capital investment on our part than a traditional store lease with a landlord. We also believe there is an opportunity to transition our real estate strategy from a leasing model to a development model, where we potentially buy and develop our Design Galleries then recoup the investments through a sale-leaseback arrangement resulting in lower capital investment and lower rent. In the event that such capital and other expenditures require us to pursue additional funding sources, we can provide no assurances that we will be successful in securing additional funding on attractive terms or at all.

There can be no assurance that we will have sufficient financial resources, or will be able to arrange financing on favorable terms to the extent necessary to fund all of our initiatives, or that sufficient incremental debt will be available to us in order to fund our cash payments in respect of the repayment of our outstanding convertible senior notes in an aggregate principal amount of $650 million at maturity of such senior convertible notes or our term loan at the maturity dates of such term loan. In addition, agreements governing existing or new debt facilities may restrict our ability to operate our business in the manner we currently expect or to make required payments with respect to existing commitments including the repayment of the principal amount of our convertible senior notes in cash upon maturity of such senior notes. To the extent we need to seek waivers from any provider of debt financing, or we fail to observe the covenants or other requirements of existing or new debt facilities, any such event could have an impact on our other commitments and obligations including triggering cross defaults or other consequences with respect to other indebtedness. Our current level of indebtedness, and any additional indebtedness that we may incur, exposes us to certain risks with regards to interest rate increases and fluctuations. Our ability to make interest payments or to refinance any of our indebtedness to manage such interest rates may be limited or negatively affected by credit market conditions, macroeconomic trends and other risks.

Any weakening of, or other adverse developments in, the U.S. or global credit markets could affect our ability to manage our debt obligations and our ability to access future debt. We cannot assure you that we will be able to raise necessary funds on favorable terms, if at all, or that future financing requirements would not require us to raise money through an equity financing or by other means that could be dilutive to holders of our capital stock. If we fail to raise sufficient additional funds, we may be required to delay or abandon some of our planned future expenditures or aspects of our current operations.

Cash Flow Analysis

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

	Year Ended		
	February 3, 2018	January 28, 2017	January 30, 2016
	(in thousands)		
Provided by operating activities	$555,102	$78,845	$126,704
Provided by (used in) investing activities	64,043	(321,497)	(227,397)
Provided by (used in) financing activities	(688,413)	(2,241)	286,782
Increase (decrease) in cash and cash equivalents	(69,116)	(244,444)	185,781
Cash and cash equivalents at end of period	17,907	87,023	331,467

We have experienced substantial fluctuation in our cash and cash equivalents year over year. Cash and cash equivalents decreased by $69.1 million from fiscal 2016 to fiscal 2017 and decreased by $244.4 million from fiscal 2015 to fiscal 2016.

Net Cash Provided By Operating Activities

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

For fiscal 2017, net cash provided by operating activities was $555.1 million and consisted of net income of $2.2 million, non-cash items of $215.6 million and a decrease in cash used for working capital and other activities of $337.3 million. Working capital and other activities consisted primarily of decreases in inventory of $220.8 million due to our SKU rationalization initiative, outlet inventory optimization efforts and revised DC network strategy, as well as increases in accounts payable and accrued liabilities of $64.5 million related to timing of payments. We also had decreases in prepaid expenses and other current assets of $45.5 million primarily due to amortization of our capitalized catalog costs, reduction in prepaid rent and a reduction of federal and state tax receivables.

For fiscal 2016, net cash provided by operating activities was $78.8 million and consisted of net income of $5.4 million and non-cash items of $150.8 million, partially offset by an increase in cash used for working capital and other activities of $77.4 million. Working capital and other activities consisted primarily of decreases in accounts payable and accrued liabilities of $50.3 million related to timing of payments, increases in prepaid expenses of $36.9 million related to the timing of the distribution of our Interiors Source Book and estimated federal tax payments and decreases in other current liabilities of $23.8 million related to payments for federal and state tax liabilities. This was partially offset by increases in deferred revenue and customer deposits of $24.0 million and an increase in other non-current obligations of $8.7 million primarily due to a deferred contract incentive payment.

For fiscal 2015, net cash provided by operating activities was $126.7 million and consisted of net income of $91.1 million and non-cash items of $78.1 million, partially offset by an increase in cash used for working capital and other activities of $42.5 million. Working capital and other activities consisted primarily of increases in inventory of $166.5 million related to the increase in both existing and new products, as well as to support the opening of our new distribution center in Northern California. This was partially offset by increases in accounts payable and accrued liabilities of $29.2 million, increases in other current liabilities of $39.6 million primarily due to an increase in our federal tax liabilities, increases in deferred revenue and customer deposits of $33.2 million and increases in deferred rent and lease incentives of $13.6 million primarily due to the profit participation arrangements for our distribution center facilities.

Net Cash Provided By (Used In) Investing Activities

Investing activities consist primarily of investments in capital expenditures related to new Design Galleries, the acquisition of buildings and land, investments in supply chain and systems infrastructure, construction related deposits, acquisition of businesses, as well as activities associated with investing in available-for-sale securities.

For fiscal 2017, net cash provided by investing activities was $64.0 million primarily as a result of sales and maturities of investments in available-for-sale securities of $145.0 million and $46.9 million, respectively, the proceeds of which were used to fund the share repurchases made under the $300 Million Repurchase Program. In addition, we had net proceeds from the sale of building and land and the sale of an aircraft of $10.2 million and $4.9 million, respectively. These increases to cash were partially offset by investments in new Galleries, information technology and systems infrastructure, and supply chain investments of $112.5 million, purchases of investments in available-for-sale securities of $16.1 million and payments of $14.4 million to escrow accounts for future construction of Design Galleries.

For fiscal 2016, net cash used in investing activities was $321.5 million primarily due to $157.6 million of investments in new Galleries, information technology and systems infrastructure, supply chain, and other corporate assets, as well as our acquisition of Waterworks, net of cash acquired, of $116.1 million. In addition, we made payments of $23.4 million to escrow accounts for future construction of Design Galleries and investments in available-for-sale securities of $248.5 million, partially offset by maturities and sales of such investments of $187.3 million and $37.1 million, respectively.

For fiscal 2015, net cash used in investing activities was $227.4 million and consisted of investments of $133.5 million related to new Galleries, supply chain, renovations to our corporate headquarters, information technology and systems infrastructure. During fiscal 2015, we made payments of $20.0 million to escrow accounts for future construction of Design Galleries. In addition, we made investments in available-for-sale securities of $217.4 million, partially offset by maturities of such investments of $143.8 million.

Net Cash Provided By (Used In) Financing Activities

Financing activities consist primarily of borrowings related to the convertible senior notes offerings, credit facilities, as well as share repurchases and other equity related transactions.

For fiscal 2017, net cash used in financing activities was $688.4 million primarily due to $1.0 billion of share repurchases made under the $300 Million Repurchase Program and $700 Million Repurchase Program. Cash funding for the share repurchase programs was provided by available cash balances, net borrowings under the asset based credit facility of $200.0 million, as well as borrowings under the term loans of $180.0 million, borrowings under loans secured by certain equipment of $20.0 million and borrowings under a promissory note secured by our aircraft of $14.0 million. Proceeds from exercise of employee stock options were $24.9 million. The cash provided by these financing activities was partially offset by repayment of the second lien term loan of $100.0 million, $10.2 million of payments on build-to-suit transactions, debt issuance costs of $8.3 million and $5.8 million cash paid for employee taxes related to net settlement of equity awards.

For fiscal 2016, net cash used in financing activities was $2.2 million primarily due to tax shortfalls from the exercise of stock options of $3.3 million and cash paid for employee taxes related to net settlement of equity awards of $1.6 million. The cash used in these financing activities was partially offset by net proceeds from the exercise of stock options of $3.3 million.

For fiscal 2015, net cash provided by financing activities was $286.8 million primarily due to the $300 million convertible senior notes issued in June 2015, which provided net proceeds of $256.0 million after taking into consideration the convertible note hedge and warrant transactions, as well as discounts upon original issuance and offering costs. Net proceeds and excess tax benefits from the exercise of stock options provided $25.6 million and $10.4 million, respectively. The cash provided by these financing activities was partially offset by cash paid for employee taxes related to net settlement of equity awards of $5.0 million.

Non-Cash Transactions

Non-cash transactions consist of non-cash additions of property and equipment and the issuance of notes payable related to share repurchases from former employees.

Build-to-Suit Lease Transactions

The non-cash additions of property and equipment due to build-to-suit lease transactions are the result of the accounting requirements of Accounting Standards Codification (“ASC”) 840—Leases (“ASC 840”) for those construction projects for which we are the “deemed owner” of the construction project given the extent to which we are involved in constructing the leased asset. If we are the “deemed owner” for accounting purposes, upon commencement of the construction project, we are required to capitalize contributions by the landlord toward construction as property and equipment on our consolidated balance sheets. The contributions by the landlord toward construction, including the building, existing site improvements at construction commencement and any amounts paid by the landlord to those responsible for construction, are included as property and equipment additions due to build-to-suit lease transactions within the non-cash section of our consolidated statements of cash flows.

Over the lease term, these non-cash additions to property and equipment due to build-to-suit lease transactions do not impact our cash outflows, nor do they impact net income within our consolidated statements of income.

Convertible Senior Notes

0.00% Convertible Senior Notes due 2020

In June 2015, we issued in a private offering $250 million principal amount of 0.00% convertible senior notes due 2020 and, in July 2015, we issued an additional $50 million principal amount pursuant to the exercise of the overallotment option granted to the initial purchasers as part of our June 2015 offering (collectively, the “2020 Notes”). The 2020 Notes are governed by the terms of an indenture between us and U.S. Bank National Association, as the Trustee. The 2020 Notes will mature on July 15, 2020, unless earlier purchased by us or converted. The 2020 Notes will not bear interest, except that the 2020 Notes will be subject to “special interest” in certain limited circumstances in the event of our failure to perform certain of our obligations under the indenture governing the 2020 Notes. The 2020 Notes are unsecured obligations and do not contain any financial covenants or restrictions on the payments of dividends, the incurrence of indebtedness or the issuance or repurchase of securities by us or any of our subsidiaries. Certain events are also considered “events of default” under the 2020 Notes, which may result in the acceleration of the maturity of the 2020 Notes, as described in the indenture governing the 2020 Notes. The 2020 Notes are guaranteed by our primary operating subsidiary, Restoration Hardware, Inc., as Guarantor. The guarantee is the unsecured obligation of the Guarantor and is subordinated to the Guarantor’s obligations from time to time with respect to its credit agreement and ranks equal in right of payment with respect to Guarantor’s other obligations.

The initial conversion rate applicable to the 2020 Notes is 8.4656 shares of common stock per $1,000 principal amount of 2020 Notes, which is equivalent to an initial conversion price of approximately $118.13 per share. The conversion rate will be subject to adjustment upon the occurrence of certain specified events, but will not be adjusted for any accrued and unpaid special interest. In addition, upon the occurrence of a “make-whole fundamental change” as defined in the indenture, we will, in certain circumstances, increase the conversion rate by a number of additional shares for a holder that elects to convert its 2020 Notes in connection with such make-whole fundamental change.

Prior to March 15, 2020, the 2020 Notes will be convertible only under the following circumstances: (1) during any calendar quarter commencing after September 30, 2015, if, for at least 20 trading days (whether or not consecutive) during the 30 consecutive trading day period ending on the last trading day of the immediately preceding fiscal quarter, the last reported sale price of our common stock on such trading day is greater than or equal to 130% of the applicable conversion price on such trading day; (2) during the five consecutive business day period after any ten consecutive trading day period in which, for each day of that period, the trading price per $1,000 principal amount of 2020 Notes for such trading day was less than 98% of the product of the last reported sale price of our common stock and the applicable conversion rate on such trading day; or (3) upon the occurrence of specified corporate transactions. February 3, 2018, none of these conditions have occurred and, as a result, the 2020 Notes are not convertible as of February 3, 2018. On and after March 15, 2020, until the close of business on the second scheduled trading day immediately preceding the maturity date, holders may convert all or a portion of their 2020 Notes at any time, regardless of the foregoing circumstances. Upon conversion, the 2020 Notes will be settled, at our election, in cash, shares of our common stock, or a combination of cash and shares of our common stock.

We may not redeem the 2020 Notes; however, upon the occurrence of a fundamental change (as defined in the indenture governing the notes), holders may require us to purchase all or a portion of their 2020 Notes for cash at a price equal to 100% of the principal amount of the 2020 Notes to be purchased plus any accrued and unpaid special interest to, but excluding, the fundamental change purchase date.

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

In accounting for the debt issuance costs related to the issuance of the 2020 Notes, we allocated the total amount incurred to the liability and equity components based on their relative values. Debt issuance costs attributable to the liability component are amortized to interest expense using the effective interest method over the expected life of the 2020 Notes, and debt issuance costs attributable to the equity component are netted with the equity component in stockholders' equity (deficit).

Debt issuance costs related to the 2020 Notes were comprised of discounts upon original issuance of $3.8 million and third party offering costs of $2.3 million. Discounts and third party offering costs attributable to the liability component were recorded as a contra-liability and are presented net against the convertible senior notes due 2020 balance on the consolidated balance sheets.

2020 Notes—Convertible Bond Hedge and Warrant Transactions

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

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

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

0.00% Convertible Senior Notes due 2019

In June 2014, we issued $350 million aggregate principal amount of 0.00% convertible senior notes due 2019 (the "2019 Notes") in a private offering. The 2019 Notes are governed by the terms of an indenture between us and U.S. Bank National Association, as the Trustee. The 2019 Notes will mature on June 15, 2019, unless earlier purchased by us or converted. The 2019 Notes will not bear interest, except that the 2019 Notes will be subject to "special interest" in certain limited circumstances in the event of our failure to perform certain of our obligations under the indenture governing the 2019 Notes. The 2019 Notes are unsecured obligations and do not contain any financial covenants or restrictions on the payments of dividends, the incurrence of indebtedness or the issuance or repurchase of securities by us or any of our subsidiaries. Certain events are also considered "events of default" under the 2019 Notes, which may result in the acceleration of the maturity of the 2019 Notes, as described in the indenture governing the 2019 Notes.

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

Prior to March 15, 2019, the 2019 Notes will be convertible only under the following circumstances: (1) during any calendar quarter commencing after September 30, 2014, if, for at least 20 trading days (whether or not consecutive) during the 30 consecutive trading day period ending on the last trading day of the immediately preceding fiscal quarter, the last reported sale price of our common stock on such trading day is greater than or equal to 130% of the applicable conversion price on such trading day; (2) during the five consecutive business day period after any ten consecutive trading day period in which, for each day of that period, the trading price per $1,000 principal amount of 2019 Notes for such trading day was less than 98% of the product of the last reported sale price of our common stock and the applicable conversion rate on such trading day; or (3) upon the occurrence of specified corporate transactions. As of February 3, 2018, none of these conditions have occurred and, as a result, the 2019 Notes are not convertible as of February 3, 2018. On and after March 15, 2019, until the close of business on the second scheduled trading day immediately preceding the maturity date, holders may convert all or a portion of their 2019 Notes at any time, regardless of the foregoing circumstances. Upon conversion, the 2019 Notes will be settled, at our election, in cash, shares of our common stock, or a combination of cash and shares of our common stock.

We may not redeem the 2019 Notes; however, upon the occurrence of a fundamental change (as defined in the indenture governing the notes), holders may require us to purchase all or a portion of their 2019 Notes for cash at a price equal to 100% of the principal amount of the 2019 Notes to be purchased plus any accrued and unpaid special interest to, but excluding, the fundamental change purchase date.

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

In accounting for the debt issuance costs related to the issuance of the 2019 Notes, we allocated the total amount incurred to the liability and equity components based on their relative values. Debt issuance costs attributable to the liability component are amortized to interest expense using the effective interest method over the expected life of the 2019 Notes, and debt issuance costs attributable to the equity component are netted with the equity component in stockholders' equity (deficit).

Debt issuance costs related to the 2019 Notes were comprised of discounts and commissions payable to the initial purchasers of $4.4 million and third party offering costs of $1.0 million. Discounts, commissions payable to the initial purchasers and third party offering costs attributable to the liability component were recorded as a contra-liability and are presented net against the convertible senior notes due 2019 balance on the consolidated balance sheets.

2019 Notes—Convertible Bond Hedge and Warrant Transactions

In connection with the offering of the 2019 Notes, we entered into convertible note hedge transactions whereby we have the option to purchase a total of approximately 3.0 million shares of our common stock at a price of approximately $116.09 per share. The total cost of the convertible note hedge transactions was $73.3 million. In addition, we sold warrants whereby the holders of the warrants have the option to purchase a total of approximately 3.0 million shares of our common stock at a price of $171.98 per share. The warrants contain certain adjustment mechanisms whereby the total number of shares to be purchased under such warrants may be increased up to a cap of 6.0 million shares of common stock (which cap may also be subject to adjustment). We received $40.4 million in cash proceeds from the sale of these warrants. Taken together, the purchase of the convertible note hedges and sale of the warrants are intended to offset any actual dilution from the conversion of the 2019 Notes and to effectively increase the overall conversion price from $116.09 per share to $171.98 per share. As these transactions meet certain accounting criteria, the convertible note hedges and warrants are recorded in stockholders' equity (deficit) and are not accounted for as derivatives. The net costs incurred in connection with the convertible note hedge and warrant transactions were recorded as a reduction to additional paid-in capital on the consolidated balance sheets.

We recorded a deferred tax liability of $27.5 million in connection with the debt discount associated with the 2019 Notes and recorded a deferred tax asset of $28.6 million in connection with the convertible note hedge transactions. The deferred tax liability and deferred tax asset are recorded in non-current deferred tax assets on the consolidated balance sheets.

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

Asset Based Credit Facility

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. On June 28, 2017, Restoration Hardware, Inc. entered into an eleventh amended and restated credit agreement among Restoration Hardware, Inc., Restoration Hardware Canada, Inc., various subsidiaries of RH named therein as borrowers or guarantors, the lenders party thereto and Bank of America, N.A. as administrative agent and collateral agent (the “credit agreement”). The credit agreement has a revolving line of credit with availability of up to $600.0 million, of which $10.0 million is available to Restoration Hardware Canada, Inc., and includes a $200.0 million accordion feature under which the revolving line of credit may be expanded by agreement of the parties from $600.0 million to up to $800.0 million if and to the extent the lenders revise their credit commitments to encompass a larger facility. In addition, the credit agreement establishes an $80.0 million LILO term loan facility.

The availability of credit at any given time under the credit agreement is limited by reference to a borrowing base formula based upon numerous factors, including the value of eligible inventory and eligible accounts receivable. As a result of the borrowing base formula, actual borrowing availability under the revolving line of credit could be less than the stated amount of the revolving line of credit (as reduced by the actual borrowings and outstanding letters of credit under the revolving line of credit). All obligations under the credit agreement are secured by substantially all of the assets, including accounts receivable, inventory, intangible assets, property, equipment, goods and fixtures of Restoration Hardware, Inc., Restoration Hardware Canada, Inc., RH US, LLC, Waterworks Operating Co., LLC and Waterworks IP Co., LLC.

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

The credit agreement contains various restrictive covenants, including, among others, limitations on the ability to incur liens, make loans or other investments, incur additional debt, issue additional equity, merge or consolidate with or into another person, sell assets, pay dividends or make other distributions or enter into transactions with affiliates, along with other restrictions and limitations typical to credit agreements of this type and size.

In addition, under our credit agreement, we are required to meet specified financial ratios in order to undertake certain actions, and we may be required to maintain certain levels of excess availability or meet a specified consolidated fixed-charge coverage ratio (“FCCR”). The trigger for the FCCR occurs if the domestic availability under the revolving line of credit is less than the greater of (i) $40.0 million and (ii) 10% of the sum of (a) the lesser of (x) the aggregate revolving commitments under the credit agreement and (y) the aggregate revolving borrowing base, plus (b) the lesser of (x) the then outstanding amount of the LILO term loan or (y) the LILO term loan borrowing base. If the availability under the credit agreement is less than the foregoing amount, then Restoration Hardware, Inc. is required to maintain an FCCR of at least one to one. As of February 3, 2018, Restoration Hardware, Inc. was in compliance with all applicable covenants of the credit agreement.

The credit agreement requires a daily sweep of all cash receipts and collections to prepay the loans under the agreement while (i) an event of default exists or (ii) the availability under the revolving line of credit for extensions of credit is less than the greater of (A) $40.0 million and (B) 10% of the sum of (a) the lesser of (x) the aggregate revolving commitments under the credit agreement and (y) the aggregate revolving borrowing base, plus (b) the lesser of (x) the then outstanding amount of the LILO term loan or (y) the LILO term loan borrowing base.

As of February 3, 2018, Restoration Hardware, Inc. had $200.0 million in outstanding borrowings and $186.4 million of availability under the revolving line of credit, net of $33.8 million in outstanding letters of credit. As of February 3, 2018, Restoration Hardware, Inc. had $80.0 million outstanding borrowings under the LILO term loan facility. As a result of the consolidated FCCR restriction that limits the last 10% of borrowing availability, actual incremental borrowing available to the Company and the other affiliated parties under the revolving line of credit would be approximately $136.4 million, as of February 3, 2018.

Second Lien Credit Agreement

On July 7, 2017, Restoration Hardware, Inc., a wholly-owned subsidiary of RH, entered into the second lien credit agreement, dated as of July 7, 2017, among Restoration Hardware, Inc., as lead borrower, the guarantors party thereto, the lenders party thereto, each of whom are funds and accounts managed or advised by Apollo Capital Management, L.P., and its affiliated investment managers, and Wilmington Trust, National Association as administrative agent and collateral agent with respect to the second lien term loan in an aggregate principal amount equal to $100.0 million with a maturity date of January 7, 2023. The second lien term loan of $100.0 million was repaid in full on October 10, 2017. As a result of the repayment, we incurred a $4.9 million loss on extinguishment of debt, which includes a prepayment penalty of $3.0 million and acceleration of amortization of debt issuance costs of $1.9 million.

Intercreditor Agreement

On July 7, 2017, in connection with the second lien credit agreement, Restoration Hardware, Inc. entered into an intercreditor agreement (the “intercreditor agreement”) with the administrative agent and collateral agent under the credit agreement and the administrative agent and collateral agent under the second lien credit agreement. The intercreditor agreement established various customary inter-lender terms, including, without limitation, with respect to priority of liens, permitted actions by each party, application of proceeds, exercise of remedies in case of default, releases of liens and certain limitations on the amendment of the credit agreement and the second lien credit agreement without the consent of the other party. The intercreditor agreement was terminated upon repayment of the second lien term loan on October 10, 2017.

Share Repurchase Programs

During fiscal 2017, we repurchased approximately 20.2 million shares of our common stock under two separate repurchase programs for an aggregate repurchase amount of approximately $1 billion, which represented 49.5% of the shares outstanding as of the end of fiscal 2016. We generated $433 million in free cash flow in 2017 which supported our share repurchase programs. We believe that these share repurchase programs will continue to be an excellent allocation of capital for the long term benefit of our shareholders. We may undertake other repurchase programs in the future with respect to our securities.

$300 Million Share Repurchase Program

On February 21, 2017, our board of directors authorized a stock repurchase program of up to $300 million (the “$300 Million Repurchase Program”) through open market purchases, privately negotiated transactions or other means, including through Rule 10b18 open market repurchases, Rule 10b5-1 trading plans or through the use of other techniques such as accelerated share repurchases. During the three months ended April 29, 2017, we repurchased approximately 7.8 million shares of our common stock under the $300 Million Repurchase Program at an average price of $38.24 per share, for an aggregate repurchase amount of approximately $300 million. No additional shares will be repurchased in future periods under the $300 Million Repurchase Program.

$700 Million Share Repurchase Program

Following completion of the $300 Million Repurchase Program, our board of directors authorized on May 2, 2017 an additional stock repurchase program of up to $700 million (the “$700 Million Repurchase Program”) through open market purchases, privately negotiated transactions or other means, including through Rule 10b18 open market repurchases, Rule 10b5-1 trading plans or through the use of other techniques such as accelerated share repurchases including through privately-negotiated arrangements in which a portion of the share repurchase program is committed in advance through a financial intermediary and/or in transactions involving hedging or derivatives. During the three months ended July 29, 2017, we repurchased approximately 12.4 million shares of our common stock under the $700 Million Repurchase Program at an average price of $56.60 per share, for an aggregate repurchase amount of approximately $700 million. No additional shares will be repurchased in future periods under the $700 Million Repurchase Program.

Contractual Obligations

As of February 3, 2018, our future contractual cash obligations over the next several periods were as follows:

	Payments Due by Period				
	Total	2018	2019-2020	2021–2022	Thereafter
	(in thousands)				
Convertible senior notes due 2019	$350,000	$—	$350,000	$—	$—
Convertible senior notes due 2020	300,000	—	300,000	—	—
Asset based credit facility (1)	199,970	—	—	199,970	—
Term loan (2)	80,000	—	—	80,000	—
Operating leases (3)	670,291	89,304	143,470	108,943	328,574
Other non-current obligations (4)	787,983	37,080	81,830	88,973	580,100
Capital lease obligations	14,651	1,424	2,840	2,494	7,893
Equipment security notes	18,497	4,633	9,280	4,584	—
Notes payable for share repurchases	19,390	—	893	15,920	2,577
Promissory note	13,183	1,400	2,800	8,983	—
Letters of credit	33,818	33,818	—	—	—
Total	$2,487,783	$167,659	$891,113	$509,867	$919,144

(1) Under the credit agreement, the asset based credit facility and LILO term loan facility both have a maturity date of June 28, 2022.

(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 table above does not include future obligations for renewal options that have not yet been exercised. The future operating lease obligations would change if we were to exercise these options. Amounts above do not include estimated contingent rent due under operating leases. Our obligation for contingent rent as of February 3, 2018 was $2.8 million.

(3) Other non-current obligations include estimated payments for rent associated with build-to-suit lease transactions. These amounts may be reduced in the event we are able to effect a sale-leaseback on any of these locations.

Other Commitments

The Company enters into various cancellable commitments related to the procurement of merchandise inventory. As of February 3, 2018, these merchandise inventory purchase commitments were $339.6 million.

As of February 3, 2018, the liability of $2.9 million for unrecognized tax benefits associated with uncertain tax positions (refer to Note 13—Income Taxes in our consolidated financial statements) has not been included in the contractual obligations table above as we are not able to reasonably estimate when cash payments for these liabilities will occur or the amount by which these liabilities will increase or decrease over time.

As of February 3, 2018, we had a $1.0 million liability for our provisional estimate of the transition tax due to the Tax Act. The liability will be paid over eight years, with the final payment expected to be made in fiscal 2025.

Off Balance Sheet Arrangements

We have no material off balance sheet arrangements as of February 3, 2018.

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 on 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 direct-to-customer and home-delivered sales are recognized when the merchandise is delivered to the customer. Revenues from “cash-and-carry” store sales are recognized at the point of sale in the store. Discounts or other accommodations provided to customers are accounted for as a reduction of sales.

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.

We defer revenue associated with orders that have been shipped by us to our customers but have not yet been received by the customer. As we recognize revenue when the merchandise is received by our customers, it is included as deferred revenue on the consolidated balance sheets while in-transit.

We collect annual membership fees related to the RH Members Program, which is recorded as deferred revenue and is recognized as revenue on a straight-line basis over the membership period, or one year.

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.

We reserve 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.

Our customers may return purchased items for a refund. We provide an allowance for sales returns, net of cost of goods sold, based on historical return rates.

Merchandise Inventories

Our 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 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) 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 obsolescence or shrinkage change 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 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 after they are mailed and the majority of the amortization occurs within the first five to nine months, with the exception of the Holiday Source Books, which are generally fully amortized within a three-month period after they are mailed. 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. Management does not believe that changes in the assumptions used in these estimates would have a significant effect on our 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 statements of income.

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 or whenever events occur or circumstances change that would indicate that the fair value of a reporting unit is less than its carrying amount. Conditions that may indicate impairment include, but are not limited to, a significant adverse change in customer demand or business climate that could affect the value of an asset; general economic conditions, such as increasing Treasury rates or unexpected changes in gross domestic product growth; a change in 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.

We perform our annual goodwill impairment testing in the fourth fiscal quarter. Historically, through our fourth quarter ending January 28, 2017, we applied a two-step impairment test: in step one, the carrying value of the reporting unit is compared with its fair value; in step two, which is applied when the carrying value is more than its fair value, the amount of goodwill impairment, if any, is derived by deducting the fair value of the reporting unit's assets and liabilities from the fair value of its equity, and comparing that amount with the carrying amount of goodwill.

In January 2017, the FASB issued Accounting Standards Update No. 2017-04—Intangibles—Goodwill and Other (Topic 350) ("ASU 2017-04"). ASU 2017-04 amends the guidance to simplify the subsequent measurement of goodwill by removing step two of the goodwill impairment test (the requirement to calculate the implied fair value of goodwill to measure a goodwill impairment charge). Instead, an entity should perform its annual, or interim, goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount. An entity should recognize an impairment charge for the amount by which the carrying amount exceeds the reporting unit's fair value. We early adopted ASU 2017-04 in fiscal 2017 and applied the amended guidance to our annual impairment tests performed in the fourth quarter of fiscal 2017.

We determine fair values using the discounted cash flow approach ("income approach") or the market multiple valuation approach ("market approach"), when available and appropriate, or a combination of both. We assess the valuation methodology based upon the relevance and availability of the data at the time we perform the valuation. If multiple valuation methodologies are used, the results are weighted appropriately.

Under the income approach, fair value is determined based on the present value of estimated future cash flows, discounted at an appropriate risk-adjusted rate. We use our internal forecasts to estimate future cash flows and include an estimate of long-term future growth rates based on our most recent views of the long-term outlook for each respective reporting unit. Actual results may differ from those assumed in our forecasts. We derive our discount rates using a capital asset pricing model and analyzing published rates for industries relevant to our reporting units to estimate the cost of equity financing. We use discount rates that are commensurate with the risks and uncertainty inherent in the respective businesses and in our internally developed forecasts.

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

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

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

For the RH Segment reporting unit, during fiscal 2017, fiscal 2016 and fiscal 2015, we reviewed goodwill for impairment by assessing qualitative factors to determine whether it was more likely than not that the fair value of the reporting unit was less than its carrying amount. Based on the qualitative tests performed in each fiscal year, we determined that it was not more likely than not that the fair value of the reporting unit was less than its carrying amount for fiscal 2017, fiscal 2016 and fiscal 2015, and therefore we did not recognize goodwill impairment with respect to the RH Segment in any such fiscal year.

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

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

Based on the estimated fair value of the Waterworks reporting unit as of the assessment date, we recorded a $33.7 million non-cash impairment in the fourth quarter of fiscal 2017 to reduce the carrying value of goodwill in our

Waterworks reporting unit. The remaining goodwill balance of the Waterworks reporting unit is $17.4 million as of February 3, 2018.

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 is less than the carrying value, we recognize a loss equal to the difference between the carrying value and the fair value, usually determined by the estimated discounted cash flow analysis of the asset.

We evaluate long-lived tangible assets at an individual gallery level, which is the lowest level at which independent cash flows can be identified.

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 gallery-level historical results, current trends, and operating and cash flow projections. Our estimates are subject to uncertainty and may be affected by a number of factors outside our control, including general economic conditions and the competitive environment. While we believe our estimates and judgments about future cash flows are reasonable, future impairment charges may be required if the expected cash flow estimates, as projected, do not occur or if events change requiring us to revise our estimates.

Lease Accounting

We lease stores, distribution facilities, office space and, less significantly, certain machinery and equipment. We classify leases at the inception of the lease as a capital lease or an operating lease.

Build-to-Suit Lease Transactions

We are sometimes involved in the construction of leased stores, which, depending on the extent to which we are involved, we may be the “deemed owner” of the leased premises for accounting purposes during the construction period pursuant to ASC 840. If we are the “deemed owner” for accounting purposes, upon commencement of the construction project, we are required to capitalize the cash and non-cash assets contributed by the landlord for construction as property and equipment on our consolidated balance sheets. The contributions by the landlord toward construction, including the building, existing site improvements at construction commencement and any amounts paid by the landlord to those responsible for construction, are included as property and equipment additions due to build-to-suit lease transactions within the non-cash section of our consolidated statements of cash flows. Over the lease term, these non-cash additions to property and equipment due to build-to-suit lease transactions do not impact our cash outflows, nor do they impact net income within our consolidated statements of income.

Upon completion of the construction project, we perform a sale-leaseback analysis to determine if we do not have any forms of “continuing involvement” and therefore can remove the assets and related liabilities from our consolidated balance sheets. If the assets and related liabilities cannot be removed from our consolidated balance sheets, we account for the transactions as a financing lease. These lease transactions are referred to as build-to-suit lease transactions.

Rent expense relating to the land is recognized on a straight-line basis once construction begins, which is determined using the fair value of the leased land at construction commencement and our incremental borrowing rate. Once cash payments commence under the lease, all amounts in excess of land rent expense are recorded as a debt-service payment and are recognized as interest expense and a reduction of the financing obligation.

Similar to capital leases, the expense recorded within the consolidated statements of income over the lease term is equal to the cash rent payments made under the lease. The primary difference in the consolidated statements of income between build-to-suit lease transactions and operating leases is the timing of recognition and the classification of expenses. Expenses related to operating leases are classified as rent expense compared to expenses related to build-to-suit lease transactions which are classified as a combination of rent expense, depreciation expense and interest expense.

Operating and Capital Leases

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.

Certain of our property and equipment are held under capital leases. These assets are included in property and equipment and depreciated over the lesser of the useful life of the asset or the lease term. For buildings held under capital leases, unless the fair value of the land at lease inception exceeds 25% of the aggregate fair value of the leased land and buildings, rent payments under the leases are recognized using the effective interest method as a reduction of the capital lease obligation and interest expense. Pursuant to ASC 840, at lease inception, if the fair value of the underlying land exceeds 25% of the fair value of the real estate (land and buildings), we allocate a portion of the cash payments under the lease to land rent expense equal to the product of the fair value of the leased land at construction commencement and our incremental borrowing rate. The remaining cash payment is treated as debt-service payments and recognized as a reduction of the capital lease obligation and an increase in 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 rent expenses, we recognize rent expense on a straight-line basis over the lease term. Tenant improvement allowances received from landlords under operating leases are recorded in deferred rent and lease incentives on the consolidated balance sheets, and are amortized on a straight-line basis over the lease term.

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 plan is estimated on the date of grant using a Black-Scholes Merton option pricing model which requires the input of subjective assumptions regarding the expected term, expected volatility, dividend yield and risk-free interest rate. 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.

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.

As of February 3, 2018, we had $1.2 million in valuation allowances against deferred tax assets in certain foreign jurisdictions due to historical losses.

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

For information regarding recently issued accounting pronouncements, refer to Note 3—Significant Accounting Polices in our consolidated financial statements within Part II of this Annual Report on Form 10-K.

Item 7A. Quantitative and Qualitative Disclosure of Market Risks

Interest Rate Risk

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

We are subject to interest rate risk in connection with borrowings under our revolving line of credit which bears interest at variable rates and we may incur additional indebtedness that bears interest at variable rates. At February 3, 2018, $200.0 million was outstanding under the revolving line of credit. As of February 3, 2018, the undrawn borrowing availability under the revolving line of credit was $186.4 million, net of $33.8 million in outstanding letters of credit. As a result of the FCCR restriction that limits the last 10% of borrowing availability, actual incremental borrowing available under the revolving line of credit would be approximately $136.4 million. Based on the average interest rate on the revolving line of credit during the three months ended February 3, 2018, and to the extent that borrowings were outstanding on such line of credit, we do not believe that a 10% change in the interest rate would have a material effect on our consolidated results of operations or financial condition. To the extent that we incur additional indebtedness, we may increase our exposure to risk from interest rate fluctuations.

We are subject to interest rate risk in connection with borrowings under our LILO term loan, which bears interest at variable rates. At February 3, 2018, $80.0 million was outstanding under the LILO term loan. Based on the average interest rates on the LILO term loan during the three months ended February 3, 2018, 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.

As of February 3, 2018, we had $350 million principal amount of 0.00% convertible senior notes due 2019 outstanding (the “2019 Notes”). As this instrument does not bear interest, we do not have interest rate risk exposure related to this debt.

As of February 3, 2018, we had $300 million principal amount of 0.00% convertible senior notes due 2020 outstanding (the “2020 Notes”). As this instrument does not bear interest, we do not have interest rate risk exposure related to this debt.

Market Price Sensitive Instruments

0.00% Convertible Senior Notes due 2019

In connection with the issuance of the 2019 Notes, we entered into privately-negotiated convertible note hedge transactions with certain counterparties. The convertible note hedge transactions relate to, collectively, 3.0 million shares of our common stock, which represents the number of shares of our common stock underlying the 2019 Notes, subject to anti-dilution adjustments substantially similar to those applicable to the 2019 Notes. These convertible note hedge transactions are expected to reduce the potential earnings dilution with respect to our common stock upon conversion of the 2019 Notes and/or reduce our exposure to potential cash or stock payments that may be required upon conversion of the 2019 Notes.

We also entered into separate warrant transactions with the same group of counterparties initially relating to the number of shares of our common stock underlying the convertible note hedge transactions, subject to customary anti-dilution adjustments. The warrant transactions will have a dilutive effect with respect to our common stock to the extent that the price per share of our common stock exceeds the strike price of the warrants unless we elect, subject to certain conditions, to settle the warrants in cash. The strike price of the warrant transactions is initially $171.98 per share. Refer to Note 10—Convertible Senior Notes in our consolidated financial statements.

0.00% Convertible Senior Notes due 2020

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

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

Impact of Inflation

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

Item 8. Financial Statements and Supplementary Data

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders

RH

Opinions on the Financial Statements and Internal Control over Financial Reporting

We have audited the accompanying consolidated balance sheets of RH and its subsidiaries as of February 3, 2018 and January 28, 2017, and the related consolidated statements of income, comprehensive income, stockholders' equity (deficit) and cash flows for each of the three years in the period ended February 3, 2018, including the related notes (collectively referred to as the "consolidated financial statements"). We also have audited the Company's internal control over financial reporting as of February 3, 2018, based on criteria established in Internal Control - Integrated Framework (2013) issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Company as of February 3, 2018 and January 28, 2017, and the results of their operations and their cash flows for each of the three years in the period ended February 3, 2018 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 3, 2018, based on criteria established in Internal Control - Integrated Framework (2013) issued by the COSO.

Basis for Opinions

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

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

Our audits of the consolidated financial statements included performing procedures to assess the risks of material misstatement of the consolidated financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the consolidated financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

Definition and Limitations of Internal Control over Financial Reporting

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

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

/s/ PricewaterhouseCoopers LLP

San Francisco, California

March 29, 2018

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

RH

CONSOLIDATED BALANCE SHEETS

(In thousands, except share amounts)

	February 3, 2018	January 28, 2017
ASSETS		
Current assets:		
Cash and cash equivalents	$17,907	$87,023
Short-term investments	—	142,677
Accounts receivable—net	31,412	34,191
Merchandise inventories	527,026	752,304
Asset held for sale	—	4,900
Prepaid expense and other current assets	68,585	117,162
Total current assets	644,930	1,138,257
Long-term investments	—	33,212
Property and equipment—net	800,698	682,056
Goodwill	141,893	173,603
Trademarks and domain names	100,663	100,624
Other intangible assets—net	39	133
Deferred tax assets	23,311	28,466
Other non-current assets	21,332	36,169
Total assets	$1,732,866	$2,192,520
LIABILITIES AND STOCKHOLDERS' EQUITY (DEFICIT)		
Current liabilities:		
Accounts payable and accrued expenses	$318,765	$226,980
Deferred revenue and customer deposits	149,404	145,918
Other current liabilities	51,166	43,271
Total current liabilities	519,335	416,169
Asset based credit facility	199,970	—
Term loan—net	79,499	—
Convertible senior notes due 2019—net	327,731	312,379
Convertible senior notes due 2020—net	252,994	235,965
Financing obligations under build-to-suit lease transactions	229,323	203,015
Deferred rent and lease incentives	54,983	60,439
Other non-current obligations	76,367	44,684
Total liabilities	1,740,202	1,272,651
Commitments and contingencies (Note 19)	—	—
Stockholders' equity (deficit):		
Preferred stock, $0.0001 par value per share, 10,000,000 shares authorized, no shares issued or outstanding as of February 3, 2018 and January 28, 2017	—	—
Common stock, $0.0001 par value per share, 180,000,000 shares authorized, 41,737,470 shares issued and 21,517,338 shares outstanding as of February 3, 2018;	2	4

41,123,521 shares issued and 40,828,633 shares outstanding as of January 28, 2017		
Additional paid-in capital	860,288	790,866
Accumulated other comprehensive loss	(171)	(1,692)
Retained earnings	152,394	150,214
Treasury stock—at cost, 20,220,132 shares as of February 3, 2018 and 294,888 shares as of January 28, 2017	(1,019,849)	(19,523)
Total stockholders' equity (deficit)	(7,336)	919,869
Total liabilities and stockholders' equity (deficit)	$1,732,866	$2,192,520

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

RH

CONSOLIDATED STATEMENTS OF INCOME

(In thousands, except share and per share amounts)

	Year Ended February 3, 2018	January 28, 2017	January 30, 2016
Net revenues	$2,440,174	$2,134,871	$2,109,006
Cost of goods sold	1,591,107	1,455,084	1,356,314
Gross profit	849,067	679,787	752,692
Selling, general and administrative expenses	717,766	626,751	567,131
Income from operations	131,301	53,036	185,561
Other expenses			
Interest expense—net	62,570	44,482	35,677
Goodwill impairment	33,700	—	—
Loss on extinguishment of debt	4,880	—	—
Total other expenses	101,150	44,482	35,677
Income before income taxes	30,151	8,554	149,884
Income tax expense	27,971	3,153	58,781
Net income	$2,180	$5,401	$91,103
Weighted-average shares used in computing basic net income per share	27,053,616	40,691,483	40,190,448
Basic net income per share	$0.08	$0.13	$2.27
Weighted-average shares used in computing diluted net income per share	29,253,208	40,926,840	42,256,559
Diluted net income per share	$0.07	$0.13	$2.16

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

RH

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(In thousands)

	Year Ended February 3, 2018	January 28, 2017	January 30, 2016
Net income	$2,180	$5,401	$91,103
Net gains (losses) from foreign currency translation	1,510	1,003	(2,164)
Net unrealized holding gains (losses) on available-for-sale investments	11	5	(34)
Total comprehensive income	$3,701	$6,409	$88,905

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

RH

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY (DEFICIT)

(In thousands, except share amounts)

	Common Stock		Additional Paid-In	Accumulated Other Comprehensive Income (Loss)	Retained	Treasury Stock		Total Stockholders' Equity (Deficit)
	Shares	Amount	Capital		Earnings	Shares	Amount	
Balances—January 31, 2015	39,892,540	4	668,989	(502)	53,710	292,263	(19,285)	702,916
Stock-based compensation		—	24,223	—	—	—	—	24,223
Issuance of restricted stock	6,535	—	—	—	—	—	—	—
Vested and delivered restricted stock units	78,769	—	(4,863)	—	—	—	—	(4,863)
Exercise of stock options—including tax benefit	608,056	—	35,885	—	—	—	—	35,885
Repurchases of common stock	(2,625)	—	—	—	—	2,625	(238)	(238)
Equity component value of convertible note issuance—net	—	—	77,192	—	—	—	—	77,192
Sale of common stock warrant	—	—	30,390	—	—	—	—	30,390
Purchase of convertible note hedge	—	—	(68,250)	—	—	—	—	(68,250)
Net income	—	—	—	—	91,103	—	—	91,103
Net losses from foreign currency translation	—	—	—	(2,164)	—	—	—	(2,164)
Net unrealized holding gains	—	—	—	(34)	—	—	—	(34)

(losses) on investments								
Balances—January 30, 2016	40,583,275	4	763,566	(2,700)	144,813	294,888	(19,523)	886,160
Stock-based compensation	—	—	28,930	—	—	—	—	28,930
Issuance of restricted stock	33,555	—	—	—	—	—	—	—
Vested and delivered restricted stock units	88,538	—	(1,531)	—	—	—	—	(1,531)
Exercise of stock options—including tax benefit	123,265	—	(99)	—	—	—	—	(99)
Net income	—	—	—	—	5,401	—	—	5,401
Net gains from foreign currency translation	—	—	—	1,003	—	—	—	1,003
Net unrealized holding gains (losses) on investments	—	—	—	5	—	—	—	5
Balances—January 28, 2017	40,828,633	4	790,866	(1,692)	150,214	294,888	(19,523)	919,869
Stock-based compensation	—	—	50,283	—	—	—	—	50,283
Issuance of restricted stock	15,631	—	—	—	—	—	—	—
Vested and delivered restricted stock units	197,660	—	(4,504)	—	—	—	—	(4,504)
Exercise of stock options	695,546	—	23,643	—	—	—	—	23,643
Repurchases of common stock	(20,220,132)	(2)	—	—	—	20,220,132	(1,000,326)	(1,000,328)
Retirement of treasury stock	—	—	—	—	—	(294,888)	—	—
Net income	—	—	—	—	2,180	—	—	2,180
Net gains from foreign currency translation	—	—	—	1,510	—	—	—	1,510
	—	—	—	11	—	—	—	11

Net unrealized holding gains (losses) on investments								
Balances—February 3, 2018	21,517,338	$ 2	$ 860,288	$ (171)	$ 152,394	20,220,132	$ (1,019,849)	$ (7,336)

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

RH

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

	Year Ended		
	February 3, 2018	January 28, 2017	January 30, 2016
CASH FLOWS FROM OPERATING ACTIVITIES			
Net income	$2,180	$5,401	$91,103
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	70,135	56,995	44,595
Goodwill impairment	33,700	—	—
Assets impairments and lease losses	6,481	17,137	—
Product recalls	7,707	4,615	—
Net non-cash charges resulting from inventory step-up	2,527	6,835	—
Amortization of purchase premiums and accretion of purchases discount—net	99	1,022	1,166
Amortization of debt discount	30,457	28,822	22,114
Excess tax (benefit) shortfall from exercise of stock options	—	3,288	(10,443)
Stock-based compensation expense	50,709	29,214	24,223
Non-cash loss on extinguishment of debt	1,880	—	—
Deferred income taxes	6,572	(221)	(6,011)
Other non-cash interest expense	5,325	3,121	2,473
Change in assets and liabilities—net of acquisition:			
Accounts receivable	2,758	588	(2,629)
Merchandise inventories	220,767	(4,304)	(166,505)
Prepaid expense and other assets	45,537	(36,889)	10,817
Accounts payable and accrued expenses	64,460	(50,307)	29,196
Deferred revenue and customer deposits	3,366	23,977	33,213
Other current liabilities	680	(23,820)	39,580
Deferred rent and lease incentives	1,059	4,662	13,597
Other non-current obligations	(1,297)	8,709	215
Net cash provided by operating activities	555,102	78,845	126,704
CASH FLOWS FROM INVESTING ACTIVITIES			
Capital expenditures	(112,455)	(157,644)	(119,461)
Acquisition of buildings and land	—	—	(13,999)
Construction related deposits	(14,387)	(23,380)	(20,049)
Purchase of trademarks and domain names	(39)	(322)	(339)
Proceeds from sale of assets held for sale—net	15,123	—	—
Purchase of investments	(16,109)	(248,485)	(217,379)
Maturities of investments	46,890	187,338	143,830
Sales of investments	145,020	37,096	—
Acquisition of business—net of cash acquired	—	(116,100)	—
Net cash provided by (used in) investing activities	64,043	(321,497)	(227,397)

CASH FLOWS FROM FINANCING ACTIVITIES			
Borrowing under asset based credit facility	600,000	—	—
Repayments under asset based credit facility	(400,030)	—	—
Borrowings under term loans	180,000	—	—
Repayments under term loans	(100,000)	—	—
Borrowing under promissory and equipment security notes	34,000	—	—
Repayments under promissory and equipment security notes	(2,319)	—	—
Proceeds from issuance of convertible senior notes	—	—	296,250
Proceeds from issuance of warrants	—	—	30,390
Purchase of convertible note hedges	—	—	(68,250)
Debt issuance costs	(8,298)	—	(2,382)
Repurchases of common stock—including commissions	(1,000,326)	—	—
Payments on build-to-suit lease transactions	(10,200)	—	—
Proceeds from exercise of stock options	24,896	3,261	25,606
Excess tax benefit (shortfall) from exercise of stock options	—	(3,288)	10,443
Tax withholdings related to issuance of stock-based awards	(5,759)	(1,603)	(5,027)
Other financing activities	(377)	(611)	(248)
Net cash provided by (used in) financing activities	(688,413)	(2,241)	286,782
Effects of foreign currency exchange rate translation	152	449	(308)
Net increase (decrease) in cash and cash equivalents	(69,116)	(244,444)	185,781
Cash and cash equivalents			
Beginning of period	87,023	331,467	145,686
End of period	$17,907	$87,023	$331,467
Cash paid for interest	$28,180	$16,615	$13,369
Cash paid for taxes	4,025	48,464	29,135
Non-cash transactions:			
Property and equipment additions due to build-to-suit lease transactions	35,386	55,991	96,323
Property and equipment reduction due to effected sale leaseback	—	—	(74,855)
Property and equipment additions from use of construction related deposits	35,024	10,720	13,915
Property and equipment additions in accounts payable and accrued expenses at period-end	25,182	9,201	12,108
Property and equipment acquired under capital lease	847	16	88
Trademarks and domain names additions in accounts payable and accrued expenses at period-end	—	—	107
Issuance of non-current notes payable related to share repurchases from former employees	—	—	238

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

RH

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1—NATURE OF BUSINESS

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

On May 27, 2016, the Company acquired a controlling interest in Design Investors WW Acquisition Company, LLC, which owns the business operating under the name “Waterworks.” Refer to Note 4—Business Combination.

As of February 3, 2018, the Company operated a total of 83 retail Galleries and 32 outlet stores in 32 states, the District of Columbia and Canada, and includes 15 Waterworks Showrooms in the United States and in the U.K., and had sourcing operations in Shanghai and Hong Kong.

NOTE 2—ORGANIZATION

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

On November 1, 2012, the Company acquired all of the outstanding shares of capital stock of Restoration Hardware, Inc., a Delaware corporation, and Restoration Hardware, Inc. became a direct, wholly owned subsidiary of the Company. Restoration Hardware, Inc. was a direct, wholly owned subsidiary of Home Holdings 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.” On November 7, 2012, the Company completed its initial public offering.

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

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 year ended February 3, 2018 (“fiscal 2017”) consisted of 53 weeks. The fiscal years ended January 28, 2017 (“fiscal 2016”), and January 30, 2016 (“fiscal 2015”) each consisted of 52 weeks.

Use of Accounting Estimates

The preparation of the Company’s consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates and such differences could be material to the consolidated financial statements.

Cash and Cash Equivalents

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

Investments

All of the Company's investments are classified as available-for-sale and are carried at fair value. The Company invests excess cash primarily in investment-grade interest-bearing securities such as money market funds, certificates of deposit, commercial paper, government agency obligations and guaranteed obligations of the U.S. government, all of which are subject to minimal credit and market risks. Investments that have an original maturity of 91 days or more at the date of purchase and a current maturity of less than one year are classified as short-term investments, while investments with a current maturity of more than one year are classified as long-term investments. Fair value is determined based on quoted market rates when observable or utilizing data points that are observable, such as quoted prices, interest rates and yield curves. The cost of available-for-sale marketable securities sold is based on the specific identification method. Unrealized holding gains and losses, net of tax, are recorded in accumulated other comprehensive loss on the consolidated statements of stockholders' equity (deficit) until realized. Realized gains and losses, interest income, dividends, and amortization and accretion of purchase premiums and discounts on investments are included in interest expense on the consolidated statements of income. Total interest income on investments was \$0.3 million, \$2.3 million and \$1.5 million in fiscal 2017, fiscal 2016 and fiscal 2015, respectively. Total accretion of purchase discounts on investments was \$0.1 million, \$0.3 million, and \$0.1 million in fiscal 2017, fiscal 2016 and fiscal 2015, respectively. Total amortization of purchase premiums on investments was \$0.1 million, \$1.3 million and \$1.2 million in fiscal 2017, fiscal 2016 and fiscal 2015, respectively. Realized gains and losses were not material in fiscal 2017, fiscal 2016 and fiscal 2015. The Company has not recorded any dividends.

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 3, 2018 and January 28, 2017, and at various time throughout these fiscal years, the Company had cash in financial institutions in excess of the amount insured by the FDIC and CDIC. The Company performs ongoing evaluations of these institutions to limit its concentration of credit risk.

Accounts Receivable

Accounts receivable consist primarily of receivables from the Company's credit card processors for sales transactions, receivables related to the Company's contract business and other miscellaneous receivables. Accounts receivable is presented net of allowance for doubtful accounts, which is recorded on a specific identification basis. The allowance for doubtful accounts was \$1.8 million and \$2.4 million as of February 3, 2018 and January 28, 2017, 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 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 shipped 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 or inventory balances. The Company's inventory reserve balances were $31.4 million and $33.2 million as of February 3, 2018 and January 28, 2017, respectively.

Product Recalls

During fiscal 2017 and fiscal 2016, the Company initiated product recalls for certain of its products. In addition, in fiscal 2017, the Company adjusted the accrual related to certain product recalls initiated in fiscal 2016. The recall adjustments had the following effect on the Company's income before taxes (in thousands):

	Year Ended	
	February 3, 2018	January 28, 2017
Reduction of net revenues	$3,207	$3,441
Incremental cost of goods sold and inventory charges	4,315	535
Impact on gross profit	7,522	3,976
Incremental selling, general and administrative expenses	185	639
Impact on income before income taxes	$7,707	$4,615

The product recall accrual as of February 3, 2018 and January 28, 2017 was $1.2 million and $4.3 million, respectively, and is included in other current liabilities on the consolidated balance sheets.

Advertising Expenses

Advertising expenses primarily represent the costs associated with the Company's catalog mailings, as well as print and website marketing. Total advertising expense, which is recorded in selling, general and administrative expenses on the consolidated statements of income, was $106.6 million, $79.8 million, and $107.7 million in fiscal 2017, fiscal 2016, and fiscal 2015, 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 after they are mailed and the majority of the amortization occurs within the first five to nine months, with the exception of the Holiday Source Books, which are generally fully amortized within a three-month period after they are mailed. 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 statements of income.

The Company had $44.1 million and $61.3 million of capitalized catalog costs that are included in prepaid expense and other current assets on the consolidated balance sheets as of February 3, 2018, and January 28, 2017, 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:

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

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

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

Interest is capitalized on construction in progress and software projects during the period in which expenditures have been made, activities are in progress to prepare the asset for its intended use and interest expense is being incurred. The Company capitalized interest of $3.3 million, $2.4 million and $2.3 million in fiscal 2017, fiscal 2016 and fiscal 2015, respectively. During fiscal 2017, $2.5 million of the $3.3 million capitalized interest relates to the capitalization of non-cash interest associated with the amortization of the convertible senior notes debt discount. During fiscal 2016 and fiscal 2015, all of the $2.4 million and $2.3 million capitalized interest, respectively, relates to the capitalization of non-cash interest associated with the amortization of the convertible senior notes debt discount.

Property and equipment acquired under non-cancelable leases, which meet the criteria of capital leases, are capitalized and amortized over the lesser of the useful life of the asset or the lease term. For buildings held under capital lease, unless the fair value of the land at lease inception exceeds 25% of the aggregate fair value of the leased land and building, rent payments under the leases are recognized using the effective interest method as a reduction of the capital lease obligation and interest expense. Pursuant to Accounting Standards Codification ("ASC") 840—Leases ("ASC 840"), at lease inception, if the fair value of the underlying land exceeds 25% of the fair value of the real estate (land and building), the Company allocates a portion of the cash payments under the lease to land rent expense equal to the product of the fair value of the leased land at construction commencement and the Company's incremental borrowing rate. The remaining cash payment is treated as debt-service payments and recognized as a reduction of the capital lease obligation and an increase in interest expense.

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. For further discussion regarding impairments refer to the "Impairment" accounting policy below.

Intangible Assets

Intangible assets reflect the value assigned to trademarks, domain names and the fair market value of the Company’s leases. The Company does not amortize trademarks and domain names as the Company defines the life of these assets as indefinite.

Impairment

Goodwill

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

The Company performs its annual goodwill impairment testing in the fourth fiscal quarter. Historically, through its fourth quarter ending January 28, 2017, the Company applied a two-step impairment test: in step one, the carrying value of the reporting unit is compared with its fair value; in step two, which is applied when the carrying value is more than its fair value, the amount of goodwill impairment, if any, is derived by deducting the fair value of the reporting unit's assets and liabilities from the fair value of its equity, and comparing that amount with the carrying amount of goodwill.

In January 2017, the FASB issued Accounting Standards Update No. 2017-04—Intangibles—Goodwill and Other (Topic 350) ("ASU 2017-04"). ASU 2017-04 amends the guidance to simplify the subsequent measurement of goodwill by removing step two of the goodwill impairment test (the requirement to calculate the implied fair value of goodwill to measure a goodwill impairment charge). Instead, an entity should perform its annual, or interim, goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount. An entity should recognize an impairment charge for the amount by which the carrying amount exceeds the reporting unit's fair value. The Company early adopted ASU 2017-04 in fiscal 2017 and applied the amended guidance to its annual impairment tests performed in the fourth quarter of fiscal 2017.

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

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

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

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

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

For the RH Segment reporting unit, during fiscal 2017, fiscal 2016 and fiscal 2015, the Company reviewed goodwill for impairment by assessing qualitative factors to determine whether it was more likely than not that the fair value of the reporting unit was less than its carrying amount. Based on the qualitative tests performed in each fiscal year, the Company determined that it was not more likely than not that the fair value of the reporting unit was less than its carrying amount for fiscal 2017, fiscal 2016 and fiscal 2015, and therefore the Company did not recognize goodwill impairment with respect to the RH Segment in any such fiscal year.

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

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

Based on the estimated fair value of the Waterworks reporting unit as of the assessment date, the Company recorded a $33.7 million non-cash impairment in the fourth quarter of fiscal 2017 to reduce the carrying value of goodwill in the Waterworks reporting unit. The remaining goodwill balance of the Waterworks reporting unit is $17.4 million as of February 3, 2018.

Trademarks and Domain Names

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

The Company qualitatively assesses indefinite-lived intangible asset impairment to determine whether it is more likely than not that the fair value of the asset is less than its carrying amount. If trademarks and domain names are not qualitatively assessed or if trademarks and domain names 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 results of operations and projected future cash flows.

For the RH Segment reporting unit, during fiscal 2017, fiscal 2016 and fiscal 2015, the Company qualitatively assessed indefinite-lived intangible asset for impairment and determine it was more likely than not that the fair value of the assets were greater than their carrying amounts. Based on the qualitative tests performed in each fiscal year, the Company did not perform quantitative impairment tests in any year. The Company has not recognized goodwill impairment for the RH Segment reporting unit. The Company did not recognize any impairment with respect to trademarks and domain names for the RH Segment reporting unit in fiscal 2017, fiscal 2016 or fiscal 2015.

In connection with the goodwill impairment test performed for the Waterworks reporting unit in fiscal 2017, described above, the Company performed an impairment test on the trademarks allocated to the reporting unit which utilized the discounted cash flow methodology. Based on the quantitative impairment test performed, which resulted in fair value of the trademarks in excess of book value by approximately 26%, the Company concluded that the trademarks allocated to the Waterworks reporting unit were not impaired as of February 3, 2018. The Company did not recognize any impairment with respect to trademarks and domain names for the Waterworks reporting unit in fiscal 2017 or fiscal 2016.

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 is less than the carrying value, the Company recognizes a loss equal to the difference between the carrying value and the fair value, usually determined by the estimated discounted cash flow analysis of the asset.

The Company evaluates long-lived tangible assets at an individual gallery level, which is the lowest level at which independent cash flows can be identified.

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 gallery-level historical results, current trends, and operating and cash flow projections. The Company’s estimates are subject to uncertainty and may be affected by a number of factors outside its control, including general economic conditions and the competitive environment. While the Company believes its estimates and judgments about future cash flows are reasonable, future impairment charges may be required if the expected cash flow estimates, as projected, do not occur or if events change requiring the Company to revise its estimates.

The Company did not record impairment for long-lived tangible assets at the individual gallery level in fiscal 2017, fiscal 2016 or fiscal 2015. Due to certain distribution center closures and business line integrations in fiscal 2017 and fiscal 2016, the Company recorded impairment for certain corporate assets and other long-lived assets in fiscal 2017 and fiscal 2016, as discussed below under “Distribution Center Closures,” “Asset Held for Sale” and “RH Contemporary Art Impairment.” No additional impairment has been recorded for corporate assets and other long-lived assets in fiscal 2017, fiscal 2016 and fiscal 2015.

Distribution Center Closures

During the third quarter of fiscal 2017, the Company initiated a plan to close two of its distribution centers, one located in Mira Loma, CA and one located in Dallas, TX. The Mira Loma distribution center closure was finalized in November 2017 and the Dallas distribution center closure was finalized in January 2018, both of which occurred in the fourth quarter of fiscal 2017.

As a result of the distribution center closures, the Company incurred restructuring related costs in the RH Segment, including loss on disposal of capitalized property and equipment and liability for lease losses of $2.1 million, as well as costs for employee termination benefits of $0.9 million. The total expense of $3.0 million was included in selling, general and administrative expenses on the consolidated statements of income, which represents the total charges expected to be incurred with the distribution center closures.

As of February 3, 2018, the Company’s liability for lease losses associated with the distribution center closures, which is estimated as the net present value of the difference between lease payments and receipts under sublease agreements, was $2.6 million and is included in other non-current obligations on the consolidated balance sheets.

Asset Held for Sale

An asset is considered to be held for sale when all of the following criteria are met:

- Management commits to a plan to sell the property;
- It is unlikely that the disposal plan will be significantly modified or discontinued;
- The property is available for immediate sale in its present condition;
- Actions required to complete the sale of the property have been initiated;
- Sale of the asset is probable and the completed sale is expected to occur within one year; and
- The property is actively being marketed for sale at a price that is reasonable given its current market value.

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

During the fourth quarter of fiscal 2016, the Company committed to a plan to sell an aircraft, which resulted in a reclassification of such aircraft from property and equipment to asset held for sale on the consolidated balance sheets as of January 28, 2017. The Company performed an assessment and determined that based on management’s best estimate of the selling price of the aircraft as of January 28, 2017, it had an impairment of $4.8 million in fiscal 2016.

Such impairment charge is included in selling, general and administrative expenses on the consolidated statements of income. In April 2017, the sale of the aircraft was completed for a purchase price of $5.2 million and the Company incurred additional costs of $0.3 million to dispose of the asset.

RH Contemporary Art Impairment

During the fourth quarter of fiscal 2016, the Company initiated and executed a plan to integrate the RH Contemporary Art (“RHCA”) product line into the broader RH platform and no longer operates RHCA as a separate division. As a result, the Company incurred restructuring related costs in the RH Segment, including loss on disposal of capitalized property and equipment of $5.5 million, liability for lease losses of $3.2 million, inventory impairment of $2.7 million and other associated costs of $0.3 million. The Company did not incur any costs for employee termination benefits associated with the integration. The impact to cost of goods sold and selling, general and administrative expenses on the consolidated statements of income in fiscal 2016 was $1.1 million and $10.6 million, respectively.

During the fourth quarter of fiscal 2017, the Company recorded expense of $4.4 million in the RH Segment related to the remeasurement of the liability for lease losses for RHCA resulting from an update to both the timing and the amount of future estimated lease related cash inflows based on present market conditions, which is included in selling, general and administrative expenses on the consolidated statements of income.

As of February 3, 2018 and January 28, 2017, the Company's liability for lease losses associated with the RHCA impairment, which is estimated as the net present value of the difference between lease payments and receipts under sublease agreements, was $7.1 million and $3.2 million, respectively, and is included in other non-current obligations on the consolidated balance sheets.

The RHCA liability for lease losses fiscal 2017 activity was as follows (in thousands):

Balance at beginning of fiscal year	$3,188
Payments made under lease agreement	(1,699)
Payments received under sublease agreement	1,003
Remeasurement	4,417
Interest	191
Balance at end of fiscal year	$7,100

Lease Accounting

The Company leases stores, distribution facilities, office space and, less significantly, certain machinery and equipment. The Company classifies leases at the inception of the lease as a capital lease or an operating lease.

Build-to-Suit Lease Transactions

The Company is sometimes involved in the construction of leased stores, which, depending on the extent to which it is involved, the Company may be the "deemed owner" of the leased premises for accounting purposes during the construction period pursuant to ASC 840. If the Company is the "deemed owner" for accounting purposes, upon commencement of the construction project, it is required to capitalize the cash and non-cash assets contributed by the landlord for construction as property and equipment on its consolidated balance sheets. The contributions by the landlord toward construction, including the building, existing site improvements at construction commencement and any amounts paid by the landlord to those responsible for construction, are included as property and equipment additions due to build-to-suit lease transactions within the non-cash section of the consolidated statements of cash flows. Over the lease term, these non-cash additions to property and equipment due to build-to-suit lease transactions do not impact the Company's cash outflows, nor do they impact net income within the consolidated statements of income.

Upon completion of the construction project, the Company performs a sale-leaseback analysis to determine if it does not have any forms of "continuing involvement" and therefore can remove the assets and related liabilities from its consolidated balance sheets. If the assets and related liabilities cannot be removed from the Company's consolidated balance sheets, the Company accounts for the transactions as a financing lease. These lease transactions are referred to as build-to-suit lease transactions.

Rent expense relating to the land is recognized on a straight-line basis once construction begins, which is determined using the fair value of the leased land at construction commencement and the Company's incremental borrowing rate.

Once cash payments commence under the lease, all amounts in excess of land rent expense are recorded as a debt-service payment and are recognized as interest expense and a reduction of the financing obligation.

Similar to capital leases, the expense recorded within the consolidated statements of income over the lease term is equal to the cash rent payments made under the lease. The primary difference in the consolidated statements of income between build-to-suit lease transactions and operating leases is the timing of recognition and the classification of expenses. Expenses related to operating leases are classified as rent expense compared to expenses related to build-to-suit lease transactions which are classified as a combination of rent expense, depreciation expense and interest expense.

Operating and Capital Leases

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.

Certain of the Company’s property and equipment are held under capital leases. These assets are included in property and equipment and depreciated over the lesser of the useful life of the asset or the lease term. For buildings held under capital leases, unless the fair value of the land at lease inception exceeds 25% of the aggregate fair value of the leased land and buildings, rent payments under the leases are recognized using the effective interest method as a reduction of the capital lease obligation and interest expense. Pursuant to ASC 840, at lease inception, if the fair value of the underlying land exceeds 25% of the fair value of the real estate (land and buildings), the Company allocates a portion of the cash payments under the lease to land rent expense equal to the product of the fair value of the leased land at construction commencement and the Company’s incremental borrowing rate. The remaining cash payment is treated as debt-service payments and recognized as interest expense and a reduction of the capital lease obligation.

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 rent expenses, the Company recognizes rent expense on a straight-line basis over the lease term. Tenant improvement allowances received from landlords under operating leases are recorded in deferred rent and lease incentives on the consolidated balance sheets, and are amortized on a straight-line basis over the lease term.

Debt Issuance Costs

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

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

Revenue Recognition

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

The Company recognizes shipping and handling fees as 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.

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 3, 2018	January 28, 2017	January 30, 2016
Balance at beginning of fiscal year	$10,077	$12,688	$10,235
Waterworks acquisition—beginning balance	—	523	—
Provision for sales returns	108,134	106,508	104,028
Actual sales returns	(107,646)	(109,642)	(101,575)
Balance at end of fiscal year	$10,565	$10,077	$12,688

Deferred Revenue and Customer Deposits

Deferred revenue primarily 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. Deferred revenue also includes the unrecognized portion of the annual RH Members Program fee. The annual membership fee is recorded as deferred revenue when collected from customers and is recognized as revenue on a straight-line basis over the membership period, or one year.

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

Gift Cards and Merchandise Credits

The Company sells gift cards and issues merchandise credits to its customers in its stores and through its websites and product catalogs. Such gift cards and merchandise credits do not have expiration dates. Revenue associated with gift cards and merchandise credits is deferred until either (i) redemption of the gift cards 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 cards or merchandise credits to the relevant jurisdictions (breakage). The breakage rate is based on monitoring of cards issued, actual card redemptions and the Company’s analysis of when it believes it is remote that redemptions will occur. Breakage resulted in a reduction of selling, general and administrative expenses on the consolidated statements of income of $3.0 million, $3.0 million and $2.0 million in fiscal 2017, fiscal 2016, and fiscal 2015, 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 $2.7 million and $2.8 million related to health care coverage as of February 3, 2018 and January 28, 2017, respectively.

The Company carries workers’ compensation insurance subject to a deductible amount for which the Company is responsible on each claim. The Company had liabilities of $3.3 million and $3.1 million related to workers’ compensation claims, primarily for claims that do not meet the per-incident deductible, as of February 3, 2018 and January 28, 2017, respectively.

Stock-Based Compensation

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

Cost of Goods Sold

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

Selling, General and Administrative Expenses

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

Net Income Per Share

Basic net income per share is computed as net income divided by the weighted-average number of common shares outstanding for the period. Diluted net income per share is computed as net income divided by the weighted-average number of common shares outstanding for the period 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 net income 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 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.

The United States enacted the Tax Cuts and Jobs Act (the "Tax Act") on December 22, 2017, which had a significant impact to the Company's provision for income taxes as of February 3, 2018. The Tax Act includes a number of changes to existing U.S. tax laws that impact us, including the reduction of the U.S. corporate income tax rate from 35% to 21% effective January 1, 2018. The Tax Act also provides for a one-time transition tax on accumulated foreign earnings and the acceleration of depreciation for certain assets, as well as prospective changes beginning in 2018, including limitations on the deductibility of executive compensation and interest, the elimination of certain domestic deductions and credits, the elimination of the Alternative Minimum Tax regime, and modifications to the deductibility and carryforward period of net operating losses. The Tax Act transitions U.S. international taxation from a worldwide system to a modified territorial system and includes base erosion prevention measures on non-U.S. earnings, which may have the effect of subjecting certain earnings of the Company's foreign subsidiaries to U.S. taxation. The Company's provision for income taxes in fiscal 2017 included $7.0 million of income tax expense as a result of the Tax Act, including $6.0 million for the provisional re-measurement of the deferred tax assets for the reduction in the U.S. corporate income tax rate from 35% to 21% and a $1.0 million charge for the provisional estimate of the transition tax.

The Tax Act requires complex computations to be performed that were not previously required under U.S. tax law, significant judgments to be made in interpretation of the provisions of the Tax Act and significant estimates in calculations, and the preparation and analysis of information not previously relevant or regularly produced. The U.S. Treasury Department, the Internal Revenue Service, and other standard-setting bodies could interpret or issue guidance on how provisions of the Tax Act will be applied or otherwise administered that is different from the Company's interpretation. As the Company completes its analysis of the Tax Act, reviews all information, collects and prepares necessary data, and interprets any additional guidance, the Company may make adjustments to provisional amounts that the Company has recorded, which could have a material adverse effect on its business, results of operations or financial condition.

Comprehensive Income

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

Foreign Currency Translation

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

Recently Issued Accounting Standards

Stock-Based Compensation

In March 2016, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update No. 2016-09—Improvements to Employee Share Based Payment Accounting ("ASU 2016-09"). The new guidance simplifies several aspects of the accounting for employee share-based payment transactions including the accounting for income taxes, forfeitures, and statutory tax withholding requirements, as well as classification in the statement of cash flows. One provision requires that the excess income tax benefits and tax deficiencies related to share-based payments be recognized within income tax expense in the statements of income, rather than within additional paid-in capital on the balance sheet. The new guidance was effective for the Company beginning on January 29, 2017. As a result of the adoption of this new guidance, the Company recognized an excess tax benefit of $7.0 million in the provision for income taxes as a discrete item in fiscal 2017. These amounts may not necessarily be indicative of future amounts that may be recognized as any excess tax benefits recognized would be dependent on future stock price, employee exercise behavior and applicable tax rates. As permitted, the Company elected to classify excess tax benefits (shortfalls) as an operating activity in the consolidated statements of cash flows instead of as a financing activity on a prospective basis and did not retrospectively adjust prior periods.

In May 2017, the FASB issued Accounting Standards Update No. 2017-09—Compensation—Stock Compensation (Topic 718): Scope of Modification Accounting. The new guidance clarifies when modification accounting should be applied for changes to terms or conditions of a share-based payment award. The new guidance is effective for fiscal years beginning after December 15, 2017, including interim periods within that reporting period, with early adoption permitted. The standard will be applied prospectively. The Company is evaluating the impact of adopting this new accounting standard on its consolidated financial statements.

Goodwill and Intangibles

In January 2017, the FASB issued Accounting Standards Update No. 2017-04—Intangibles—Goodwill and Other (Topic 350). The updated guidance simplifies the measurement of goodwill impairment by removing step two of the goodwill impairment test, which requires the determination of the fair value of individual assets and liabilities of a reporting unit. The new guidance requires goodwill impairment to be measured as the amount by which a reporting unit's carrying value of its net assets exceeds its fair value; however, the loss recognized should not exceed the total amount of goodwill allocated to that reporting unit. The amendments should be applied on a prospective basis. The new standard is effective for fiscal years beginning after December 15, 2019 with early adoption permitted for interim or annual goodwill impairment tests performed after January 1, 2017. The Company adopted this guidance on a prospective basis in fiscal 2017 and applied the guidance for its annual impairment tests performed in the fourth quarter of fiscal 2017. As a result, in fiscal 2017, the goodwill impairment associated with the Waterworks reporting unit was measured as the amount by which the reporting unit's carrying value exceeded its fair value and did not perform step two of the goodwill impairment test. For further discussion regarding goodwill impairment refer to the "Impairment" accounting policy above.

Revenue from Contracts with Customers

In May 2014, the FASB and International Accounting Standards Board issued their converged accounting standards update on revenue recognition, Accounting Standards Update 2014-09—Revenue from Contracts with Customers (Topic 606). This guidance outlines a single comprehensive model for companies to use in accounting for revenue arising from contracts with customers and supersedes most current revenue recognition guidance, including industry-specific guidance. The core principle of the revenue model is that revenue is recognized when a customer obtains control of a good or service. A customer obtains control when it has the ability to direct the use of and obtain the benefits from the good or service. Under the new guidance, transfer of control is no longer the same as transfer of risks and rewards as indicated in the prior guidance. In 2016, the FASB issued several amendments to the standard, including principal versus agent considerations when another party is involved in providing goods or services to a customer, the application of identifying performance obligations, and the recognition of expected breakage amounts.

Topic 606 is effective for fiscal years beginning after December 15, 2017, including interim periods within that reporting period, with early adoption permitted for annual reporting periods beginning after December 15, 2016. The Company adopted Topic 606 in the first quarter of fiscal 2018. The Company has elected to adopt using a modified retrospective approach with the cumulative effect of initially applying the new standard recognized in retained earnings at the date of adoption. The Company has completed its evaluation of Topic 606 and has finalized the new accounting policies it will adopt in the first quarter of fiscal 2018, however, the Company is still in the process of determining the final financial impact of adoption.

The adoption of Topic 606 will materially impact the timing of recognizing advertising expense related to direct response advertising, including costs associated with the Company's Source Books. Prior to adoption of Topic 606, costs associated with Source Books were capitalized and amortized over their expected period of future benefit. Such amortization was based upon the ratio of actual revenues to the total of actual and estimated future revenues on an individual Source Book basis. Each Source Book is generally fully amortized within a twelve-month period after they were mailed and the majority of the amortization occurs within the first five to nine months, with the exception of the Holiday Source Books, which were generally fully amortized within a three-month period after they were mailed. Under Topic 606, the Company will recognize expense associated with the Source Books upon the delivery of the Source Books to the carrier. In the case of multiple printings of a Source Book, the creative costs will be expensed in full upon the initial delivery of Source Books to the carrier. Upon adoption of Topic 606, all capitalized costs as of February 3, 2018 associated with Source Books that had been delivered to the carrier prior to or on February 3, 2018 will be reclassified to retained earnings on the consolidated balance sheets.

In applying the guidance related to the indicators of transfer of control, the Company has concluded that revenue recognized for merchandise delivered via the home-delivery channel will continue to be recognized upon delivery. However, revenue recognized for merchandise delivered via all other delivery channels will be recognized upon shipment, which is not expected to have a material impact upon adoption or in future periods.

The Company has elected to adopt the practical expedient related to shipping and handling activities. Under this option, in instances where revenue is recognized for the related merchandise prior to shipping and handling activities occurring (i.e., revenue recognized upon shipment), the related costs of those shipping and handling activities will be accrued for in the same period. Costs of shipping and handling will continue to be included in cost of goods sold.

Under the new standard the Company will recognize gift card breakage proportional to actual gift card redemptions and such breakage will be recorded within net revenues on the consolidated statements of income. Gift card breakage was previously recorded as a reduction to selling, general and administrative expenses when the likelihood of redemption was remote.

Prior to the adoption of Topic 606, the annual membership fee for the RH Members Program was recorded as deferred revenue when collected from customers and recognized as revenue on a straight-line basis over the twelve month membership period. With the adoption of Topic 606, new membership fees will be recorded as deferred revenue when collected from customers and recognized as revenue based on expected product revenues over the annual membership period, based on historical trends of sales to members. This will result in a majority of revenue being recognized during the first six months of the membership period. The adoption of Topic 606 will not have an impact on membership renewal fees, which will continue to be recognized as revenue on a straight-line basis over the twelve month membership period, until the Company has more information regarding membership renewal purchasing trends. The impact of adopting Topic 606 is not expected to be material to net revenues.

The Company will continue to recognize a liability for expected refunds to customers based on historical return rates. In connection with adoption of Topic 606, the Company will no longer report the liability net of the return, but rather will recognize an asset and a corresponding adjustment to cost of goods sold for the right to recover goods from customers on settling the refund liability. Upon adoption, this will result in an increase to prepaid and other current assets, and other current liabilities on the consolidated balance sheets, and will not impact the consolidated statements of income.

Accounting for Leases

In February 2016, the FASB issued Accounting Standards Update 2016-02—Leases, which, for operating leases, requires a lessee to recognize a right-of-use asset and a lease liability, initially measured at the present value of the lease payments, in its balance sheet. The standard also requires a lessee to recognize a single lease cost, calculated so that the cost of the lease is allocated over the lease term, on a generally straight-line basis. The ASU is effective for public companies for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early adoption is permitted. The Company is currently evaluating the effects that the adoption of ASU 2016-02 will have on its consolidated financial statements and anticipates the new guidance will significantly impact its consolidated financial statements given the Company has a significant number of leases.

Financial Instruments

In January 2016, the FASB issued Accounting Standards Update 2016-01—Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities, which amends various aspects of the recognition, measurement, presentation and disclosure for financial instruments. The new standard is effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. Early adoption is permitted only for certain provisions. The Company is evaluating the impact of adopting this new accounting standard on its consolidated financial statements.

Cash Flow: Classification and Restricted Cash

In August 2016, the FASB issued Accounting Standards Update No. 2016-15—Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments. The new guidance addresses eight specific cash flow issues with the objective of reducing an existing diversity in practices regarding the matter in which certain cash receipts and payments are presented and classified in the consolidated statements of cash flows. The new guidance is effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. Early adoption is permitted. The Company is evaluating the impact of adopting this new accounting standard on its consolidated financial statements.

In November 2016, the FASB issued Accounting Standards Update No. 2016-18—Statement of Cash Flows (Topic 230): Restricted Cash. The new guidance requires that a statement of cash flows explain the change during the period in the total of cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents. Amounts generally described as restricted cash and restricted cash equivalents should be included with cash and cash equivalents when reconciling the beginning-of-period and end-of-period total amounts on the statement of cash flows. The new guidance is effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. Early adoption is permitted. Adoption of the standard will be applied using a retrospective transition method to each period presented. The Company is evaluating the impact of adopting this new accounting standard on its consolidated financial statements.

Income Taxes: Intra-Entity Asset Transfers

In October 2016, the FASB issued Accounting Standards Update No. 2016-16—Income Taxes (Topic 740): Intra-Entity Transfers of Assets Other Than Inventory. The new guidance requires the recognition of the income tax consequences of an intercompany asset transfer, other than transfers of inventory, when the transfer occurs. For intercompany transfers of inventory, the income tax effects will continue to be deferred until the inventory has been sold to a third party. The new guidance is effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. Early adoption is permitted. The Company is evaluating the impact of adopting this new accounting standard on its consolidated financial statements.

NOTE 4—BUSINESS COMBINATION

On May 27, 2016, the Company acquired a controlling interest in Design Investors WW Acquisition Company, LLC, which owns the business operating under the name “Waterworks.” The purchase price of the acquisition was approximately $119.9 million consisting of $118.4 million funded with available cash and $1.5 million representing the fair value of rollover units. The rollover units, which are classified as a liability, are included in non-current liabilities on the consolidated balance sheets (refer to Note 16—Stock-Based Compensation). After the transaction, and giving effect to equity interests acquired by management in the business, the Company owns in excess of 90% of the total equity interest in Waterworks, and owns 100% of the voting equity interest.

The Company did not incur any acquisition-related costs during fiscal 2017. In fiscal 2016, the Company incurred $2.8 million of acquisition-related costs associated with the transaction. These costs and expenses include fees associated with financial, legal and accounting advisors, and employment related costs, and are included in selling, general and administrative expenses on the consolidated statements of income.

The Company recorded a purchase price allocation adjustment of $1.9 million during the first half of 2017. The adjustment primarily related to a subset of inventory acquired for which the Company completed a fair value analysis based on the facts and circumstances that existed as of the acquisition date. Subsequent to the acquisition date, only a small portion of such inventory had been sold and therefore the impact on the Company's results of operations for historical periods since the acquisition was insignificant. The following table summarizes the purchase price allocation based on the estimated fair value of the acquired assets and assumed liabilities, prior to and after the purchase price allocation adjustments (in thousands):

	January 28, 2017	Purchase Price Allocation Adjustments	Final Purchase Price Allocation
Tangible assets acquired and liabilities assumed	$18,615	$ (1,916)	$16,699
Trademarks	52,100	—	52,100
Goodwill	49,229	1,916	51,145
Total	$119,944	$ —	$119,944

Any future changes to the purchase price will be recorded directly to the consolidated statements of income and will not impact the goodwill recorded as a result of the acquisition.

Under purchase accounting rules, the Company valued the acquired finished goods inventory to fair value, which is defined as the estimated selling price less the sum of (a) costs of disposal and (b) a reasonable profit allowance for the Company's selling effort. This valuation resulted in an increase in inventory carrying value of approximately $9.7 million for marketable inventory.

Trademarks have been assigned an indefinite life and therefore are not subject to amortization. The goodwill is representative of the benefits and expected synergies from the integration of Waterworks products and Waterworks' management and employees, which do not qualify for separate recognition as an intangible asset. A portion of the trademarks and goodwill are not deductible for tax purposes.

Results of operations of Waterworks have been included in the Company's consolidated statements of income since the May 27, 2016 acquisition date. Pro forma results of the acquired business have not been presented as the results were not considered material to the Company's consolidated financial statements for all periods presented and would not have been material had the acquisition occurred at the beginning of fiscal 2016.

NOTE 5—PREPAID EXPENSE AND OTHER ASSETS

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

	February 3, 2018	January 28, 2017
Capitalized catalog costs	$44,122	$61,258
Vendor deposits	9,701	13,276
Federal tax receivable	—	13,124
Prepaid expense and other current assets	14,762	29,504
Total prepaid expense and other current assets	$68,585	$117,162

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

	February 3, 2018	January 28, 2017
Construction related deposits	$7,407	$28,044
Other deposits	4,997	4,706
Deferred financing fees	4,446	1,530
Other non-current assets	4,482	1,889
Total other non-current assets	$21,332	$36,169

NOTE 6—PROPERTY AND EQUIPMENT

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

	February 3, 2018	January 28, 2017
Leasehold improvements [1]	$556,443	$439,574
Computer software	130,890	120,051
Furniture, fixtures and equipment	81,469	73,730
Machinery, equipment and aircraft	52,757	50,979
Land	11,382	11,396
Building and building improvements	4,927	10,113
Build-to-suit property [2]	237,909	202,713
Building and equipment under capital leases	8,060	7,603
Total property and equipment	1,083,837	916,159
Less—accumulated depreciation and amortization [3]	(283,139)	(234,103)
Total property and equipment—net	$800,698	$682,056

(1) Leasehold improvements include construction in progress of $110.4 million and $68.4 million as of February 3, 2018 and January 28, 2017, respectively.
(2) The Company capitalizes assets and records a corresponding non-current liability for build-to-suit lease transactions where it is considered the owner, for accounting purposes. Refer to “Lease Accounting” within Note 3—Significant Accounting Policies.
(3) Includes accumulated amortization related to equipment under capital leases of $2.1 million and $1.6 million as of February 3, 2018 and January 28, 2017, respectively.

The Company recorded depreciation expense of $70.0 million, $56.9 million, and $44.2 million in fiscal 2017, fiscal 2016, and fiscal 2015, respectively.

NOTE 7—GOODWILL AND TRADEMARKS AND DOMAIN NAMES

The following sets forth the fiscal 2017 goodwill and trademarks and domain names activity for the RH Segment and Waterworks (in thousands):

	January 28, 2017	Additions	Purchase Price Allocation Adjustments [1]	Impairment [2]	Foreign Currency Translation	February 3, 2018
RH Segment						
Goodwill	$124,374	$ —	$ —	$ —	$ 74	$124,448
Trademarks and domain names	48,524	39	—	—	—	48,563

Waterworks [1]						
Goodwill	49,229	—	1,916	(33,700)	—	17,445
Trademarks	52,100	—	—	—	—	52,100

(1) The Company recorded goodwill and trademarks of $49.2 million and $52.1 million, respectively, in fiscal 2016 related to its acquisition of Waterworks. During fiscal 2017, Waterworks goodwill increased due to purchase price accounting adjustments. Refer to Note 4—Business Combination.

(2) Refer to “Impairment” within Note 3—Significant Accounting Policies.

NOTE 8—ACCOUNTS PAYABLE, ACCRUED EXPENSES AND OTHER CURRENT LIABILITIES

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

	February 3, 2018	January 28, 2017
Accounts payable	$195,313	$134,720
Accrued compensation	47,534	26,886
Accrued freight and duty	23,757	27,955
Accrued sales taxes	19,525	14,908
Accrued catalog costs	9,000	3,874
Accrued occupancy	8,612	8,137
Accrued professional fees	3,555	2,082
Other accrued expenses	11,469	8,418
Total accounts payable and accrued expenses	$318,765	$226,980

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

	February 3, 2018	January 28, 2017
Unredeemed gift card and merchandise credit liability	$24,138	$24,524
Allowance for sales returns	10,565	10,077
Current portion of non-current debt	6,033	—
Federal and state tax payable	5,391	619
Product recall reserve	1,201	4,324
Other liabilities	3,838	3,727
Total other current liabilities	$51,166	$43,271

NOTE 9—OTHER NON-CURRENT OBLIGATIONS

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

	February 3, 2018	January 28, 2017
Notes payable for share repurchases	$19,390	$19,390
Equipment security notes [(1)]	13,864	—
Promissory note [(2)]	11,627	—
Lease loss liabilities	9,684	3,188

Capital lease obligations—non-current	7,509	7,242
Deferred contract incentive (3)	5,358	7,739
Unrecognized tax benefits	3,728	2,508
Rollover units and profit interests (4)	2,211	1,784
Other non-current obligations	2,996	2,833
Total other non-current obligations	$76,367	$44,684

(1) Represents the non-current portion of equipment security notes secured by certain of the Company's distribution center property and equipment.
(2) Represents the non-current portion of a promissory note secured by the Company's aircraft.
(3) Represents the non-current portion of an incentive payment received in relation to a 5-year service agreement. The amount will be amortized over the term of the agreement.
(4) Represents rollover units and profit interests associated with the acquisition of Waterworks. Refer to Note 16—Stock-Based Compensation.

NOTE 10—CONVERTIBLE SENIOR NOTES

0.00% Convertible Senior Notes due 2020

In June 2015, the Company issued in a private offering $250 million principal amount of 0.00% convertible senior notes due 2020 and, in July 2015, the Company issued an additional $50 million principal amount pursuant to the exercise of the overallotment option granted to the initial purchasers as part of its June 2015 offering (collectively, the “2020 Notes”). The 2020 Notes are governed by the terms of an indenture between the Company and U.S. Bank National Association, as the Trustee. The 2020 Notes will mature on July 15, 2020, unless earlier purchased by the Company or converted. The 2020 Notes will not bear interest, except that the 2020 Notes will be subject to “special interest” in certain limited circumstances in the event of the failure of the Company to perform certain of its obligations under the indenture governing the 2020 Notes. The 2020 Notes are unsecured obligations and do not contain any financial covenants or restrictions on the payments of dividends, the incurrence of indebtedness or the issuance or repurchase of securities by the Company or any of its subsidiaries. Certain events are also considered “events of default” under the 2020 Notes, which may result in the acceleration of the maturity of the 2020 Notes, as described in the indenture governing the 2020 Notes. The 2020 Notes are guaranteed by the Company’s primary operating subsidiary, Restoration Hardware, Inc., as Guarantor. The guarantee is the unsecured obligation of the Guarantor and is subordinated to the Guarantor’s obligations from time to time with respect to its credit agreement and ranks equal in right of payment with respect to Guarantor’s other obligations.

The initial conversion rate applicable to the 2020 Notes is 8.4656 shares of common stock per $1,000 principal amount of 2020 Notes, which is equivalent to an initial conversion price of approximately $118.13 per share. The conversion rate will be subject to adjustment upon the occurrence of certain specified events, but will not be adjusted for any accrued and unpaid special interest. In addition, upon the occurrence of a “make-whole fundamental change” as defined in the indenture, the Company will, in certain circumstances, increase the conversion rate by a number of additional shares for a holder that elects to convert its 2020 Notes in connection with such make-whole fundamental change.

Prior to March 15, 2020, the 2020 Notes will be convertible only under the following circumstances: (1) during any calendar quarter commencing after September 30, 2015, if, for at least 20 trading days (whether or not consecutive) during the 30 consecutive trading day period ending on the last trading day of the immediately preceding fiscal quarter, the last reported sale price of the Company’s common stock on such trading day is greater than or equal to 130% of the applicable conversion price on such trading day; (2) during the five consecutive business day period after any ten consecutive trading day period in which, for each day of that period, the trading price per $1,000 principal amount of 2020 Notes for such trading day was less than 98% of the product of the last reported sale price of the Company’s common stock and the applicable conversion rate on such trading day; or (3) upon the occurrence of specified corporate transactions. As of February 3, 2018, none of these conditions have occurred and, as a result, the 2020 Notes are not convertible as of February 3, 2018. On and after March 15, 2020, until the close of business on the second scheduled trading day immediately preceding the maturity date, holders may convert all or a portion of their 2020 Notes at any time, regardless of the foregoing circumstances. Upon conversion, the 2020 Notes will be settled, at the Company’s election, in cash, shares of the Company’s common stock, or a combination of cash and shares of the Company’s common stock. If the Company has not delivered a notice of its election of settlement method prior to the final conversion period it will be deemed to have elected combination settlement with a dollar amount per note to be received upon conversion of $1,000.

The Company may not redeem the 2020 Notes; however, upon the occurrence of a fundamental change (as defined in the indenture governing the notes), holders may require the Company to purchase all or a portion of their 2020 Notes for cash at a price equal to 100% of the principal amount of the 2020 Notes to be purchased plus any accrued and unpaid special interest to, but excluding, the fundamental change purchase date.

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

In accounting for the debt issuance costs related to the issuance of the 2020 Notes, the Company allocated the total amount incurred to the liability and equity components based on their relative values. Debt issuance costs attributable to the liability component are amortized to interest expense using the effective interest method over the expected life of the 2020 Notes, and debt issuance costs attributable to the equity component are netted with the equity component in stockholders' equity (deficit).

Debt issuance costs related to the 2020 Notes were comprised of discounts upon original issuance of $3.8 million and third party offering costs of $2.3 million. Discounts and third party offering costs attributable to the liability component are recorded as a contra-liability and are presented net against the convertible senior notes due 2020 balance on the consolidated balance sheets. The Company recorded $1.0 million, $1.0 million and $0.6 million related to the amortization of debt issuance costs in fiscal 2017, fiscal 2016 and fiscal 2015, respectively, related to the 2020 Notes.

The carrying values of the 2020 Notes, excluding the discounts upon original issuance and third party offering costs, are as follows (in thousands):

	February 3, 2018	January 28, 2017
Liability component		
Principal	$300,000	$300,000
Less: Debt discount	(44,135)	(60,124)
Net carrying amount	$255,865	$239,876
Equity component (1)	$84,003	$84,003

(1) Included in additional paid-in capital on the consolidated balance sheets.

The Company recorded interest expense of $16.0 million, $15.0 million and $8.9 million for the amortization of the debt discount related to the 2020 Notes during fiscal 2017, fiscal 2016 and fiscal 2015, respectively.

2020 Notes—Convertible Bond Hedge and Warrant Transactions

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

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

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

0.00% Convertible Senior Notes due 2019

On June 18, 2014, the Company issued $350 million principal amount of 0.00% convertible senior notes due 2019 (the “2019 Notes”) in a private offering. The 2019 Notes are governed by the terms of an indenture between the Company and U.S. Bank National Association, as the Trustee. The 2019 Notes will mature on June 15, 2019, unless earlier purchased by the Company or converted. The 2019 Notes will not bear interest, except that the 2019 Notes will be subject to “special interest” in certain limited circumstances in the event of the failure of the Company to perform certain of its obligations under the indenture governing the 2019 Notes. The 2019 Notes are unsecured obligations and do not contain any financial covenants or restrictions on the payments of dividends, the incurrence of indebtedness or the issuance or repurchase of securities by the Company or any of its subsidiaries. Certain events are also considered “events of default” under the 2019 Notes, which may result in the acceleration of the maturity of the 2019 Notes, as described in the indenture governing the 2019 Notes.

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

Prior to March 15, 2019, the 2019 Notes will be convertible only under the following circumstances: (1) during any calendar quarter commencing after September 30, 2014, if, for at least 20 trading days (whether or not consecutive) during the 30 consecutive trading day period ending on the last trading day of the immediately preceding fiscal quarter, the last reported sale price of the Company’s common stock on such trading day is greater than or equal to 130% of the applicable conversion price on such trading day; (2) during the five consecutive business day period after any ten consecutive trading day period in which, for each day of that period, the trading price per $1,000 principal amount of 2019 Notes for such trading day was less than 98% of the product of the last reported sale price of the Company’s common stock and the applicable conversion rate on such trading day; or (3) upon the occurrence of specified corporate transactions. As of February 3, 2018, none of these conditions have occurred and, as a result, the 2019 Notes are not convertible as of February 3, 2018. On and after March 15, 2019, until the close of business on the second scheduled trading day immediately preceding the maturity date, holders may convert all or a portion of their 2019 Notes at any time, regardless of the foregoing circumstances. Upon conversion, the 2019 Notes will be settled, at the Company’s election, in cash, shares of the Company’s common stock, or a combination of cash and shares of the Company’s common stock. If the Company has not delivered a notice of its election of settlement method prior to the final conversion period it will be deemed to have elected combination settlement with the specified dollar amount of $1,000.

The Company may not redeem the 2019 Notes; however, upon the occurrence of a fundamental change (as defined in the indenture governing the notes), holders may require the Company to purchase all or a portion of their 2019 Notes for cash at a price equal to 100% of the principal amount of the 2019 Notes to be purchased plus any accrued and unpaid special interest to, but excluding, the fundamental change purchase date.

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

In accounting for the debt issuance costs related to the issuance of the 2019 Notes, the Company allocated the total amount incurred to the liability and equity components based on their relative values. Debt issuance costs attributable to the liability component are amortized to interest expense using the effective interest method over the expected life of the 2019 Notes, and debt issuance costs attributable to the equity component are netted with the equity component in stockholders’ equity (deficit).

Debt issuance costs related to the 2019 Notes were comprised of discounts and commissions payable to the initial purchasers of $4.4 million and third party offering costs of $1.0 million. Discounts, commissions payable to the initial purchasers and third party offering costs attributable to the liability component were recorded as a contra-liability and are presented net against the convertible senior notes balance on the consolidated balance sheets. The Company recorded $0.9 million, $0.8 million and $0.8 million related to the amortization of debt issuance costs in fiscal 2017, fiscal 2016 and fiscal 2015, respectively, related to the 2019 Notes.

The carrying values of the 2019 Notes, excluding the discounts and commissions payable to the initial purchasers and third party offering costs, are as follows (in thousands):

	February 3, 2018	January 28, 2017
Liability component		
Principal	$350,000	$350,000
Less: Debt discount	(20,988)	(35,457)
Net carrying amount	$329,012	$314,543
Equity component [(1)]	$70,482	$70,482

(1) Included in additional paid-in capital on the consolidated balance sheets.

The Company recorded interest expense of $14.5 million, $13.8 million and $13.2 million for the amortization of the debt discount related to the 2019 Notes in fiscal 2017, fiscal 2016 and fiscal 2015, respectively.

2019 Notes—Convertible Bond Hedge and Warrant Transactions

In connection with the offering of the 2019 Notes, the Company entered into convertible note hedge transactions whereby the Company has the option to purchase a total of approximately 3.0 million shares of its common stock at a price of approximately $116.09 per share. The total cost of the convertible note hedge transactions was $73.3 million. In addition, the Company sold warrants whereby the holders of the warrants have the option to purchase a total of approximately 3.0 million shares of the Company’s common stock at a price of $171.98 per share. The warrants contain certain adjustment mechanisms whereby the total number of shares to be purchased under such warrants may be increased up to a cap of 6.0 million shares of common stock (which cap may also be subject to adjustment). The Company received $40.4 million in cash proceeds from the sale of these warrants. Taken together, the purchase of the convertible note hedges and sale of the warrants are intended to offset any actual dilution from the conversion of the 2019 Notes and to effectively increase the overall conversion price from $116.09 per share to $171.98 per share. As these transactions meet certain accounting criteria, the convertible note hedges and warrants are recorded in stockholders’ equity (deficit), are not accounted for as derivatives and are not remeasured each reporting period. The net costs incurred in connection with the convertible note hedge and warrant transactions were recorded as a reduction to additional paid-in capital on the consolidated balance sheets.

The Company recorded a deferred tax liability of $27.5 million in connection with the debt discount associated with the 2019 Notes and recorded a deferred tax asset of $28.6 million in connection with the convertible note hedge transactions. The deferred tax liability and deferred tax assets are included in non-current deferred tax assets on the consolidated balance sheets.

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

NOTE 11—CREDIT FACILITIES

The following credit facilities were outstanding as of February 3, 2018 (in thousands):

	Outstanding Amount	Unamortized Debt Issuance Costs	Net Carrying Amount
Asset based credit facility	$ 199,970	$ —	$ 199,970
LILO term loan	80,000	(501)	79,499
Total credit facilities	$ 279,970	$ (501)	$ 279,469

Asset Based Credit Facility & LILO Term Loan

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.

On June 28, 2017, Restoration Hardware, Inc. entered into an eleventh amended and restated credit agreement among Restoration Hardware, Inc., Restoration Hardware Canada, Inc., various subsidiaries of RH named therein as borrowers or guarantors, the lenders party thereto and Bank of America, N.A. as administrative agent and collateral agent (the "credit agreement"). The credit agreement has a revolving line of credit with availability of up to $600.0 million, of which $10.0 million is available to Restoration Hardware Canada, Inc., and includes a $200.0 million accordion feature under which the revolving line of credit may be expanded by agreement of the parties from $600.0 million to up to $800 million if and to the extent the lenders revise their credit commitments to encompass a larger facility. In addition, the credit agreement establishes an $80.0 million LILO term loan facility.

The Company incurred $3.9 million of deferred financing fees related to the credit agreement, which are included in other non-current assets on the consolidated balance sheets, and will be amortized on a straight line basis over the life of the revolving line of credit, which has a maturity date of June 28, 2022. As a result of the credit agreement, unamortized deferred financing fees of $0.1 million related to the previous facility were expensed during fiscal 2017 and $1.1 million related to the previous facility will be amortized over the life of the new revolving line of credit.

The Company incurred $0.6 million of debt issuance costs related to the LILO term loan facility, which are presented net against the term loans balance on the consolidated balance sheets, and will be amortized over the life of the revolving line of credit.

The availability of credit at any given time under the credit agreement is limited by reference to a borrowing base formula based upon numerous factors, including the value of eligible inventory and eligible accounts receivable. As a result of the borrowing base formula, actual borrowing availability under the revolving line of credit could be less than the stated amount of the revolving line of credit (as reduced by the actual borrowings and outstanding letters of credit under the revolving line of credit). All obligations under the credit agreement are secured by substantially all of the assets, including accounts receivable, inventory, intangible assets, property, equipment, goods and fixtures of Restoration Hardware, Inc., Restoration Hardware Canada, Inc., RH US, LLC, Waterworks Operating Co., LLC and Waterworks IP Co., LLC.

Borrowings under the revolving line of credit and LILO term loan facility are subject to interest, at the borrowers' option, at either the bank's reference rate or LIBOR (or, in the case of the revolving line of credit, the Bank of America "BA" Rate or the Canadian Prime Rate, as such terms are defined in the credit agreement, for Canadian borrowings denominated in Canadian dollars or the United States Index Rate or LIBOR for Canadian borrowings denominated in United States dollars) plus an applicable margin rate, in each case.

The credit agreement contains various restrictive covenants, including, among others, limitations on the ability to incur liens, make loans or other investments, incur additional debt, issue additional equity, merge or consolidate with or into another person, sell assets, pay dividends or make other distributions, or enter into transactions with affiliates, along with other restrictions and limitations typical to credit agreements of this type and size.

In addition, under the credit agreement, the Company is required to meet specified financial ratios in order to undertake certain actions, and the Company may be required to maintain certain levels of excess availability or meet a specified consolidated fixed-charge coverage ratio ("FCCR"). The trigger for the FCCR occurs if the domestic availability under the revolving line of credit is less than the greater of (i) $40.0 million and (ii) 10% of the sum of (a) the lesser of (x) the aggregate revolving commitments under the credit agreement and (y) the aggregate revolving borrowing base, plus (b) the lesser of (x) the then outstanding amount of the LILO term loan or (y) the LILO term loan borrowing base. If the availability under the credit agreement is less than the foregoing amount, then Restoration Hardware, Inc. is required to maintain an FCCR of at least one to one. As of February 3, 2018, Restoration Hardware, Inc. was in compliance with all applicable covenants of the credit agreement.

The credit agreement requires a daily sweep of all cash receipts and collections to prepay the loans under the agreement while (i) an event of default exists or (ii) the availability under the revolving line of credit for extensions of credit is less than the greater of (A) $40.0 million and (B) 10% of the sum of (a) the lesser of (x) the aggregate revolving commitments under the credit agreement and (y) the aggregate revolving borrowing base, plus (b) the lesser of (x) the then outstanding amount of the LILO term loan or (y) the LILO term loan borrowing base.

As of February 3, 2018, Restoration Hardware, Inc. had $200.0 million in outstanding borrowings and $186.4 million of availability under the revolving line of credit, net of $33.8 million in outstanding letters of credit. As of February 3, 2018, Restoration Hardware, Inc. had $80.0 million outstanding borrowings under the LILO term loan facility. As a result of the consolidated FCCR restriction that limits the last 10% of borrowing availability, actual incremental borrowing available to the Company and the other affiliated parties under the revolving line of credit was approximately $136.4 million as of February 3, 2018.

Second Lien Credit Agreement

On July 7, 2017, Restoration Hardware, Inc., a wholly-owned subsidiary of RH, entered into a credit agreement (the "second lien credit agreement"), dated as of July 7, 2017, among Restoration Hardware, Inc., as lead borrower, the guarantors party thereto, the lenders party thereto, each of whom are funds and accounts managed or advised by Apollo Capital Management, L.P., and its affiliated investment managers, and Wilmington Trust, National

Association as administrative agent and collateral agent with respect to an initial term loan in an aggregate principal amount equal to $100.0 million with a maturity date of January 7, 2023 (the “second lien term loan”). The Company incurred $3.6 million of debt issuance costs related to the second lien credit agreement. The second lien term loan of $100.0 million was repaid in full on October 10, 2017. As a result of the repayment, the Company incurred a $4.9 million loss on extinguishment of debt, which includes a prepayment penalty of $3.0 million and acceleration of amortization of debt issuance costs of $1.9 million.

The second lien term loan bore interest at an annual rate generally based on LIBOR plus 8.25%. This rate was a floating rate that reset periodically based upon changes in LIBOR rates during the life of the second lien term loan. At the date of borrowing, the rate was set at one month LIBOR plus 8.25%.

All obligations under the second lien term loan were secured by a second lien security interest in assets of the loan parties including inventory, receivables and certain types of intellectual property. The second lien security interest was granted with respect to substantially the same collateral that secures the credit agreement. The second lien ranked junior in priority and is subordinated to the first lien in favor of the lenders with respect to the credit agreement.

The second lien credit agreement contained various restrictive and affirmative covenants generally in line with the covenants and restrictions contained in the credit agreement including required financial reporting, limitations on the ability to incur liens, make loans or other investments, incur additional debt, make certain restricted payments, or enter into transactions with affiliates, along with other restrictions and limitations typical to credit agreements of this type and size.

The second lien credit agreement also contained a financial ratio covenant not found in the credit agreement based upon a senior secured leverage ratio of consolidated secured debt to consolidated earnings before interest, taxes, depreciation and amortization ("EBITDA").

The second lien credit agreement also contained a consolidated fixed charge coverage ratio generally based on the same formulation set forth in the credit agreement such that the borrower may not make certain "restricted payments" in the event that certain ratios were not met and contained certain events of default and other customary terms and conditions for a second lien credit agreement.

Intercreditor Agreement

On July 7, 2017, in connection with the second lien credit agreement, Restoration Hardware, Inc. entered into an intercreditor agreement (the "intercreditor agreement") with the administrative agent and collateral agent under the credit agreement and the administrative agent and collateral agent under the second lien credit agreement. The intercreditor agreement established various customary inter-lender terms, including, without limitation, with respect to priority of liens, permitted actions by each party, application of proceeds, exercise of remedies in case of default, releases of liens and certain limitations on the amendment of the credit agreement and the second lien credit agreement without the consent of the other party. The intercreditor agreement was terminated upon repayment of the second lien term loan on October 10, 2017.

NOTE 12—FAIR VALUE OF FINANCIAL INSTRUMENTS

Financial Assets and Liabilities

Certain financial assets and liabilities are required to be carried at fair value. Fair value is the price that would be received to sell an asset, or paid to transfer a liability, in an orderly transaction between market participants at the measurement date. In determining the fair value, the Company utilizes market data or assumptions that it believes market participants would use in pricing the asset or liability, which would maximize the use of observable inputs and minimize the use of unobservable inputs to the extent possible, including assumptions about risk and the risks inherent in the inputs of the valuation technique.

The degree of judgment used in measuring the fair value of financial instruments generally correlates to the level of pricing observability. Pricing observability is impacted by a number of factors, including the type of financial instrument, whether the financial instrument is new to the market and not yet established and the characteristics specific to the transaction. Financial instruments with readily available active quoted prices for which fair value can be measured generally will have a higher degree of pricing observability and a lesser degree of judgment used in measuring fair value. Conversely, financial instruments rarely traded or not quoted will generally have less, or no, pricing observability and a higher degree of judgment used in measuring fair value.

The Company's financial assets and liabilities measured and reported at fair value are classified and disclosed in one of the following categories:

- Level 1—Quoted prices are available in active markets for identical investments as of the reporting date.
- Level 2—Pricing inputs are other than quoted prices in active markets, which are either directly or indirectly observable as of the reporting date, and fair value is determined through the use of models or other valuation methodologies.
- Level 3—Pricing inputs are unobservable for the investment and include situations where there is little, if any, market activity for the investment. The inputs used in the determination of fair value require significant management judgment or estimation.

A financial instrument's categorization within the fair value hierarchy is based upon the lowest level of input that is significant to the fair value measurement.

Fair Value Measurements

All of the Company’s investments are classified as available-for-sale and are carried at fair value. The Company did not hold any short-term or long-term investments as of February 3, 2018. Assets measured at fair value were as follows as of January 28, 2017 (in thousands):

	Level 1	Level 2	Total
Cash equivalents			
Money market funds	$2,510	$—	$2,510
Commercial paper	—	5,493	5,493
Total cash equivalents	2,510	5,493	8,003
Short-term investments			
Commercial paper	—	34,534	34,534
Government agency obligations	2,553	105,590	108,143
Total short-term investments	2,553	140,124	142,677
Long-term investments			
Government agency obligations	—	33,212	33,212
Total long-term investments	—	33,212	33,212
Total	$5,063	$178,829	$183,892

The following table summarizes the amortized cost and estimated fair value of the available-for-sale securities within the Company’s investment portfolio as of January 28, 2017 based on stated maturities, which are recorded within cash and cash equivalents, short-term investments and long-term investments on the consolidated balance sheets (in thousands):

	Cost	Fair Value
Range of maturity		
Due within 1 year	$148,155	$148,170
Due in 1 to 2 years	$33,238	$33,212

The Company invests excess cash primarily in investment-grade interest-bearing securities such as money market funds, certificates of deposit, commercial paper, government agency obligations and guaranteed obligations of the U.S. government, all of which are subject to minimal credit and market risks. The Company estimates the fair value of its commercial paper and U.S. government agency bonds by taking into consideration valuations obtained from third party pricing services. The pricing services utilize industry standard valuation models, including both income and market based approaches, for which all significant inputs are observable, either directly or indirectly, to estimate fair value. These inputs include reported trade dates of and broker/dealer quotes on the same or similar securities; issuer credit spreads; benchmark securities, prepayment/default projections based on historical data; and other observable inputs.

There were no purchases, sales, issuances, or settlements related to recurring level 3 measurements during fiscal 2017 and fiscal 2016. There were no transfers into or out of level 1 and level 2 during fiscal 2017 and fiscal 2016.

Fair Value of Financial Instruments

Amounts reported as cash and equivalents, receivables, and accounts payable and accrued expenses approximate fair value due to the short-term nature of activity within these accounts. The estimated fair value and carrying value of the 2019 Notes and 2020 Notes were as follows (in thousands):

	February 3, 2018		January 28, 2017	
	Fair Value	Carrying Value (1)	Fair Value	Carrying Value (1)
Convertible senior notes due 2019	$324,866	$329,012	$295,381	$314,543
Convertible senior notes due 2020	$261,047	$255,865	$232,463	$239,876

(1) Carrying value represents the principal amount less the equity component of the 2019 Notes and 2020 Notes classified in stockholders' equity (deficit), and does not exclude the discounts upon original issuance, discounts and commissions payable to the initial purchasers and third party offering costs, as applicable.

The fair value of each of the 2019 Notes and 2020 Notes was determined based on inputs that are observable in the market or that could be derived from, or corroborated with, observable market data, including the trading price of the Company's convertible notes, when available, the Company's stock price and interest rates based on similar debt issued by parties with credit ratings similar to the Company (Level 2).

The estimated fair value of the asset based credit facility and LILO term loan was $200.0 million and $80.0 million, respectively, each of which approximates cost, as of February 3, 2018. Fair value approximates cost for both the asset based credit facility and LILO term loan as the interest rate associated with each facility is variable and resets frequently.

NOTE 13—INCOME TAXES

The United States enacted the Tax Cuts and Jobs Act (the "Tax Act") on December 22, 2017, which had a significant impact to the Company's fiscal 2017 provision for income taxes. The Tax Act includes a number of changes to existing U.S. tax laws that impact the Company, including the reduction of the U.S. corporate income tax rate from 35% to 21% effective January 1, 2018. The Tax Act also provides for a one-time transition tax on accumulated foreign earnings and the acceleration of depreciation for certain assets, as well as prospective changes beginning in 2018, including limitations on the deductibility of executive compensation and interest, the elimination of certain domestic deductions and credits, the elimination of the Alternative Minimum Tax regime, and modifications to the deductibility and carryforward period of net operating losses. The Tax Act transitions U.S. international taxation from a worldwide system to a modified territorial system and includes base erosion prevention measures on non-U.S. earnings, which may have the effect of subjecting certain earnings of the Company's foreign subsidiaries to U.S. taxation. The Company's fiscal 2017 provision for income taxes included $7.0 million of income tax expense as a result of the Tax Act, including $6.0 million for the provisional re-measurement of the Company's net deferred tax assets for the reduction in the U.S. corporate income tax rate from 35% to 21% and a $1.0 million charge for Company's provisional estimate of the transition tax.

In December 2017, the SEC staff issued Staff Accounting Bulletin No. 118—Income Tax Accounting Implications of the TCJA ("SAB 118"), which allows the Company to record provisional amounts during a measurement period not to extend beyond one year of the enactment date. Since the Tax Act was passed late in the fourth quarter of fiscal 2017, and ongoing guidance and accounting interpretation are expected over the next 12 months, the Company considers the accounting of the transition tax, deferred tax re-measurements and other items to be incomplete due to the forthcoming guidance and its ongoing analysis of final year-end data and tax positions. The Company expects to complete its analysis within the measurement period in accordance with SAB 118.

The following is a summary of the income before income taxes (in thousands):

	Year Ended		
	February 3, 2018	January 28, 2017	January 30, 2016
Domestic	$28,859	$8,370	$148,756
Foreign	1,292	184	1,128

Total income before income taxes	$30,151	$8,554	$149,884

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

	Year Ended February 3, 2018	January 28, 2017	January 30, 2016
Current			
Federal	$18,593	$751	$55,676
State	2,761	2,410	9,112
Foreign	933	694	227
Total current tax expense	22,287	3,855	65,015
Deferred			
Federal	6,042	2,109	(5,691)
State	(355)	(2,414)	(648)
Foreign	(3)	(397)	105
Total deferred tax expense (benefit)	5,684	(702)	(6,234)
Total income tax expense	$27,971	$3,153	$58,781

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

	Year Ended February 3, 2018	January 28, 2017	January 30, 2016
Provision at federal statutory tax rate	33.7 %	35.0 %	35.0 %
Non-deductible stock-based compensation	26.7	—	—
Federal statutory tax rate change	20.1	—	—
Goodwill impairment	17.9	—	—
State income taxes—net of federal tax impact	4.8	4.8	3.7
Aircraft expenses	3.6	3.3	0.1
Foreign income inclusion—transition tax	3.3	—	—
Meals and entertainment	1.5	5.0	0.2
Net adjustments to tax accruals and other	1.4	1.2	0.1
Other permanent items	1.3	2.8	0.1
Valuation allowance	1.1	0.9	—
Transaction costs	—	2.6	—
Stock compensation—excess benefits	(20.9)	—	—
Foreign income	(0.9)	(4.2)	(0.1)
Tax rate adjustments	(0.6)	(5.8)	0.1
Donation of appreciated property	(0.2)	(8.7)	—
Effective tax rate	92.8 %	36.9 %	39.2 %

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

	February 3, 2018	January 28, 2017
Non-current deferred tax assets (liabilities)		
Stock-based compensation	$25,047	$37,804
Deferred lease credits	18,355	25,457
Inventory	16,132	37,198
Accrued expense	10,488	18,024
Deferred revenue	3,313	1,887
Net operating loss carryforwards	1,584	1,044
U.S. impact of Canadian transfer pricing	1,089	1,404
Charitable contributions	106	1,877
Property and equipment	(21,869)	(32,396)
Trademarks and intangibles	(14,991)	(28,345)
Prepaid expense and other	(12,379)	(28,387)
State tax benefit	(2,394)	(4,143)
Convertible senior notes	(1,890)	(3,867)
Other	1,910	1,669

Non-current deferred tax assets	24,501	29,226
Valuation allowance	(1,190)	(760)
Net non-current deferred tax assets	$23,311	$28,466

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

	Year Ended		
	February 3, 2018	January 28, 2017	January 30, 2016
Balance at beginning of fiscal year	$760	$ 158	$ 176
Net changes in deferred tax assets and liabilities	430	602	(18)
Balance at end of fiscal year	$1,190	$ 760	$ 158

102

The Company has recorded deferred tax assets and liabilities based upon estimates of their realizable value, such estimates are based upon likely future tax consequences. In assessing the need for a valuation allowance, the Company considers both positive and negative evidence related to the likelihood of realization of the deferred tax assets. If, based on the weight of available evidence, it is more likely than not that the deferred tax assets will not be realized, the Company records a valuation allowance.

As of February 3, 2018 and January 28, 2017, the Company had $1.2 million and $0.8 million, respectively, in valuation allowances against deferred tax assets in certain foreign jurisdictions due to historical losses.

As of February 3, 2018, the Company had state net operating loss carryovers of $2.4 million and foreign net operating loss carryovers of $7.1 million. The state net operating loss carryovers will begin to expire in 2022, and the foreign net operating loss carryovers have an indefinite carryforward. 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 3, 2018	January 28, 2017	January 30, 2016
Balance at beginning of fiscal year	$2,190	$921	$ 940
Gross increases (decreases)—prior period tax positions	5,491	53	(88)
Gross increases—current period tax positions	471	1,216	69
Balance at end of fiscal year	$8,152	$2,190	$ 921

As of February 3, 2018, the Company has $8.2 million of unrecognized tax benefits, of which $6.5 million would reduce income tax expense and the effective tax rate, if recognized. The remaining unrecognized tax benefits would offset other deferred tax assets, if recognized. In October 2017, the Company filed an amended federal tax return claiming a $5.4 million refund, however, no income tax benefit was recorded during fiscal 2017 given the technical nature and amount of the refund claim. An income tax benefit related to this refund claim could be recorded in a future period upon settlement with the respective taxing authority. As of February 3, 2018, the Company has $0.4 million of exposures related to unrecognized tax benefits that are expected to decrease in the next 12 months.

The Company accounts for interest and penalties related to exposures as a component of income tax expense. The Company had interest accruals of $0.5 million and $0.3 million associated with exposures as of February 3, 2018, and January 28, 2017, respectively.

The Company is subject to taxation in the United States and various states and foreign jurisdictions. As of February 3, 2018, the Company is subject to examination by the tax authorities for fiscal 2014, fiscal 2015 and fiscal 2016. With few exceptions, as of February 3, 2018, the Company is no longer subject to U.S. federal, state, local, or foreign examinations by tax authorities for years before fiscal 2014.

NOTE 14—NET INCOME PER SHARE

The weighted-average shares used for net income per share is as follows:

	Year Ended February 3, 2018	January 28, 2017	January 30, 2016
Weighted-average shares—basic	27,053,616	40,691,483	40,190,448
Effect of dilutive stock-based awards	2,199,592	235,357	2,066,111
Weighted-average shares—diluted	29,253,208	40,926,840	42,256,559

The following number of options and restricted stock units were excluded from the calculation of diluted net income per share because their inclusion would have been anti-dilutive:

	Year Ended February 3, 2018	January 28, 2017	January 30, 2016
Options	2,895,471	7,243,697	522,390
Restricted stock units	229,308	609,676	12,916
Total anti-dilutive stock-based awards	3,124,779	7,853,373	535,306

NOTE 15—SHARE REPURCHASES

$700 Million Share Repurchase Program

On May 2, 2017, the Company's Board of Directors authorized a stock repurchase program of up to $700 million (the "$700 Million Repurchase Program"). Under the $700 Million Repurchase Program, the Company repurchased approximately 12.4 million shares of its common stock at an average price of $56.60 per share, for an aggregate repurchase amount of approximately $700 million, during the three months ended July 29, 2017. As the $700 Million Repurchase Program was completed during the three months ended July 29, 2017, no additional shares were repurchased during the six months ended February 3, 2018 and there will be no repurchases in future periods under this repurchase authorization.

$300 Million Share Repurchase Program

On February 21, 2017, the Company's Board of Directors authorized a stock repurchase program of up to $300 million (the "$300 Million Repurchase Program"). Under the $300 Million Repurchase Program, the Company repurchased approximately 7.8 million shares of its common stock at an average price of $38.24 per share, for an aggregate repurchase amount of approximately $300 million, during the three months ended April 29, 2017. As the $300 Million Repurchase Program was completed during the three months ended April 29, 2017, no additional shares were repurchased during the nine months ended February 3, 2018 and there will be no repurchases in future periods under this repurchase authorization.

Share Repurchases Under Equity Plans

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. The repurchases are settled with the issuance of promissory notes that bear interest, which is paid annually. The Company did not repurchase any shares or issue any promissory notes in fiscal 2017 or fiscal 2016. The Company's repurchase and promissory note issuance activity for fiscal 2015 is as follows:

	Year Ended January 30, 2016	
Shares repurchased	2,625	
Fair value at purchase price (in thousands)	$ 238	
Weighted-average interest rate	3	%
Weighted-average term	7 years	

As of both February 3, 2018 and January 28, 2017, the aggregate unpaid principal amount of the notes payable for share repurchases of $19.4 million is included in other non-current obligations on the consolidated balance sheets. The Company recorded interest expense on the outstanding notes of $1.0 million in each of fiscal 2017, fiscal 2016 and fiscal 2015.

Of the $19.4 million notes payable for share repurchases outstanding as of both February 3, 2018 and January 28, 2017, $15.5 million was due to a current board member of the Company

NOTE 16—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 an award will vest, the Company recognizes compensation expense equal to the number of shares which are probable to vest multiplied by the fair value of the related shares measured at the grant date.

Stock-based compensation expense is included in selling, general and administrative expenses on the consolidated statements of income. The Company recorded stock-based compensation expense of $50.7 million, $29.2 million and $24.2 million in fiscal 2017, fiscal 2016 and fiscal 2015, respectively. No stock-based compensation cost has been capitalized in the accompanying consolidated financial statements.

2012 Stock Incentive Plan and 2012 Stock Option Plan

The Restoration Hardware 2012 Stock Incentive Plan (the “Stock Incentive Plan”) was adopted on November 1, 2012. The Stock Incentive Plan provides for the grant of incentive stock options to the Company’s employees, non-qualified stock options, stock appreciation rights, restricted stock, restricted stock units, dividend equivalent rights, cash-based awards and any combination thereof to the Company’s employees, directors and consultants and the Company’s parent and subsidiary corporations’ employees, directors and consultants.

The Restoration Hardware 2012 Stock Option Plan (the “Option Plan”) was adopted on November 1, 2012 and on such date 6,829,041 fully vested options were granted under this plan to certain of the Company’s employees and advisors. Aside from these options granted on November 1, 2012, no other awards will be granted under the Option Plan.

As of January 28, 2017, there were a total of 415,530 shares issuable under the Stock Incentive Plan. On January 30, 2017, an additional 816,573 shares became issuable under the Stock Incentive Plan in accordance with the Stock Incentive Plan evergreen provision, increasing the total number of shares issuable under the Stock Incentive Plan to 1,232,103. Awards under the plans reduce the number of shares available for future issuance. Cancellations and forfeitures of awards previously granted under the Stock Incentive Plan increase the number of shares available for future issuance. Cancellations and forfeitures of awards previously granted under the Option Plan are immediately retired and are no longer available for future issuance.

The number of shares available for future issuance under the Stock Incentive Plan as of February 3, 2018 was 495,653. Shares issued as a result of award exercises under the Stock Incentive Plan and Option Plan and will be funded with the issuance of new shares. On February 5, 2018, an additional 430,347 shares became issuable under the Stock Incentive Plan in accordance with the Stock Incentive Plan evergreen provision.

2012 Stock Incentive Plan and 2012 Stock Option Plan—Stock Options

A summary of stock option activity under the Stock Incentive Plan and the Option Plan for fiscal 2017 is as follows:

	Options	Weighted-Average Exercise Price
Outstanding—January 28, 2017	8,473,659	$ 49.00
Granted [(1)]	1,242,400	50.21

Exercised	(729,593)		35.77
Cancelled	(369,888)		48.04
Outstanding—February 3, 2018	8,616,578	$	50.31

(1) Includes the option granted to Mr. Friedman on May 2, 2017 to purchase 1,000,000 shares of the Company's common stock with an exercise price equal to $50 per share. Refer to Chairman and Chief Executive Officer Option Grant below.

The fair value of stock options issued was estimated on the date of grant using the following assumptions:

	Year Ended February 3, 2018	January 28, 2017	January 30, 2016
Expected volatility	48.3 %	44.9 %	37.7 %
Expected life (years)	9.3	6.5	6.5
Risk-free interest rate	2.2 %	1.4 %	1.8 %
Dividend yield	—	—	—

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

	Year Ended February 3, 2018	January 28, 2017	January 30, 2016
Weighted-average fair value per share of stock options granted	$24.24	$15.88	$36.43
Aggregate intrinsic value of stock options exercised (in thousands)	$27,362	$1,238	$32,590
Fair value of stock options vested (in thousands)	$38,402	$13,726	$8,611

Information about stock options outstanding, vested or expected to vest, and exercisable as of February 3, 2018 is as follows:

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Number of Options	Weighted-Average Remaining Contractual Life (in years)	Weighted-Average Exercise Price	Number of Options	Weighted-Average Exercise Price
$24.00 - $44.52	2,471,758	7.96	$ 34.65	716,698	$ 32.51

$45.21 - $45.82	62,500	9.41	45.22	—	—
$46.50 - $46.50	2,976,826	4.74	46.50	2,976,826	46.50
$47.53 - $75.43	2,615,885	7.21	62.24	2,263,415	62.56
$76.80 - $101.84	489,609	7.14	89.35	188,215	88.65
Total	8,616,578	6.58	$ 50.31	6,145,154	$ 52.08
Vested or expected to vest	7,788,663	6.41	$ 50.92		

The aggregate intrinsic value of options outstanding, options vested or expected to vest, and options exercisable as of February 3, 2018 was $360.1 million, $320.7 million, and $245.8 million, respectively. Stock options exercisable as of February 3, 2018 had a weighted-average remaining contractual life of 6.10 years.

The Company recorded stock-based compensation expense for stock options of $37.5 million, $16.3 million and $10.4 million in fiscal 2017, fiscal 2016 and fiscal 2015, respectively. The fiscal 2017 expense of $37.5 million includes the $23.9 million of expense associated with the option grant to Mr. Friedman in May 2017. Refer to Chairman and Chief Executive Officer Option Grant below. As of February 3, 2018, the total unrecognized compensation expense related to unvested options was $24.6 million, which is expected to be recognized on a straight-line basis over a weighted-average period of 3.07 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 for fiscal 2017 is as follows:

	Awards	Weighted-Average Grant Date Fair Value	Intrinsic Value
Outstanding—January 28, 2017	1,118,019	$ 53.52	
Granted	105,981	55.31	
Released	(287,957)	58.48	
Cancelled	(133,330)	49.47	
Outstanding—February 3, 2018	802,713	$ 52.65	$73,881,705

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

	Year Ended February 3, 2018	January 28, 2017	January 30, 2016
Weighted-average fair value per share of awards granted	$55.31	$40.18	$90.14
Grant date fair value of awards released (in thousands)	$16,839	$5,170	$12,223

The Company recorded stock-based compensation expense for restricted stock awards of $12.8 million, $12.6 million and $13.8 million in fiscal 2017, fiscal 2016 and fiscal 2015, respectively. As of fiscal 2017, the total unrecognized compensation expense related to unvested restricted stock awards was $20.9 million, which is expected to be recognized on a straight-line basis over a weighted-average period of 3.05 years.

Chairman and Chief Executive Officer Option Grant

On May 2, 2017, the Company's Board of Directors granted Mr. Friedman an option to purchase 1,000,000 shares of the Company's common stock with an exercise price equal to $50 per share.

The option contains dual-condition restrictions consisting of both time-based service restrictions over four years and performance-based restrictions linked to achieving the Company's common stock price objectives of $100, $125 and $150 per share. The option is fully vested on the date of grant but the shares underlying the option remain subject to transfer restrictions to the extent the performance-based and time-based requirements have not been met. The option resulted in a non-cash stock compensation charge of $23.9 million in fiscal 2017, which is included in the $37.5 million stock-based compensation expense for stock options recorded in fiscal 2017 discussed above.

Time-Based Restrictions

The time-based restrictions are measured over an initial four year service period from the date of the award and these restrictions will lapse at the end of each of these first four years at a rate of 250,000 shares per year if (i) Mr. Friedman remains employed at the end of such year, and (ii) the stock price goals have been achieved in such year as described further below.

Performance-Based Restrictions

The stock price objectives are measured each year and are set at prices for the Company's common stock of $100, $125 and $150 per share. If all three stock price objectives are met in the first performance year, restrictions will lapse as to 250,000 shares in aggregate at the end of such year, with 83,333 shares tied to a $100 price per share, 83,333 shares tied to a $125 price per share and 83,334 shares tied to a $150 price per share.

The same price performance tests are applied in the second year of performance such that restrictions will lapse for an additional 250,000 shares at the end of the second year and then again as to an additional 250,000 shares at the end of each of the third and fourth years so long as Mr. Friedman remains employed at the end of each year.

To the extent that any of the price performance objectives is not reached within one of these first four performance years, the stock price objective can be achieved in any subsequent year until the 8th anniversary of the date of grant.

2012 Stock Incentive Plan—Grant to Waterworks Associates

On May 27, 2016, the date of the Company's acquisition of Waterworks, the Company granted stock options to certain Waterworks associates under the Stock Incentive Plan to purchase 322,784 shares of its common stock, with an exercise price of $33.54 per share, which is equal to the closing price of the Company's common stock on the date of grant. These options are fully vested as of the date of grant but any shares issued upon exercise of such options will be subject to selling restrictions which are scheduled to lapse in five equal installments on the first, second, third, fourth and fifth anniversaries of the grant date. The fully vested options resulted in a non-cash stock-based compensation charge of $3.7 million in fiscal 2016, which is included in the $16.3 million stock-based compensation expense for stock options recorded in fiscal 2016 discussed above.

Rollover Units

In connection with the acquisition of Waterworks, $1.5 million rollover units in the Waterworks subsidiary (the "Rollover Units") were recorded as part of the transaction. The Rollover Units are subject to the terms of the Waterworks LLC agreement, including redemption rights at an amount equal to the greater of (i) the $1.5 million remitted as consideration in the business combination or (ii) an amount based on the percentage interest represented in the overall valuation of the Waterworks subsidiary (the "Appreciation Rights"). The Appreciation Rights are measured at fair value and are subject to fair value measurements during the expected life of the Rollover Units, with changes to fair value recorded in the consolidated statements of income. The fair value of the Appreciation Rights is determined based on an option pricing method ("OPM"). The Company did not record any expense related to the Appreciation Rights during fiscal 2017 and fiscal 2016. As of both February 3, 3018 and January 28, 2017, the liability associated with the Rollover Units and related Appreciation Rights was $1.5 million, which is included in other non-current obligations on the consolidated balance sheets.

Profit Interests

In connection with the acquisition of Waterworks, profit interests units in the Waterworks subsidiary (the "Profit Interests") were issued to certain Waterworks associates. The Profit Interests are measured at their grant date fair value and expensed on a straight-line basis over their expected life, or five years. The Profit Interests are subject to fair value measurements during their expected life, with changes to fair value recorded in the consolidated statements of income. The fair value of the Profit Interests is determined based on an OPM. The Company recorded $0.4 million and $0.3 million related to the Profit Interests in fiscal 2017 and fiscal 2016, respectively, which is included in selling, general and administrative expenses on the consolidated statements of income. As of February 3, 2018 and January 28, 2017, the liability associated with the Profit Interests was $0.7 million and $0.3 million, respectively, which is included in other non-current obligations on the consolidated balance sheets.

NOTE 17—EMPLOYEE BENEFIT PLANS

The Company has a 401(k) plan for its employees who meet certain service and age requirements. Participants may contribute up to 50% of their salaries limited to the maximum allowed by the Internal Revenue Service regulations. The Company, at its discretion, may contribute funds to the 401(k) plan. The Company made no contributions to the

401(k) plan during fiscal 2017, fiscal 2016, or fiscal 2015.

NOTE 18—RELATED PARTY TRANSACTIONS

Aircraft Time Sharing Agreement

On March 29, 2016, Restoration Hardware, Inc., a wholly-owned subsidiary of the Company entered into an Amended and Restated Aircraft Time Sharing Agreement (the “Time Sharing Agreement”) with Gary Friedman, its Chairman and Chief Executive Officer. The Time Sharing Agreement governs use of any of the Company’s aircraft (“Corporate Aircraft”) by Mr. Friedman for personal trips and provides that Mr. Friedman will lease such Corporate Aircraft and pay Restoration Hardware, Inc. an amount equal to the aggregate actual expenses of each personal use flight based on the variable costs of the flight, with the amount of such lease payments not to exceed the maximum payment level established under the Federal Aviation Administration rules. Mr. Friedman maintains a deposit with the Company, to be used towards payment of amounts due under the Time Sharing Agreement. The amount of the deposit is immaterial to the consolidated financial statements.

NOTE 19—COMMITMENTS AND CONTINGENCIES

Leases

The Company leases certain property consisting of retail and outlet stores, corporate offices, distribution centers and equipment. A majority of the Company's leases expire at various dates through fiscal 2035. The Company has a lease for one Gallery location that expires in fiscal 2058. 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 rent payments, with provisions for additional rent based on a percentage of sales, after meeting certain sales thresholds, and for payment of certain expenses.

The aggregate future minimum rent payments under leases in effect as of February 3, 2018, are as follows (in thousands):

Lease agreements accounted for as:	Capital Leases (1)	Operating Leases	Build-to-Suit	Total
2018	$1,424	$89,304	$ 37,080	$127,808
2019	1,458	76,509	39,593	117,560
2020	1,382	66,961	42,237	110,580
2021	1,227	57,470	43,996	102,693
2022	1,267	51,473	44,977	97,717
Thereafter	7,893	328,574	580,100	916,567
Minimum lease commitments	14,651	$670,291	$ 787,983	$1,472,925
Less—amount representing interest	(6,671)			
Present value of capital lease obligations	7,980			
Less—current capital lease obligations	(471)			
Non-current capital lease obligations	$7,509			

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

Lease payments that depend on factors that are not measurable at the inception of the lease, such as future sales volume, represent contingent rent expense and are excluded from minimum lease payments and included in the determination of total rent 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 rent payments and contingent rent expense under lease agreements accounted for as operating leases and as build-to-suit lease transactions are as follows (in thousands):

	Year Ended		
	February 3, 2018	January 28, 2017	January 30, 2016

Lease agreements accounted for as operating leases			
Minimum rent	$91,152	$87,520	$76,246
Contingent rent	8,063	7,140	10,209
Total operating leases	$99,215	$94,660	$86,455
Lease agreements accounted for as build-to-suit lease transactions (1)			
Minimum rent	$32,256	$16,066	$12,755
Contingent rent	833	726	442
Total build-to-suit lease transactions	$33,089	$16,792	$13,197

(1) As described in Note 3—Significant Accounting Policies, the cash payments made under leases accounted for as build-to-suit lease transactions get allocated to land rent expense and as debt service payments (a portion to interest expense and a portion to financing obligation). Minimum rent payments recognized as interest expense within the consolidated statements of income were $15.4 million, $12.1 million and $9.9 million in fiscal 2017, fiscal 2016 and fiscal 2015, respectively. Minimum rent payments allocated to the financing obligations under build-to-suit lease transactions within the consolidated balance sheets were $10.2 million and $0.4 million in fiscal 2017 and fiscal 2016, respectively. The remaining minimum rent payments of $6.7 million, $3.6 million and $2.9 million in fiscal 2017, fiscal 2016 and fiscal 2015, respectively, represent land rent expense and were included in cost of goods sold on the consolidated statements of income. Contingent rent under build-to-suit lease transactions is recognized as interest expense within the consolidated statements of income.

In addition to the above, the non-cash rent benefit recognized within the consolidated statements of income was $1.0 million in fiscal 2017 and the non-cash rent expense recognized within the consolidated statements of income was $1.2 million and $2.9 million in fiscal 2016 and fiscal 2015, respectively. Non-cash rent represents the straight-line impact and amortization of tenant allowances under operating leases and land rent expense recorded for build-to-suit lease transactions prior to cash payments occurring under the leases.

Commitments

The Company had no material off balance sheet commitments as of February 3, 2018.

Contingencies

The Company is involved in lawsuits, claims and proceedings incident to the ordinary course of its business. These disputes are increasing in number as the business expands and the Company grows larger. Litigation is inherently unpredictable. As a result, the outcome of matters in which the Company is involved could result in unexpected expenses and liability that could adversely affect the Company's operations. In addition, any claims against the Company, whether meritorious or not, could be time consuming, result in costly litigation, require significant amounts of management time and result in the diversion of significant operational resources.

The Company reviews the need for any loss contingency reserves and establishes reserves when, in the opinion of management, it is probable that a matter would result in liability, and the amount of loss, if any, can be reasonably estimated. Generally, in view of the inherent difficulty of predicting the outcome of those matters, particularly in cases in which claimants seek substantial or indeterminate damages, it is not possible to determine whether a liability has been incurred or to reasonably estimate the ultimate or minimum amount of that liability until the case is close to resolution, in which case no reserve is established until that time. When and to the extent that the Company does establish a reserve, there can be no assurance that any such recorded liability for estimated losses will be for the appropriate amount, and actual losses could be higher or lower than what the Company accrues from time to time. The Company believes that the ultimate resolution of its current matters will not have a material adverse effect on its consolidated financial statements.

RH Modern Securities Class Action

On February 2, 2017, City of Miami General Employees' & Sanitation Employees' Retirement Trust filed a class action complaint in the United States District Court, Northern District of California, against the Company, Gary Friedman, and Karen Boone. On March 16, 2017, Peter J. Errichiello, Jr. filed a similar class action complaint in the same forum and against the same parties. On April 26, 2017, the court consolidated the two actions. The consolidated action is captioned In re RH, Inc. Securities Litigation. The complaints allege, among other things, fraud in connection with alleged misstatements under sections 10(b) and 20(a) of the Securities Exchange Act of 1934, as amended. Both complaints purport to make claims on behalf of a class of purchasers of Company common stock from March 26, 2015 to June 8, 2016. The alleged misstatements relate to forward looking statements regarding the roll out of the RH Modern product line. An amended consolidated complaint was filed in June 2017 and the Company and its officers have moved to dismiss the complaint. On February 26, 2018, the Court filed an order denying the Company's motion to dismiss the complaint and the case will now move into a discovery phase. The claims are still at an early stage. While the outcome of litigation is inherently uncertain, the Company and its officers intend to vigorously defend the claims and believe the complaint lacks merit.

NOTE 20—SEGMENT REPORTING

The Company defines reportable and operating segments on the same basis that it uses to evaluate performance internally by the CODM. The Company has determined that the Chief Executive Officer is its CODM. As of February 3, 2018, the Company had two operating segments: RH Segment and Waterworks. The two operating segments include all sales channels accessed by the Company’s customers, including sales through catalogs, sales through the Company’s websites, sales through stores, and sales through the commercial channel.

The Company’s two operating segments are strategic business units that offer products for the home furnishings customer. While RH Segment and Waterworks have a shared management team and customer base, the Company has determined that their results cannot be aggregated as they do not share similar economic characteristics, as well as due to other quantitative factors.

The Company uses operating income to evaluate segment profitability. Operating income is defined as net income before interest expense—net, loss on extinguishment of debt and income tax expense.

Prior to the Waterworks acquisition, the Company had one reportable segment. As the Company's acquisition of Waterworks was completed on May 27, 2016, reportable segment financial information for Waterworks below represents thirty-five weeks of results for fiscal 2016, whereas the RH Segment results represent fifty-two weeks for fiscal 2016. The results for fiscal 2017 include fifty-three weeks for both the RH Segment and Waterworks.

Segment Information

The following table presents the statements of income metrics reviewed by the CODM to evaluate performance internally or as required under ASC 280—Segment Reporting (in thousands):

Year Ended	
February 3, 2018	January 28, 2017
RH Segment	