

RH  
Form 10-K  
March 29, 2019

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 2, 2019

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  
(State or other jurisdiction of  
incorporation or organization)

15 Koch Road  
Corte Madera, CA

45-3052669  
(I.R.S. Employer  
Identification Number)  
94925  
(Zip Code)

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

Indicate by check mark 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.

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

Emerging growth company

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

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

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As of August 3, 2018, the last business day of the registrant's most recently completed second quarter, the approximate market value of the registrant's common stock held by non-affiliates was \$2,651,665,414. 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 22, 2019, 20,478,213 shares of registrant's common stock were outstanding.

### DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's Proxy Statement for its 2019 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 2, 2019.

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RH

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## SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS AND MARKET DATA

This annual report contains forward-looking statements that are subject to risks and uncertainties. Forward-looking statements give our current expectations and projections relating to our financial condition, results of operations, plans, objectives, future performance and business. You can identify forward-looking statements by the fact that they do not relate strictly to historical or current facts. These statements may include words such as “anticipate,” “estimate,” “expect,” “project,” “plan,” “intend,” “believe,” “may,” “will,” “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 and matters that we identify as “short term,” “non-recurring,” “unusual,” “one-time,” or other words and terms of similar meaning may in fact recur in one or more future financial reporting periods. Important factors that could cause actual results to differ materially from our expectations, or cautionary statements, are disclosed in Item 1A—Risk Factors, Item 7—Management’s Discussion and Analysis of Financial Condition and Results of Operations, and elsewhere in this annual report. All forward-looking statements attributable to us, or persons acting on our behalf, are expressly qualified in their entirety by these cautionary statements, as well as other cautionary statements. You should evaluate all forward-looking statements made in this annual report in the context of these risks and uncertainties.

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

## PART I

### Item 1. Business

#### Overview

RH (“we,” “us,” or the “Company”) is a leading luxury retailer in the home furnishings marketplace. Our curated and fully-integrated assortments are presented consistently across our sales channels in sophisticated and unique lifestyle settings that we believe are on par with world-class interior designers. We offer dominant merchandise assortments across a growing number of categories, including furniture, lighting, textiles, bathware, décor, outdoor and garden, and child and teen furnishings. We position our Galleries as showrooms for our brand, while our Source Books and websites act as virtual extensions of our stores. In 2015 we began to introduce an integrated hospitality experience, including cafés, wine vaults and barista bars, into a number of our new Gallery locations. We believe this has created a unique new retail experience that cannot be replicated online, and that the addition of hospitality is helping to drive incremental sales of home furnishings in these Galleries.

Our business is fully integrated across our multiple channels of distribution, consisting of our stores, Source Books, and websites. As of February 2, 2019, we operated a total of 86 retail Galleries consisting of 20 Design Galleries, 43 legacy Galleries, 2 RH Modern Galleries and 6 RH Baby & Child Galleries throughout the United States and Canada, and 15 Waterworks showrooms throughout the United States and in the U.K. As of February 2, 2019, 6 of our Design Galleries include an integrated RH Hospitality experience and we plan to incorporate hospitality, including cafés, wine vaults and barista bars in many of the new Galleries that we open in the future. As of February 2, 2019, we operated 39 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.

#### Sales Channels

We distribute our products through a fully integrated sales platform comprised of our Stores, E-Commerce, Source Books and Trade and Contract. We believe the level of integration among all of our channels and our approach to the market distinguishes us from most other retailers. For fiscal 2018, sales of products originating in our stores represented 56% of our net revenues, while sales from our direct businesses 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 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 deal economics and availability of suitable new site locations based on several store specific aspects, such as 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 2, 2019:

- 1) Design Galleries, which average approximately 33,000 leased selling square feet;
- 2) Legacy Galleries, which average approximately 8,000 leased selling square feet;
- 3) RH Modern Galleries, which are located in Los Angeles and Dallas, and which average approximately 11,000 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 that have supported the development of a new multi-tier market approach that we believe will optimize both market share and return on invested capital over time.

First, we have developed a new RH prototype Design Gallery that is an innovative and flexible blueprint, which we believe will enable us to more quickly place our disruptive product assortment and immersive retail experience into the market. The new model is a standard we will utilize in the future that is based on key learnings from our recent Gallery openings and will range in size from 33,000 leased selling square feet inclusive of our integrated hospitality experience to 29,000 leased selling square feet without. These new Galleries will represent our assortments from RH Interiors, Modern, Baby & Child, Teen and Outdoor and contain interior design offices and presentation rooms where design professionals can work with clients on their projects. Due to the reduced square footage compared to our recent Design Gallery openings and the efficient design, this new model will be more capital efficient with less development time and cost risk, but yield similar productivity. We anticipate the new prototype Design Galleries will represent approximately two thirds of our target markets. Future prototype location examples include Edina, MN, Corte Madera, CA, Columbus, OH and Charlotte, NC.

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



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

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

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

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

In 2015 we began to introduce an integrated hospitality experience, including cafés, wine vaults and barista bars, into a number of our new Gallery locations. We believe this has created a unique new retail experience that cannot be replicated online, and that the addition of hospitality is helping to drive incremental sales of home furnishings in these Galleries. As of February 2, 2019, 6 of our Design Galleries include an integrated RH Hospitality experience and we plan to incorporate hospitality, including cafés, wine vaults and barista bars in many of the new Galleries that we open in the future.

### Retail Gallery Metrics <sup>(1)</sup>

	Year Ended February 2,  2019		February 3,  2018	
	Total Leased Selling		Total Leased Selling	
	Store Count	Square Footage <sup>(2)</sup> (in thousands)	Store Count	Square Footage <sup>(2)</sup> (in thousands)
Beginning of period	83	981	85	912
Design Galleries opened:				
Portland Design Gallery	1	26.0	—	—
Nashville Design Gallery	1	45.6	—	—
New York Design Gallery	1	50.5	—	—
Yountville Design Gallery	1	6.7	—	—
Toronto (Yorkdale) Design Gallery	—	—	1	43.3
West Palm Design Gallery	—	—	1	46.5
Modern Galleries opened:				
Dallas RH Modern Gallery	1	8.2	—	—
Baby & Child Galleries opened:				
Portland RH Baby & Child Gallery	1	4.7	—	—
Dallas RH Baby & Child Gallery	1	3.7	—	—
Waterworks Showrooms opened:				
Waterworks Scottsdale Showroom	1	2.2	—	—
Waterworks Boston Showroom	—	—	1	5.0
Legacy Galleries closed:				
Portland legacy Gallery	(1)	(4.7)	—	—
Nashville legacy Gallery	(1)	(7.1)	—	—
Washington DC legacy Gallery	(1)	(5.6)	—	—

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NY Flatiron legacy Gallery	(1 )	(21.4 )	—	—
Toronto (Bay View) legacy Gallery	—	—	(1 )	(6.0 )
Toronto (Yonge Street) legacy Gallery	—	—	(1 )	(8.6 )
West Palm legacy Gallery	—	—	(1 )	(7.1 )
Baby & Child Galleries closed:				
West Palm Baby & Child Gallery	—	—	(1 )	(2.5 )
Waterworks Showrooms closed:				
Waterworks Scottsdale Showroom	(1 )	(1.1 )	—	—
Waterworks Boston Showroom	—	—	(1 )	(2.1 )
End of period	86	1,089	83	981
Total leased square footage at end of period <sup>(3)</sup>		1,467		1,318
Weighted-average leased square footage <sup>(4)</sup>		1,409		1,262
Weighted-average leased selling square footage <sup>(4)</sup>		1,047		930
Retail sales per leased selling square foot <sup>(5)</sup>		\$ 1,177		\$ 1,252

(1) Retail data 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 2018 includes approximately 11,600 square feet related to two owned store locations. Leased selling square footage for fiscal 2017 includes approximately 4,800 square feet related to one owned store location.

- (3) Total leased square footage as of February 2, 2019 includes approximately 16,100 square feet related to two owned store locations. Total leased square footage as of February 3, 2018 includes approximately 5,400 square feet related to one owned store location.
- (4) Weighted-average leased square footage and leased selling square footage are calculated based on the number of days a Gallery location was opened during the period divided by the total number of days in the period.
- (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.
- 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 2, 2019:

Location	Store	Location	Store	Location	Store
Alabama	1	Massachusetts	2	Tennessee	1
Arizona	2	Michigan	1	Texas	9
California	20	Minnesota	1	Utah	1
Colorado	2	Missouri	1	Virginia	2
Connecticut	4	Nevada	1	Washington	1
Florida	5	New Jersey	2	District of Columbia	1
Georgia	2	New York	5	Alberta	2
Illinois	3	North Carolina	2	British Columbia	1
Indiana	1	Ohio	3	Ontario	1
Kansas	1	Oklahoma	1	London <sup>(1)</sup>	1
Louisiana	1	Oregon	2		
Maryland	1	Pennsylvania	2	Total	86

(1) The London location is a Waterworks showroom.

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

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

#### E-Commerce

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

Our e-commerce platform allows our customers to experience the unique lifestyle settings reflected in our catalogs and throughout our stores, and to shop 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 2018, our mailed Source Books included RH Interiors, RH Outdoor, RH Modern, RH Rugs, RH Teen, RH Baby & Child and RH 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 in our Source Books, websites and retail Galleries. We continue to evaluate and optimize our Source Book strategy based on our experience.

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

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

## Marketing and Advertising

Our retail Galleries and our Source Books are the primary branding and advertising vehicles for the RH brands. In addition, we employ a variety of marketing and advertising vehicles to drive customer traffic across all our channels, strengthen and reinforce our brand image and acquire new customers. These include targeted Source Book circulation, promotional mailings, email communications, online and print advertisements, and public relations activities and events. We maintain a database of customers, which includes sales patterns, detailed purchasing information, certain demographic information, as well as 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.

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, The New York Times, 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 businesses 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, excluding Waterworks, in addition to other benefits including complimentary interior design services through the RH Interior Design program and eligibility for preferred financing plans on the RH Credit Card, among other benefits. We introduced the RH Members Program in March 2016 as an alternative to prior practices involving numerous event-driven promotions. The RH Members Program allows our customers to shop for what they want, when they want, and receive the greatest value, which has resulted in orders and sales being more evenly distributed throughout the year as opposed to the peaks and valleys of orders and sales we experienced prior to the introduction of the program. 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 2018, we sourced approximately 75% of our purchase dollar volume from approximately 27 vendors. In fiscal 2018, one vendor accounted for approximately 11% of our purchase dollar volume. Based on total dollar volume of purchases for fiscal 2018, approximately 73% of our products were sourced in Asia, with approximately 41% sourced from China, 15% from the United States and the remainder from other countries and regions. In fiscal 2017, approximately 77% of our products were sourced in Asia, with approximately 46% sourced from China, 14% from the United States and the remainder from other countries and 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 offers an extensive selection of GREENGUARD Gold Certificated children's furniture. GREENGUARD Gold Certified products aid in the creation of healthier indoor environments by emitting fewer airborne chemical compounds that can contribute to health issues, including asthma, allergies and other respiratory conditions. We are in the process of obtaining GREENGUARD Certification for all of our indoor furniture products.

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

## Distribution and Delivery

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



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 completed the closure of our furniture fulfillment centers in Mira Loma, CA and Dallas, TX. In fiscal 2018, we completed the closure of our furniture fulfillment center in Essex, MD. In total, we eliminated 2.3 million square feet of distribution center space, resulting in savings in excess of \$25 million annually. We believe servicing our furniture business from two coastal distribution centers will result in improved in-stock availability and faster inventory turns, while reducing operating costs.

We operate portions of our home delivery services in 16 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 personnel deliver fully assembled items to the location of our customers' choice. We believe there is an opportunity to improve the customer experience by taking greater control of the home delivery experience over time. We believe that many third-party furniture delivery providers are designed to support mass and mid-market companies and that significant opportunity exists for developing improved solutions for the luxury market. We 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 reducing return rates, damages and deliveries per order.

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

## Competition

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

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

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

## Employees

As of February 2, 2019, we had approximately 5,200 employees, of which approximately 800 were part-time employees. As of that date, approximately 2,300 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 Modern," "RH Baby & Child," "RH Teen," "Waterworks," and "Waterworks Studio" trademarks, among others, are registered or are the subject of pending trademark applications with the United States Patent and Trademark Office and with the trademark registries of several foreign countries. Each of our trademark registrations is perpetually renewable provided that we use or continue to use the trademarks in commerce in the particular geographic market and for the goods or services covered by the registration. In addition, we own many domain names, including "restorationhardware.com," "rh.com," "rhmodern.com," "rhhbabyandchild.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 vigorously protect them against infringement.

## Fluctuation in Quarterly Results

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

## Corporate Information

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

## Regulation and Legislation

We are subject to numerous regulations, including labor and employment laws, customs, laws governing truth-in-advertising, consumer protection, privacy, safety, real estate, environmental and zoning and occupancy laws, and other laws and regulations that regulate retailers and govern the promotion and sale of merchandise and the operation of our 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. The SEC maintains a website that contains reports, proxy statements and other information about issuers, like us, who file electronically with the SEC. The address of that website is <http://www.sec.gov>.

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

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

## Item 1A. Risk Factors

Certain factors may have a material adverse effect on our business, financial condition, and results of operations. You should consider carefully the risks and uncertainties described below, in addition to other information contained in this Annual Report on Form 10-K, including our consolidated financial statements and related notes. 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 fluctuations in the growth rate of our business during the last several years, and high levels of growth may not be achieved in future periods and may not generate a corresponding improvement in our results of operations.

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

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

Some factors affecting our business, including macroeconomic conditions and policies and changes in legislation, are not within our control. In prior periods, our results of operations have been adversely affected by weakness in the overall economic environment such as periods of economic recession as well as slowdowns in the housing market. Our business 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 thereof, of introduction of new products and new product categories;
- promotional events;

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

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

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

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

We are undertaking a large number of new business initiatives at the same time in order to support our future growth. For example, we have developed and continue to refine and enhance our Gallery format, which involves larger store square footage. We also continue to add new product categories and to expand product assortments. For example, in fiscal 2015 we launched our new RH Modern and RH Teen categories. We are currently contemplating other new product lines and extensions. We introduced RH Hospitality in fiscal 2015 at RH Chicago, The Gallery at the Three Arts Club. Based on the success of our hospitality offering, we have integrated RH Hospitality into a number of our new Galleries under development incorporate an integrated RH Hospitality offering including restaurants, wine vaults, and pantries. We continue to refine and develop the RH Hospitality model as we seek to optimize this part of our business and its integration with the operation of our Gallery locations. The RH Hospitality business is different from our traditional home furnishings operations and involved evolving strategies that are untested and unproven and may expose us to operational risks. There can be no assurance that we will successfully scale RH Hospitality, that we will optimally balance the resources and square footage allocated to our hospitality offerings versus our product offerings at our Galleries, or that our hospitality offerings will be attractive to consumers in our market.

We have also embarked on an initiative to expand our product sales to international markets and are currently exploring opportunities for Design Galleries in several locations outside the United States, including the United Kingdom and Europe. International expansion would expose us to new risks, including, but not limited to, risks related to currency fluctuation, supply chain and product sourcing, international economic or political events including but not limited to the U.K.'s impending withdrawal from the European Union, commonly referred to as "Brexit," that may negatively impact the luxury market, and new regulatory regimes applicable to our products, Galleries and employees. We may be unsuccessful in adapting our operations to address such risks. We also may be unsuccessful in accurately selecting which international markets would support demand for our products or sizing our Gallery openings to such markets. If we are not successful in managing the large number of new initiatives that are underway, we might experience an adverse impact on our financial condition and results of operations.

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

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

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



We often have in the past, and may in the future, incur significant costs for any new initiative before we realize any corresponding revenue with respect to such initiative. In addition, we may incur costs as we revise, restructure or discontinue existing product categories or business offerings in favor of pursuing new initiatives or retail concepts. For example, as we continue to open larger format Design Galleries in select major metropolitan markets, we expect to close a number of legacy Galleries and replace them with our Design Gallery format. The introduction of an integrated hospitality experience, including roll out of an integrated food and beverage experience at a new Gallery location often requires significant investments by us before the location is open to customers and able to generate revenues, and we anticipate that a number of Galleries to be opened during the next several years will continue to require this form of upfront investment before they generate revenue from the food and beverage offerings. 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 ongoing refinements to our management structure and organizational design. Some of the improvements we are pursuing include changing the ways we source and deliver our products to our customers, as well as streamlining and realigning the management structure in our home office operations. We have also focused on elevating the customer experience, which includes improving our distribution and delivery of products to our customers and architecting a new fully integrated back-end operating platform, inclusive of the supply chain network, the home delivery experience as well as a new metric-driven quality system and company-wide decision data. We have focused on rationalizing our SKU count and optimizing inventory, which includes selling slower moving, discontinued and other inventory through markdowns and our outlet channel, as well as enhancing and optimizing our product sourcing capabilities and adding new management information systems. We also transitioned from a promotional to a membership model, in the early part of fiscal 2016, by introducing 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.

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

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

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

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

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

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

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

Additionally, our reputation could be jeopardized if we fail to maintain high standards for merchandise and service quality. With the growth in importance and the impact of social media 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. Our efforts to optimize our Source Books and strategies for use of the Source Books to market our business may encounter difficulties. There can be no assurance that we will be successful as we make changes to our Source Book strategy including with respect to the cadence and timing of mailings, the format of the Source Books, the team we staff for optimizing our Source Book format and mailings, and the use of the Source Books as a marketing and promotional tool including with respect to prospecting for new customers. Additionally, due to the size of our Source Books we have in the past received negative publicity from environmental groups. If we fail to adequately adjust our catalog strategy to meet our goals, or if our catalog strategy is unsuccessful, our results of operations could be negatively impacted.

We also rely on customary discounts from the basic shipping rate structure that are available for our catalog mailings, which could be changed or discontinued at any time, and we are subject to fluctuations in the market price for paper, which has historically fluctuated significantly and may continue to fluctuate in the future. Future increases in shipping

rates, paper costs or printing costs would have a negative impact on our results of operations to the extent that we are unable to offset such increases through increased sales or by raising prices, by implementing more efficient printing, mailing, delivery and order fulfillment systems, or by using alternative direct-mail formats.

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

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

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

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

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

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

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

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

We must successfully manage our supply chain and vendors in order to produce sufficient quantities of products that our customers wish to purchase in a timely manner. We must manage our supply chain and inventory levels, including predicting the appropriate levels and type of inventory to stock within each of our distribution centers, such that our "in stock" position in merchandise correlate well to consumer demand and expected delivery times. Because much of our merchandise requires that we provide vendors with significant ordering lead times, frequently before market factors are known, we may not be able to source sufficient inventory to meet demand if our products prove more popular than anticipated. In addition, our current initiatives to streamline and optimize our inventory levels may not be successful and implementing such initiatives may complicate our efforts to manage our supply chain. To the extent our business initiatives result in new product lines, new product or service offerings or expansion into new markets in the U.S. or abroad, we may need to establish new vendor relationships or new supply chain operations, which may expose us to new counterparty, regulatory, market or other risks and which may not be successful. From time to time, we have

experienced periods in which some of our vendors were not able to meet customer demand levels for certain products resulting in significant back orders for goods, higher rates of cancellation on orders in process and, in some instances, the loss of customer sales when orders could not be completed in a timely manner. In addition, vulnerabilities in the information systems of our vendors could make our vendors the targets of cybersecurity breaches or cyber fraud, which could result in disruptions in our supply chain and product sourcing. Further, the seasonal nature of some of our products requires us to carry a significant amount of inventory prior to certain selling seasons. If we are unable to accurately predict and track demand, we may be required to mark down the price of certain products in order to sell excess inventory or we may be required to sell such inventory through our outlet stores or warehouse sales. For these reasons, our results of operations in any given quarterly period may be adversely affected. We expect these factors to continue from time to time as we add new product assortments and new merchandise categories into our business.

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

Based on total dollar volume of purchases, in fiscal 2018 we sourced approximately 85% of our merchandise from outside the United States, including 73% from Asia, with approximately 41% of our products sourced 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 any trade and or other factors that impact the specific countries where our vendors' production facilities are located. Our future success will depend in large part upon our ability to maintain our existing foreign vendor relationships and to develop new ones based on the requirements of our business and any changes in trade dynamics that might dictate changes in the locations for sourcing of products. In addition, we face risks related to the ability of our vendors to scale their operations whether in connection with new products we introduce or new production locations that may be introduced, which in some cases would require substantial ongoing investments to support additional capacity. In addition, we have previously encountered difficulties in the ability of our vendors to scale production commensurate with demand from our customers. While we rely on long-term relationships with many of our vendors, we have no long-term contracts with them and generally transact business with them on an order-by-order basis.

Many of our imported products are subject to existing duties, tariffs, anti-dumping duties, quotas and other similar trade restrictions that may limit the quantity or affect the price of some types of goods that we import into the United States. In addition, substantial regulatory uncertainty exists regarding international trade relations and trade policy, both in the United States and abroad. An introduction of new duties, tariffs, quotas or other similar trade restrictions, or increases in existing duties or tariff rates, on products imported into the United States, whether actual, pending or threatened, may have a negative impact on our results of operations. Additionally, such uncertainties, even if not directly applicable to our imported products, may have a negative influence on the domestic and international economy generally and indirectly reduce market demand for our products. For example, a significant subset of our furniture and lighting sourced from China has been affected by the tariffs on such products. While we have been working with our vendor partners on mitigation strategies to seek to address the impact of such tariffs on our product pricing and costs, such efforts may not be fully sufficient to remediate the impact of the 10 per cent ad valorem duty on a subset of products imported from China, which become effective as of September 24, 2018, or any other pending or future increases in tariffs, including the recently proposed increase in the 10 per cent ad valorem duty to the rate of 25 per cent. In particular, we may not be able to receive adequate pricing concessions from our vendors and pricing increases that we seek to pass through to our customers may not be successful in achieving our objectives. Our sales may fall in response to price increases and our vendors may not be able to support the level of pricing concessions that we seek and our mitigation strategy and arrangements may not have the intended effect on our business. In addition, we have moved some of our merchandise sourcing away from China which may or may not achieve the intended benefits. In the event that any tariffs applicable to our business become applicable on a longer term basis, there can be no assurance that our efforts to mitigate the impact of such longer term tariffs will be successful.

There can be no assurance that we will not experience disruption in our business related to tariffs or other changes in trade practices and applicable rules. Tariffs and other similar trade actions are inherently unpredictable and can change quickly based on political or economic pressures or policy changes. Any changes to tariffs or other rules and practices related to cross border trade, including the possible implementation of additional tariffs, could materially increase our cost of goods sold with respect to merchandise that we purchase from vendors who manufacture products in China or other countries outside the United States, which could in turn require us to increase our prices and, in the event consumer demand declines as a result, negatively impact our financial performance. While we may seek to adopt mitigation measures and changes to our business practices to seek to counteract the effect of such tariffs on our business and results of operations, due to multiple factors that can occur in the context of trade disputes and the inherent unpredictability of how customers and market participants may respond, any mitigation measures we adopt may be not achieve their intended purpose. Certain of our competitors may be better positioned than us to withstand or react to these kinds of changes including border taxes, tariffs or other restrictions on global trade and as a result we

may lose market share to such competitors. In addition, to the extent that our competitors, our vendors or companies in other industries that manufacture products in China respond to the tariffs imposed to date or the possibility of future tariffs by shifting production to other countries in Asia or to other regions, the costs of production in such countries may increase, which may increase our costs or otherwise have an adverse impact on our product supply chain. Similarly, to the extent that we or our vendors respond to the tariffs imposed to date or the possibility of future tariffs by shifting merchandise purchases or production to other countries in Asia or to other regions, we may face delays or costs associated with developing new vendor relationships and our vendors may face delays or costs associated with bringing online new manufacturing facilities, which may increase the cost of our products or cause delays in the shipment of our merchandise that result in the cancellation of orders by our customers. An interruption or delay in supply from our foreign sources, or the imposition of additional duties, taxes or other charges on these imports, could have a material adverse effect on our business, financial condition and results of operations unless and until alternative supply arrangements are secured. Due to broad uncertainty regarding the timing, content and extent of any regulatory changes in the U.S. or abroad, we cannot predict the impact, if any, that these changes could have to our business, financial condition and results of operations.



Our dependence on foreign imports also makes us vulnerable to risks associated with products manufactured abroad, including, among other things, risks of damage, destruction or confiscation of products while in transit to our distribution centers located in the United States, product quality control charges on or assessment of additional import duties, tariffs, anti-dumping duties and quotas, loss of “most favored nation” trading status by 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, political unrest, economic uncertainties, including inflation, foreign government regulations, trade restrictions, increased labor costs and other similar factors that might affect the operations of our vendors in specific countries such as China.

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

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

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

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

A number of our vendors, particularly our artisan vendors, may have limited financial or other resources and operating histories and may receive various forms of credit from us, including with respect to payment terms or other

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

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

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

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

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

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

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

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

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

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

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

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

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

We lease nearly all of our retail store locations and we also lease our outlet stores, our corporate headquarters and other storage and office space, and our distribution and home delivery facilities. The initial lease term of our retail 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 are currently pursuing several other models for the transformation of our real estate beyond a traditional leasing approach including a real estate development model, a joint venture model and a capital light model. While these alternative models are designed to achieve superior financial returns to traditional real estate lease structures for a retail business, some of these new ways of operation will expose us to a range of different risks. Various aspects of our recently developed multi-tier real estate strategy may expose us to new forms of risk versus our traditional leasing model. Our new strategies include (1) our real estate development model where we expect either to do a sale-leaseback transaction or to pre-sell the property and structure the transaction such that the capital to build the project is advanced by the buyer during construction; (2) our hybrid or joint venture structure where we are working on joint venture projects in which we share the upside of development with the developer/landlord; and (3) our "capital light" leasing deals, where as much as 65% to 100% of the capital requirement would be funded by the landlord, versus 35% to 50% previously.

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

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

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

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

We are focused on sizing our assortments and our stores to the potential of the market by adjusting the square footage and number of stores on a geographic market-by-market basis. We plan to optimize our real estate by continuing to open larger square footage Galleries in key markets and relocating or closing selected stores in these or adjacent markets. In addition, we have developed a new RH model Design Gallery that is designed to enable us to more quickly place our product assortment and retail experience into the market and will range in size from 33,000 leased selling square feet inclusive of our integrated hospitality experience to 29,000 leased selling square feet without. We are also developing a Gallery tailored to secondary markets, targeted to be 10,000 to 18,000 leased selling square feet, which we expect will require a substantially smaller net investment than our larger Design Galleries and to pay back our capital investment within two years in most instances. We also intend to continue to open indigenous Bespoke Galleries in the second home markets where the wealthy and affluent visit and vacation, which will be tailored to reflect the local culture and be sized to the potential of each market. When we address the introduction of new stores in a particular market or changes to, or closure of, existing stores, we must make a series of decisions regarding the size and location of new stores (or the existing stores slated to undergo changes or closure) and the impact on our other existing stores in the area or being without presence or “out of the market.”

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

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

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

successfully open new stores or change our store footprint in a timely and cost-effective manner and could have a material adverse effect on our business, results of operations and financial condition.



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

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

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

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

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

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

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

with operating new facilities or reducing the size and changing functions of existing facilities. These difficulties can result in a negative experience for our customers. Any delays in fulfilling orders and delivering merchandise to customers, or related negative experience of our customers, could harm our results of operations.

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

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

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

We have historically relied on the availability of some amount of debt financing to fund our operations. We have also incurred indebtedness to finance other strategic initiatives, including our share repurchase programs, such as (i) the aggregate \$1 billion in share repurchase programs authorized by our Board of Directors, which program was fully completed during fiscal 2017, and (ii) the share repurchase program authorized by our Board of Directors in October 2018 in an aggregate amount of \$700 million of which (x) \$250.0 million in share repurchases were completed in fiscal 2018, and (y) the \$700 million authorization amount was replenished by the Board of Directors in March, 2019. We completed debt financings in fiscal 2014, fiscal 2015 and fiscal 2018 through the issuance of three series of convertible senior notes for an aggregate principal amount of \$985 million. As of February 2, 2019, we had \$57.5 million in outstanding borrowings and \$378.9 million of availability under our revolving line of credit, net of \$13.6 million in outstanding letters of credit. Our revolving line of credit contains various restrictive covenants, including, among others, limitations on the ability to incur liens, make loans or other investments, incur additional debt, issue additional equity, merge or consolidate with or into another person, sell assets, pay dividends or make other distributions, or enter into transactions with affiliates. These restrictive covenants may limit our operational and financial flexibility, and we may face financial and contractual consequences to the extent we are not able to maintain our compliance with such covenants, which could have a materially adverse effect on our business, financial condition and results of operations.

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, our real estate strategy, the purchase of our equity securities, our international expansion, 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 2018, we spent \$136.7 million for capital expenditures. The exact level of our net capital expenditures in future fiscal years, including fiscal 2019, will depend both on the level of gross capital expenditures that we undertake in our business as well as the amount of any proceeds from the sale of assets including sales of real estate. We plan to continue pursuing our real estate strategy by opening Design Galleries in select major metropolitan markets, developing new RH model Design Galleries and Galleries tailored to secondary markets, and opening indigenous Bespoke Galleries in the second home markets where the wealthy and affluent visit and vacation, as well as pursuing category extensions of our brand and exploring new business areas. We have principally relied upon leases with landlords for most of our Gallery locations to date. We have begun to pursue a real estate development model strategy for some of our new Gallery developments in which we invest in ownership of real estate such as we did in the case of our current Gallery location in San Francisco where we own both the building and the land. The real estate development model may require us to pursue additional capital expenditures than a traditional leasing model, but we may be able to recoup substantial amounts of capital and may also achieve gains on our capital investments if we are successful with this model and are able to sell the real estate interests to a real estate investor in a sale leaseback transaction. As we develop new Galleries, as well as potentially other strategic initiatives in the future like our integrated hospitality experience, we may explore other models for our real estate, which could include longer lease terms or further purchases of, or joint ventures or other forms of equity ownership in, real estate interests associated with new sites and buildings. These approaches might require greater capital investment than a traditional store lease with a landlord. In the event that such capital and other expenditures require us to pursue additional funding sources, we can provide no assurances that we will be successful in securing additional funding on attractive terms or at all.

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, while the use of capital to repurchase shares may reduce the number of our outstanding shares which could in turn yield financial benefits to our investors including the potential for increased earnings per share, such share repurchases may increase our aggregate levels of indebtedness, increase our costs for cash and/or non-cash interest expense and 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 financial and operational impact of share repurchases on our business and results of operation. Although our share repurchase programs are intended to enhance long-term stockholder value, depending on the exact financial and operational impact of these programs on our business, there can be no assurance that share repurchases will have the benefits that we expect.

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

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

In addition, while we anticipate that we 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 three series of convertible senior notes that we issued in fiscal 2014, fiscal 2015 and fiscal 2018 with cash payments. See Item 2—Management’s Discussion and Analysis of Financial Condition and Results of Operations—Liquidity and Capital Resources—Convertible Senior Notes. The \$350 million principal amount of convertible senior notes that we issued in fiscal 2014 matures on June 15, 2019 and becomes convertible by the holders on and after March 15, 2019 through the close of business on the second schedule trading day immediately preceding June 15, 2019. At the time the notes become due, and prior to maturity to the extent the notes become convertible and a holder exercises such conversion right, the trading price of our common stock may be such that we may find it necessary to settle the notes in cash. There can be no assurance that we will be able to pay the amount of cash due if holders surrender their notes for conversion. In addition, agreements governing any debt may restrict our ability to make each of the required cash payments even if we have sufficient funds to make them. Furthermore, our ability to purchase the notes or to pay cash upon the conversion of the notes may be limited by law or regulatory authority. In addition, if we fail to purchase the notes, to pay special interest, if any, due on the notes, or to pay the amount of cash due upon conversion, we will be in default under the respective indentures governing the notes, which in turn may result in the acceleration of other indebtedness we may then have. If the repayment of the other indebtedness were to be accelerated, we may not have sufficient funds to repay that indebtedness and to purchase the notes or to pay the amount of cash due upon conversion.

The need to repay our convertible senior notes or other debt obligations could cause us to incur additional borrowings or 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, U.S. or global market conditions, including as a result of volatility in the stock market, risks related to Brexit, declines in energy prices or the housing market or other U.S. or global political or economic trends, could affect our ability to access future debt and to manage our debt obligations. We cannot assure you that we will be able to raise necessary funds on favorable terms, if at all, or that future financing requirements would not be dilutive to holders of our capital stock. If we fail to raise sufficient additional funds, we may be required to delay or abandon some of our planned future expenditures or aspects of our current operations.

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

The success of our business depends upon our ability to retain continued service of certain key personnel, particularly our Chairman and Chief Executive Officer, Gary Friedman, and to attract and retain additional qualified key personnel in the future. We face risks related to loss of any key personnel and we also face risks related to any changes that may occur in key senior leadership executive positions. Any disruption in the services of our key personnel could make it

more difficult to successfully operate our business and achieve our business goals and could adversely affect our results of operation and financial condition. These changes could also increase the volatility of our stock price.

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

In August 2018, we appointed a new President, Chief Financial and Administrative Officer in connection with the departure of our previous President, Chief Financial and Administrative Officer. In March 2019, we appointed a new Chief Financial Officer as a result of the new President, Chief Financial and Administrative Officer's decision to step down due to health considerations. We may face risks related to these and other transitions in our leadership team.

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

Inasmuch as our success depends in part upon our ability to attract, motivate and retain a sufficient number of store and other employees who understand and appreciate our corporate culture and customers. Turnover in the retail industry and food and beverage industry is generally high. Excessive employee turnover will result in higher employee costs associated with finding, hiring and training new store employees. If we are unable to hire and retain store and other personnel capable of consistently providing a high level of customer service, our ability to open new stores, service the needs of our customers and expand our food and beverage business may be impaired, the performance of our existing and new stores and operations could be materially adversely affected and our brand image may be negatively impacted.

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

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

We may be the target of cyber fraud, hacking or theft. 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. Our operations are also dependent on the information technology systems and cybersecurity measures of our third party vendors. Attempted cyber intrusions into our information systems through compromised vendor networks, if successful, could compromise our information

systems. In addition, our information systems can face risks to the extent we acquire new businesses but are not able to quickly or comprehensively integrate such acquired businesses into our policies and procedures for addressing cybersecurity risks or identify and address weaknesses in such acquired entity's information systems, which risks may be compounded to the extent the information systems of an acquired entity are integrated with ours, thus providing access to a broader set of sensitive customer information through a compromised network at the acquired entity level. If a computer hacker or other third party is able to circumvent our security measures, he or she could destroy or steal valuable information or disrupt our operations. Any successful breaches or attempted intrusions could result in increased information systems costs and potential reputational damage, which could materially adversely affect our business and results of operations.

Additionally, in order for our business to function successfully, we and other market participants must be able to handle and transmit confidential and personal information securely, including in customer orders placed through our website. That information 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”) and the Environmental Protection Agency regarding formaldehyde emissions from composite wood products (e.g., plywood and medium density fiberboard).

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

We maintain a product safety and compliance program to help ensure our products are safe, legal and made consistently in compliance with our values. Nevertheless, our products have in the past (including during fiscal 2018) been, and may in the future be, subject to recall for product safety and compliance reasons. Our efforts to address the sources of these product recalls, including those due to products sourced from our vendors, may not be successful and we may continue to face additional product recalls. Concerns of product safety and compliance could result in future voluntary or involuntary removal of products, product recalls, other actions by applicable government authorities or product liability, personal injury or property damage claims. To the extent future product recalls create a negative public perception of our business, we could face reputational harm or could be subject to elevated levels of legal claims. There can be no assurance that we will have the benefit of adequate insurance or payments from third parties including our product vendors in order to address losses and expenses that we may incur in connection with product recalls. Not all of the costs and expenses that we have previously incurred in connection with product recalls have been covered by insurance or reimbursement from third parties including our product vendors. We and our product vendors may be unable to obtain such insurance or the insurance may be prohibitively expensive and any coverage that is available may be inadequate to cover costs we incur in connection with product recalls.

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

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 copyright, trademarks, patents 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 against us, depending on the outcome of such claims, could lead to further claims and proceedings including on new and otherwise unrelated matters, for example by attracting the attention of plaintiff's firms or of regulators. Litigation and other claims and regulatory proceedings against our management or us could result in unexpected expenses and liability and could also materially adversely affect our operations and our reputation.

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

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

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

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

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

In addition to increased regulatory compliance requirements, changes in laws could make ordinary conduct of our business more expensive or require us to change the way we do business. For example, 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 2018, we sourced 85% of our products from outside the United States, and we are increasing the level of our international sourcing activities in an effort to obtain more of our products directly from vendors located outside the United States. Additionally, we have expanded our business-to-business sales. The foreign and U.S. laws and regulations that are applicable to our operations are complex and may increase the costs of regulatory compliance, or limit or restrict the products or services we sell or subject our business to the possibility of regulatory actions or proceedings. The United States Foreign Corrupt Practices Act, and other similar laws and regulations, generally prohibit companies and their intermediaries from making improper payments to foreign governmental officials for the purpose of obtaining or retaining business. While our policies mandate compliance with applicable laws and regulations, including anti-bribery laws and other anti-corruption laws, we cannot assure you that we will be successful in preventing our employees or other agents from taking actions in violation of these laws or regulations. Such violations, or allegations of such violations, could disrupt our business and result in a material adverse effect on our financial condition, results of operations and cash flows.

Labor organizing and other activities could negatively impact us.

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

In addition, one of our key value driving strategies involves the development and introduction of new Gallery locations. We pursue a range of different real estate development models for these projects. In a number of these

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

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

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

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

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 2, 2019 and 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. We have completed our analysis of the Tax Act, and have not made material adjustments to the provisional amounts that we previously recorded.

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. It is difficult to predict the impact of future changes to accounting principles or current accounting practice and the exact impact of such changes may not be what we anticipate. A change in accounting rules or regulations may even affect our reporting of transactions completed before the change is effective and future changes to accounting rules or regulations or the questioning of current accounting practices may adversely

affect our results of operations. For example, we adopted Accounting Standards Update 2014-09—Revenue from Contracts with Customers (Topic 606) in the first quarter of fiscal 2018, the adoption of which materially impacted the timing of recognizing advertising expense related to direct response advertising, including costs associated with our Source Books. In addition, we adopted Accounting Standards Update 2016-02—Leases (Topic 842) in the first quarter of fiscal 2019, the adoption of which will have a material impact on our consolidated balance sheets due to the initial recognition of right of use assets and lease liabilities for our operating and finance lease arrangements. In addition, the adoption of Topic 842 will have a material impact on our consolidated statements of income, specifically cost of goods sold and interest expense—net, primarily due to the change from the build-to-suit lease transactions under the previous accounting guidance to the new finance lease classification treatment. For information regarding recently issued accounting pronouncements, refer to Note 3—Significant Accounting Policies in our consolidated financial statements within Part II of this Annual Report on Form 10-K.

Further, to the extent we experience any increases in costs or diversions in managerial or personnel resources in order to adopt new accounting rules or regulations, our results of operations could be materially adversely affected.



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

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

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

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

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

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

Our total assets include intangible assets with an indefinite life, goodwill, tradename 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 2018 and fiscal 2017, we recorded goodwill impairment related to the Waterworks reporting unit of \$17.4 million and \$33.7 million, respectively. In fiscal 2018, we recorded tradename impairment related to the Waterworks reporting unit of \$14.6 million. Additionally, in fiscal 2018 and fiscal 2017, we recorded impairment charges on long-lived assets of \$0.2 million and \$4.5 million, respectively, due to the closure of three 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 2, 2019. 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. In addition, we have experienced changes in personnel who are involved in our financial reporting. Although we believe that we have invested adequate resources in developing and maintaining the procedures, personnel and systems necessary to support our reporting obligations, there can be no assurance that these efforts have been or will be successful. Changes in personnel, systems or procedures, as well as other events might have an adverse impact on our internal controls. Deficiencies in our internal controls or other challenges in the financial reporting aspects of our business may have an adverse impact on our ability to provide financial statements in accordance with generally accepted accounting procedures and may give rise to errors in our financial statement. There can be no assurance that our internal controls and financial reporting infrastructure and personnel have in the past complied, or will continue in the future to comply, with our financial reporting obligations. If we fail to timely achieve and maintain the adequacy of our internal control over financial reporting, we may not be able to produce reliable financial reports. Our failure to achieve and maintain effective internal control over financial reporting could prevent us from filing our periodic reports on a timely basis, which could result in the loss of investor confidence in the reliability of our financial statements, harm our business, and negatively impact the trading price of our common stock.

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

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

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

## Risks Related to Ownership of Our Common Stock

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

The market price for our common stock has 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 or man-made 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. We have been subject to such class action securities litigation and may experience further claims of this kind. Any such securities litigation can result in substantial costs and expenses and the attention of management could be diverted from our business.

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

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

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

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

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

- establish a classified board of directors so that not all members of our board of directors are elected at one time;

authorize the issuance of undesignated preferred stock, the terms of which may be established and the shares of which may be issued without stockholder approval, and which may include super voting, special approval, dividend or other rights or preferences superior to the rights of the holders of common stock;

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- 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 2018, we issued \$300 million of 0.00% convertible senior notes due 2023 and, on June 26, 2018, we issued an additional \$35 million pursuant to the exercise of an overallotment option granted to the initial purchasers as part of the June 2018 offering (the “2023 Notes”). In June 2015, we issued \$250 million of 0.00% convertible senior notes due 2020 and, on July 2, 2015, we issued an additional \$50 million pursuant to the exercise of the overallotment option granted to the initial purchasers as part of the June 2015 offering (collectively, the “2020 Notes”). In June 2014, we issued \$300 million of 0.00% convertible senior notes due 2019 and, on June 24, 2014, we issued an additional \$50 million pursuant to the exercise of an overallotment option granted to the initial purchasers as part of the June 2014 offering (the “2019 Notes” and, together with the 2023 Notes and the 2020 Notes, the “Notes”). In connection with each offering of the Notes, we entered into convertible note hedge transactions with certain counterparties (the “Bond Hedge”) and warrant transactions (the “Warrants” and together with the Notes and the Bond Hedge, the “Convertible Notes 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 2023 Notes, the corresponding Bond Hedge and Warrants are intended to limit the earnings dilution that our stockholders would experience until the Company’s common stock is above approximately \$309.84 per share, the strike price of the 2023 Notes warrant transactions, which represented a 100% premium over the closing price of our common stock at the time we entered into the Bond Hedge and Warrants related to the 2023 Notes. For the 2020 Notes, the corresponding Bond Hedge and Warrants are intended to limit the earnings dilution that our stockholders would experience until the Company’s common stock is above approximately \$189.00 per share, the strike price of the 2020 Notes warrant transactions, which represented a 100% premium over the closing price of our common stock at the time we entered into the Bond Hedge and Warrants related to the 2020 Notes. 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

As of February 2, 2019, we have approximately 1,467,000 leased gross square feet for 20 Design Galleries, 43 legacy Galleries, 2 RH Modern Galleries, 6 RH Baby & Child Galleries and 15 Waterworks showrooms throughout the United States and in the U.K. 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 1,213,000 leased gross square feet for 39 outlet stores that were open as of February 2, 2019.

Most leases for our retail Galleries and outlets provide for a minimum rent, typically including annual 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 fulfillment centers and corporate facilities, as well as the size of our home delivery hubs, occupied as of February 2, 2019:

	Leased Square Footage
Location	(Approximate)
<b>RH Furniture Fulfillment Centers</b>	
Patterson, California	1,501,000
Baltimore (North East), Maryland	1,195,000
<b>RH Small Parcel Fulfillment Center</b>	
West Jefferson, Ohio <sup>(1)</sup>	1,224,000
<b>Waterworks Fulfillment Center</b>	
Brookfield, Connecticut	160,000
<b>Home Delivery Hub Locations <sup>(2)</sup></b>	1,455,000
<b>Corporate Facilities</b>	
Corte Madera, California <sup>(1) (3)</sup>	257,000
Pinole, California <sup>(4)</sup>	200,000
Danbury, Connecticut <sup>(5)</sup>	41,000
Other	18,000

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

- (2) Includes total approximate leased square footage for 16 separate home delivery hub locations.
- (3) Location of RH Headquarters. Includes approximately 8,000 square feet of warehouse space.
- (4) Represents warehouse space.
- (5) Location of Waterworks Headquarters.

#### Owned Properties

We currently own two properties, a 9,000 square foot property that is the location of our Gallery in San Francisco's Design District, and a 18,000 square foot property that is the location of our Yountville Design Gallery. Both owned properties are part of our RH Segment. In addition, we currently own land in Edina, MN which we are developing for a future Design Gallery.

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

### Item 3. Legal Proceedings

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

For additional information regarding certain securities litigation, refer to Note 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 number of stockholders of record of our common stock as of February 2, 2019 was 21. 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 five-year period ended February 2, 2019 in comparison to the NYSE Composite Index and the S&P Retailing Select Index, our peer group index. The graph and the table below assume that \$100 was invested at the market close on January 31, 2014 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.

	01/31/2014	1/30/2015	1/29/2016	01/27/2017	02/02/2018	02/01/2019
RH	100.00	154.27	108.60	45.98	162.21	235.53
NYSE Composite Index	100.00	105.71	96.64	113.20	131.28	123.70
S&P Retailing Select Index	100.00	116.62	103.36	107.60	114.63	110.42

## Repurchases of Common Stock

During the three months ended February 2, 2019, we repurchased the following shares of our common stock:

			Total Number of Shares Repurchased as Average Part of Publicly Announced Plans or Programs <sup>(2)</sup>	Approximate Dollar Value of Shares That May Yet Be Purchased Under the Plans or Programs (in millions)
	Number of Shares <sup>(1)</sup>	Purchase Price Per Share		
November 4, 2018 to December 1, 2018	—	\$ —	—	\$ 555
December 2, 2018 to January 5, 2019	891,129	\$ 118.25	886,700	\$ 450
January 6, 2019 to February 2, 2019	—	\$ —	—	\$ 450
Total	891,129		886,700	

- (1) Includes 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. There were 4,429 shares surrendered for this purpose during the three months ended February 2, 2019.
- (2) Reflects shares repurchased as part of the Fiscal 2018 \$700 Million Repurchase Program authorized by the Board of Directors on October 10, 2018.

## 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 2, 2019 and February 3, 2018 and for the fiscal years ended February 2, 2019, February 3, 2018 and January 28, 2017 were derived from consolidated financial statements included in Item 8—Financial Statements and Supplementary Data. The selected consolidated financial data as of January 28, 2017 and as of and for the periods ended January 30, 2016 and January 31, 2015 were derived from consolidated financial statements for such years not included herein.

The fiscal years ended February 2, 2019, January 28, 2017, January 30, 2016 and January 31, 2015 each consisted of 52 weeks. The fiscal year ended February 3, 2018 consisted of 53 weeks.





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

	Year Ended				
	February 2, 2019	February 3, 2018	January 28, 2017	January 30, 2016	January 31, 2015
(dollars in thousands, except per share amounts)					
<b>Consolidated Statements of Income:</b>					
Net revenues	\$2,505,653	\$2,440,174	\$2,134,871	\$2,109,006	\$1,867,422
Cost of goods sold	1,504,806	1,591,107	1,455,084	1,356,314	1,176,648
Gross profit	1,000,847	849,067	679,787	752,692	690,774
Selling, general and administrative expenses	711,617	717,766	626,751	567,131	525,048
Income from operations	289,230	131,301	53,036	185,561	165,726
Other expenses					
Interest expense—net	75,074	62,570	44,482	35,677	17,551
Goodwill and tradename impairment	32,086	33,700	—	—	—
Loss on extinguishment of debt	917	4,880	—	—	—
Total other expenses	108,077	101,150	44,482	35,677	17,551
Income before income taxes	181,153	30,151	8,554	149,884	148,175
Income tax expense	30,514	27,971	3,153	58,781	57,173
Net income	\$150,639	\$2,180	\$5,401	\$91,103	\$91,002
<b>Weighted-average shares used in computing</b>					
basic net income per share	21,613,678	27,053,616	40,691,483	40,190,448	39,457,491
Basic net income per share	\$6.97	\$0.08	\$0.13	\$2.27	\$2.31
<b>Weighted-average shares used in computing</b>					
diluted net income per share	26,533,225	29,253,208	40,926,840	42,256,559	41,378,210
Diluted net income per share	\$5.68	\$0.07	\$0.13	\$2.16	\$2.20
<b>Other Financial and Operating Data:</b>					
Direct as a percentage of net revenues <sup>(1)</sup>	44	% 44	% 45	% 49	% 50
<b>Growth in net revenues:</b>					
Stores <sup>(2)</sup>	3	% 16	% 9	% 16	% 14
Direct <sup>(1)</sup>	2	% 12	% (7)	% 10	% 28
Total	3	% 14	% 1	% 13	% 20
Comparable brand revenue growth <sup>(3)</sup>	4	% 6	% (7)	% 11	% 20
Adjusted net income <sup>(4)</sup>	\$223,694	\$89,200	\$51,789	\$114,772	\$97,636
Adjusted EBITDA <sup>(5)</sup>	\$400,770	\$268,270	\$186,225	\$273,425	\$224,961
Capital expenditures <sup>(6)</sup>	\$136,736	\$146,194	\$170,031	\$127,902	\$110,359

	February 2, 2019	February 3, 2018	January 28, 2017	January 30, 2016	January 31, 2015
	(in thousands)				
Balance Sheet Data:					
Cash and cash equivalents	\$5,803	\$17,907	\$87,023	\$331,467	\$145,686
Short-term and long-term investments <sup>(7)</sup>	—	—	175,889	152,855	80,506
Working capital <sup>(8)</sup>	110,276	132,098	722,355	861,304	540,299
Total assets	1,806,034	1,732,866	2,192,520	2,067,944	1,522,036
Financing obligations under build-to-suit lease					
transactions	228,928	229,323	203,015	146,621	124,770
Convertible senior notes due 2019—net <sup>(9)</sup>	344,146	329,012	314,543	300,711	287,487
Convertible senior notes due 2020—net <sup>(9)</sup>	272,919	255,865	239,876	224,887	—
Convertible senior notes due 2023—net <sup>(9)</sup>	253,689	—	—	—	—
Asset based credit facility	57,500	199,970	—	—	—
Term loan	—	80,000	—	—	—
Equipment security notes	—	18,497	—	—	—
Promissory note	—	13,183	—	—	—
Notes payable for share repurchases	19,633	19,390	19,390	19,523	19,523
Total debt (including current portion) <sup>(10)</sup>	956,681	923,896	581,318	552,702	314,514
Total stockholders' equity (deficit)	(22,962 )	(7,336 )	919,869	886,160	702,916

- (1) Direct net revenues include sales originating from our Source Books, websites, and phone orders, including our Contract business and a portion of our Trade business.
- (2) Stores data represents sales originating in retail stores, including Waterworks showrooms, and outlet stores. Net revenues for outlet stores, which include warehouse sales, were \$179.0 million, \$205.7 million, \$144.6 million, \$142.8 million and \$121.6 million, for fiscal 2018, fiscal 2017, fiscal 2016, fiscal 2015 and fiscal 2014, respectively.
- (3) Comparable brand revenue growth includes direct net revenues and retail comparable store sales, including RH Baby & Child, RH Modern Galleries and RH 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 2018, 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 underlying operating performance. Adjusted net income is included in this filing because management believes that adjusted net income provides meaningful supplemental information for investors regarding the performance of our business and facilitates a meaningful evaluation of actual results on a comparable basis with historical results. Our

management uses this non-GAAP financial measure in order to have comparable financial results to analyze changes in our underlying business from quarter to quarter. The following table presents a reconciliation of net income, the most directly comparable GAAP financial measure, to adjusted net income for the periods indicated below.

	Year Ended				
	February 2, 2019	February 3, 2018	January 28, 2017	January 30, 2016	January 31, 2015
	(in thousands)				
Net income	\$150,639	\$2,180	\$5,401	\$91,103	\$91,002
Adjustments pre-tax:					
Amortization of debt discount <sup>(a)</sup>	39,216	27,926	26,404	19,803	6,852
Goodwill and tradename impairment <sup>(b)</sup>	32,086	33,700	—	—	—
Reorganization related costs <sup>(c)</sup>	9,977	949	5,698	—	—
Asset impairment and lease losses <sup>(d)</sup>	7,218	4,417	12,743	—	—
Distribution center closures <sup>(e)</sup>	1,778	4,846	—	—	—
Recall accrual <sup>(f)</sup>	1,619	7,707	4,615	—	—
Loss on extinguishment of debt <sup>(g)</sup>	917	4,880	—	—	—
Impact of inventory step-up <sup>(h)</sup>	380	2,527	6,835	—	—
Legal settlement <sup>(i)</sup>	(5,289 )	—	—	—	—
Non-cash compensation <sup>(j)</sup>	—	23,872	3,672	—	—
Anti-dumping exposure <sup>(k)</sup>	—	(2,202 )	—	—	—
Gain on sale of building and land <sup>(l)</sup>	—	(2,119 )	—	—	—
Legal claim <sup>(m)</sup>	—	—	8,701	19,046	7,700
Aircraft impairment <sup>(n)</sup>	—	—	4,767	—	—
Acquisition related costs <sup>(o)</sup>	—	—	2,847	—	—
Subtotal adjusted items	87,902	106,503	76,282	38,849	14,552
Impact of income tax items <sup>(p)</sup>	(14,847 )	(19,483 )	(29,894 )	(15,180 )	(7,918 )
Adjusted net income	\$223,694	\$89,200	\$51,789	\$114,772	\$97,636

- (a) Under GAAP, certain convertible debt instruments that may be settled in cash on conversion are required to be separately accounted for as liability and equity components of the instrument in a manner that reflects the issuer's non-convertible debt borrowing rate. Accordingly, in accounting for GAAP purposes for the \$350 million aggregate principal amount of convertible senior notes that were issued in June 2014 (the "2019 Notes"), for the \$300 million aggregate principal amount of convertible senior notes that were issued in June and July 2015 (the "2020 Notes") and for the \$335 million aggregate principal amount of convertible senior notes that were issued in June 2018 (the "2023 Notes"), we separated the 2019 Notes, 2020 Notes and 2023 Notes into liability (debt) and equity (conversion option) components and we are amortizing as debt discount an amount equal to the fair value of the equity components as interest expense on the 2019 Notes, 2020 Notes and 2023 Notes over their expected lives. The equity components represent the difference between the proceeds from the issuance of the 2019 Notes, 2020 Notes and 2023 Notes and the fair value of the liability components of the 2019 Notes, 2020 Notes and 2023 Notes, respectively. Amounts are presented net of interest capitalized for capital projects of \$2.7 million, \$2.5 million, \$2.4 million, \$2.3 million and \$1.1 million during fiscal 2018, fiscal 2017, fiscal 2016, fiscal 2015 and fiscal 2014, respectively.
- (b) Represents goodwill and tradename impairment related to the Waterworks reporting unit. Refer to "Impairment" within Note 3—Significant Accounting Policies in our consolidated financial statements.
- (c) Fiscal 2018 represents severance costs and related taxes associated with reorganizations, including severance related to the closure of the Essex, MD distribution center. Fiscal 2017 represents severance costs and related taxes related to the closure of the Mira Loma, CA and Dallas, TX distribution centers, as well as the closure of the Dallas customer call center. Fiscal 2016 represents severance costs and related taxes associated with a

reorganization. The fiscal 2017 and fiscal 2016 expense is partially offset by a reversal of stock-based compensation expense related to unvested equity awards.

- (d) Fiscal 2016 represents the impairment associated with RH Contemporary Art, which 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 represented lease related charges, property and equipment disposals, and donations. In fiscal 2017 and fiscal 2018, additional lease related charges of \$4.4 million and \$3.4 million, respectively, were recorded to selling, general and administrative expenses due to the remeasurement of the lease loss liability for RH Contemporary Art resulting from an update to both the timing and the amount of future estimated lease related cash inflows. The fiscal 2018 adjustment also includes accelerated depreciation expense of \$2.6 million due to a change in the estimated useful life of certain assets and a \$1.2 million inventory impairment charge related to holiday merchandise, both of which were recorded in cost of goods sold. Fiscal 2016 also includes a \$1.0 million inventory impairment charge recorded to cost of goods sold associated with RH Kitchen due to the alignment with the Waterworks Kitchen product line strategy.

- (e) Represents disposals of inventory and property and equipment, lease related charges, inventory transfer costs and other costs associated with distribution center closures.
- (f) Represents a reduction in net revenues, impact on cost of goods sold, as well as accrual adjustments and insurance recoveries related to certain product recalls. Product recalls had the following effect on our income before income taxes:

	Year Ended		
	February 2, 2019	February 3, 2018	January 28, 2017
	(in thousands)		
Reduction of net revenues	\$4,733	\$ 3,207	\$3,441
Impact on cost of goods sold	(4,139)	4,315	535
Impact on gross profit	594	7,522	3,976
Incremental selling, general and administrative expenses	1,025	185	639
Impact on income before income taxes	\$1,619	\$ 7,707	\$4,615

- (g) Represents the loss on extinguishment of debt related to the LILO term loan, the promissory note secured by our aircraft and the equipment security notes, all of which were repaid in full in June 2018, as well as the second lien term loan which was repaid in full in October 2017.
- (h) Represents the non-cash amortization of the inventory fair value adjustment recorded in connection with our acquisition of Waterworks.
- (i) Represents a favorable legal settlement, net of related legal expenses.
- (j) 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.
- (k) 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.
- (l) Represents the gain on the sale of building and land of one of our previously owned retail Galleries.
- (m) 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.
- (n) Represents the impairment recorded upon reclassification of aircraft as asset held for sale.
- (o) Represents costs incurred in connection with our acquisition of Waterworks including professional fees.
- (p) The adjustment for fiscal 2018 is based on an adjusted tax rate of 16.9%, which is calculated based on the weighted-average fiscal 2018 quarterly adjusted pro forma tax rates and excludes a \$3.6 million tax impact associated with the Waterworks reporting unit goodwill impairment. 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 assumes a normalized tax rate of 40%.
- (5) EBITDA and Adjusted EBITDA are supplemental measures of financial performance that are not required by, or presented in accordance with, GAAP. We define EBITDA as consolidated net income before depreciation and

amortization, interest expense, goodwill and tradename impairment, loss on extinguishment of debt and provision for income taxes. Adjusted EBITDA reflects further adjustments to EBITDA to eliminate the impact of non-cash compensation, as well as certain non-recurring and other items that we do not consider representative of our underlying operating performance. EBITDA and Adjusted EBITDA are included in this filing because management believes that these metrics provide meaningful supplemental information for investors regarding the performance of our business and facilitate a meaningful evaluation of operating results on a comparable basis with historical results. Our management uses this non-GAAP financial measure in order to have comparable financial results to analyze changes in our underlying business from quarter to quarter. Our measures of EBITDA and Adjusted EBITDA are not necessarily comparable to other similarly titled captions for other companies due to different methods of calculation. The following table presents a reconciliation of net income, the most directly comparable GAAP financial measure, to EBITDA and Adjusted EBITDA for the periods indicated below.



	Year Ended				
	February 2, 2019	February 3, 2018	January 28, 2017	January 30, 2016	January 31, 2015
	(in thousands)				
Net income	\$150,639	\$2,180	\$5,401	\$91,103	\$91,002
Depreciation and amortization	74,346	70,135	56,995	44,595	34,463
Interest expense—net	75,074	62,570	44,482	35,677	17,551
Goodwill and tradename impairment <sup>(a)</sup>	32,086	33,700	—	—	—
Loss on extinguishment of debt <sup>(a)</sup>	917	4,880	—	—	—
Income tax expense	30,514	27,971	3,153	58,781	57,173
EBITDA	363,576	201,436	110,031	230,156	200,189
Non-cash compensation <sup>(b)</sup>	24,122	50,709	29,988	24,223	17,072
Reorganization related costs <sup>(a)</sup>	9,977	949	5,698	—	—
Asset impairment and lease losses <sup>(a)</sup>	4,607	4,417	12,743	—	—
Distribution center closures <sup>(a)</sup>	1,778	4,846	—	—	—
Recall accrual <sup>(a)</sup>	1,619	7,707	4,615	—	—
Impact of inventory step-up <sup>(a)</sup>	380	2,527	6,835	—	—
Legal settlement <sup>(a)</sup>	(5,289 )	—	—	—	—
Anti-dumping exposure <sup>(a)</sup>	—	(2,202 )	—	—	—
Gain on sale of building and land <sup>(a)</sup>	—	(2,119 )	—	—	—
Legal claim <sup>(a)</sup>	—	—	8,701	19,046	7,700
Aircraft impairment <sup>(a)</sup>	—	—	4,767	—	—
Acquisition related costs <sup>(a)</sup>	—	—	2,847	—	—
Adjusted EBITDA	\$400,770	\$268,270	\$186,225	\$273,425	\$224,961

- (a) Refer to the reconciliation of net income to adjusted net income table above and the related footnotes for additional information.
- (b) Represents non-cash compensation related to equity awards granted to employees, including the non-cash compensation charge related to a fully vested option grant made to Mr. Friedman in May 2017 and a non-cash compensation charge related to the fully vested option grants made in connection with our acquisition of Waterworks in fiscal 2016.
- (6) Capital expenditures include the acquisition of buildings and land of \$14.0 million in fiscal 2015.
- (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. We held no investments as of fiscal 2018 or 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, 2020 Notes and 2023 Notes. The aggregate principal amounts due under the 2019 Notes, 2020 Notes and 2023 Notes are \$350 million, \$300 million and \$335 million, respectively.
- (10) Total debt (including current portion) includes the 2019 Notes, 2020 Notes and 2023 Notes, net of debt discount, asset based credit facility, term loan, equipment security notes, aircraft promissory note, notes payable for share repurchases and capital lease obligations, and excludes financing obligations under build-to-suit lease transactions.



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

### Overview

We are a leading luxury retailer in the home furnishings marketplace. Our curated and fully-integrated assortments are presented consistently across our sales channels in sophisticated and unique lifestyle settings that we believe are on par with world-class interior designers. We offer dominant merchandise assortments across a growing number of categories, including furniture, lighting, textiles, bathware, décor, outdoor and garden, and child and teen furnishings. We position our Galleries as showrooms for our brand, while our Source Books and websites act as virtual extensions of our stores. In 2015 we began to introduce an integrated hospitality experience, including cafés, wine vaults and barista bars, into a number of our new Gallery locations. We believe this has created a unique new retail experience that cannot be replicated online, and that the addition of hospitality is helping to drive incremental sales of home furnishings in these Galleries.

Our business is fully integrated across our multiple channels of distribution, consisting of our stores, Source Books and websites. As of February 2, 2019, we operated a total of 86 retail Galleries, consisting of 20 Design Galleries, 43 legacy Galleries, 2 RH Modern Galleries and 6 RH Baby & Child Galleries throughout the United States and Canada, and 15 Waterworks showrooms throughout the United States and in the U.K. As of February 2, 2019, 6 of our Design Galleries include an integrated RH Hospitality experience and we plan to incorporate hospitality, including cafés, wine vaults and barista bars in many of the new Galleries that we open in the future. As of February 2, 2019, we operated 39 outlet stores throughout the United States and Canada.

### Key Value Driving Strategies

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

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

New Design Gallery sites are identified based on a variety of factors, such as the 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 us for the new location, as well as satisfactory and timely completion of real estate development including procurement of permits and completion of construction. Based on our analysis, we believe we have the opportunity to operate Design Galleries in 60 to 70 locations in the United States and Canada. The number of Design Galleries we open in any fiscal year is highly dependent upon these variables and individual new Design Galleries may be subject to delay or postponement depending on the circumstances of specific projects.

We opened our Portland Design Gallery in March 2018, our Nashville Design Gallery in June 2018, as well as our New York Design Gallery and our Design Gallery in Yountville, California in the Napa Valley, in September 2018. Our Galleries in Nashville, New York and Yountville include integrated cafés, wine vaults and barista bars.

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

First, we have developed a new RH prototype Design Gallery that is an innovative and flexible blueprint which we believe will enable us to more quickly place our disruptive product assortment and immersive retail experience into the market. The new model is a standard we will utilize in the future that is based on key learnings from our recent Gallery openings and will range in size from 33,000 leased selling square feet inclusive of our integrated hospitality experience to 29,000 leased selling square feet without. These new Galleries will represent our assortments from RH

Interiors, Modern, Baby & Child, Teen and Outdoor and contain interior design offices and presentation rooms where design professionals can work with clients on their projects. Due to the reduced square footage compared to our recent Design Gallery openings and efficient design, this new model will be more capital efficient with less time and cost risk, but yield similar productivity. We anticipate the new prototype Design Galleries will represent approximately two thirds of our target markets. Future prototype location examples include Edina, MN, Corte Madera, CA, Columbus, OH and Charlotte, NC.

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

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

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

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

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

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

First, due to the productivity and proof of concept of our recent new Galleries, and the addition of a powerful, traffic-generating hospitality experience, we are able to negotiate “capital light” leasing deals, where as much as 65% to 100% of the capital requirement would be funded by the landlord, versus 35% to 50% previously. We currently have 15 potential capital light deals in the development pipeline that would be scheduled to open in fiscal 2019 and beyond.

Second, in several of our current projects, we are migrating from a leasing to a development model. We currently have two Galleries, Yountville and Edina, using this new model, and have an additional four potential development projects in the pipeline. In the case of Yountville and Edina, we expect to complete a sale-leaseback that should allow us to recoup all or a large portion of our capital. In some cases we believe we may be able to pre-sell the property and structure the transaction where the capital to build the project is advanced by the buyer during construction, which could require zero upfront capital from us.

Third, we are working on joint venture projects, where we share the upside of a development with the developer/landlord. An example of this new model would be our future Gallery and Guesthouse in Aspen, where we are contributing the value of our lease to the development in exchange for a profits interest in the project. The developer will deliver to RH a substantially turnkey Gallery and Guesthouse, while we continue to retain a 20% and 25% profits interest in the properties, respectively. We would expect to monetize the profits interest at the time of sale of the properties during the first five years. The net result should be a minimal capital investment to operationalize the business, with the expectation for a net positive capital benefit at time of monetization of the profits interest.

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

**Expand Our Offering and Increase Our Market Share.** We believe we have a significant opportunity to increase our market share by:

- transforming our real estate platform;
- growing our merchandise assortment and introducing new products and categories;
- expanding our service offerings, including design services 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, advertising, and public relations activities and events. During fiscal 2017 and fiscal 2018 we deferred the introduction of major new product category expansions other than the ongoing development of RH Hospitality in conjunction with new Design Galleries. We plan a return to our product and business expansion strategy in fiscal 2019, which has been on hold as we focus on the architecture of a new operating platform.

We also plan to increase our investment in RH Interior Design in fiscal 2019 with a goal of building the leading interior design firm in North America. We believe there is a significant revenue opportunity by offering world class design and installation services as we move the brand beyond creating and selling products, to conceptualizing and selling spaces.

• **Architect New Operating Platform.** We have spent the last three years architecting a new operating platform, inclusive of transitioning from a promotional to membership model, our distribution center network redesign, the redesign of our reverse logistics and outlet business, and the reconceptualization of our home delivery and customer experience, enable us to drive lower costs and inventory levels, and higher earnings and inventory turns. Looking forward, we expect this multi-year effort to result in a dramatically improved customer experience, continued margin enhancement and significant cost savings over the next several years.

• **Maximize Cash Flow and Optimize the Allocation of Capital in the Business.** In fiscal 2017 and 2018, we have focused on maximizing cash flow in our business and the allocation of capital. We believe that our operations and current initiatives are providing a significant opportunity to optimize the allocation of capital in our business, including generating free cash flow and optimizing our balance sheet, as well as deploying capital to repay debt and repurchase shares of our common stock, which we believe creates a long term benefit to our shareholders.

In October 2018, our Board of Directors approved a share repurchase program, in an aggregate amount of \$700 million of which (x) \$250.0 million in share repurchases were completed in fiscal 2018, and (y) the \$700 million authorization amount was replenished by the Board of Directors in March, 2019. During fiscal 2018 we repurchased approximately 2.0 million shares of our common stock pursuant to this repurchase program which represented 10% of the shares outstanding as of the end of fiscal 2017. 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. This represented 50% of the shares outstanding as of the end of fiscal 2016. Our focus on cash also resulted in our generating \$163 million and \$415 million in free cash flow in fiscal 2018 and fiscal 2017, respectively (refer to “Share Repurchase Programs” below for our free cash flow calculation).

• **Increase Operating Margins.** During the period from fiscal 2016 through fiscal 2018, we have substantially increased the operating margins in our business. We anticipate continued improvements in operating margins as a result of our focus on a number of our strategic initiatives including (i) the occupancy leverage we expect to gain from our real estate transformation, (ii) product margin expansion as we continue to drive higher full price selling in our core business, and (iii) the continued cost savings of improvements to our operating platform and organizational structure.

#### Business Initiatives

We are undertaking a large number of new business initiatives in support of our key value driving strategies. In particular, during fiscal 2016 through fiscal 2018, we have pursued a range of strategic efforts to improve our business and operations including the following:

• **Introduction of Membership Model.** In March 2016, we introduced the RH Members Program, an exclusive membership model 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.

For the year ended February 2, 2019, our members drove approximately 95% of sales in our core RH business, and we had approximately 418,000 members at year end. Our core RH business reflects the product categories that the membership discount can be applied to, and as a result sales generated via Outlet, Contract, Hospitality or Waterworks are excluded.

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

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

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

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

**Distribution Center Network Redesign.** As a result of our work to redesign our distribution network and optimize inventory, in fiscal 2017 we were able to forego building a fifth furniture distribution center planned to open and consolidate our current furniture distribution center network from four primary locations to two primary locations (Northern California and Baltimore, Maryland area). 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. In fiscal 2018, we completed the closure of a smaller furniture distribution center in Essex, Maryland, eliminating 500,000 square feet of distribution center space, resulting in savings in excess of \$5 million annually. We believe managing our business in fewer facilities while decreasing our on-hand inventory will reduce fulfillment complexity, lower inventory transfer costs, increase inventory turns, improve working capital and should result in higher gross margins over time.

**Reconceptualize Reverse Logistics Business.** In fiscal 2017, we implemented initiatives to re-conceptualize our Outlet and reverse logistics business. Previously, returns of furniture would be transferred via our home delivery hubs back to a furniture distribution center, then eventually to one of our Outlet locations. Now, returns of furniture are transferred directly from our home delivery hubs to Outlets, which has reduced transportation and handling costs, and improved selling margins across our Outlet network. We believe this initiative yielded substantial savings and margin enhancement 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. While we have in-sourced the majority of our home delivery hub facilities, we 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 hospitality experience in a number of our new Galleries, will further enhance our customers' in-store



experience, allowing us to further disrupt the highly fragmented home furnishings landscape and achieve market share gains.

**Development and Refinement of Hospitality Experience.** In 2015 we began to introduce an integrated hospitality experience, including cafés, wine vaults and barista bars, into a number of our new Gallery locations. The success of our initial hospitality offering in Chicago led us to broaden this initiative by adding hospitality to a number of our other new Gallery locations. We believe this has created a unique new retail experience that cannot be replicated online, and that the addition of hospitality is helping to drive incremental sales of home furnishings in these Galleries.

**Pursue International Expansion.** We believe that our luxury brand positioning and unique aesthetic will have strong international appeal. As such, we believe there is tremendous opportunity for the RH brand to expand globally and are

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currently exploring opportunities for Design Galleries in several locations outside the United States, including the United Kingdom and Europe.

We continue to pursue and test numerous initiatives to improve many aspects of our business including through efforts to optimize inventory, elevate the home delivery experience, simplify our distribution network and improve our organizational design including by streamlining and realigning our home office operations, as well as to expand our product offering and transform our real estate using a range of different models for specific real estate development projects. 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. Delays in completion of our real estate development projects or costs overruns could also negatively affect our results of operation. Further, macroeconomic or political events outside of our control could impact our ability to pursue our initiatives or the success of such initiatives. For example, in recent periods the stock market has experienced significant volatility as well as periods of significant decline, which may negatively affect the financial health and demand levels of high-end consumers. The housing market is affected by a range of factors including home prices and interest rates and slowdowns in the housing market can have a negative impact on demand for our products. Factors that affect the higher end housing market in particular may have an outsized influence on our levels of consumer demand since our business is geared toward the higher end of the home furnishings market. The above factors and other current and future operational initiatives may create additional uncertainty with respect to our consolidated net revenues and profit in the near term.

#### Factors Affecting Our Results of Operations

Various factors affected our results for the periods presented in this “Management’s Discussion and Analysis of Financial Condition and Results of Operations,” and such discussion generally lists the factors in order of magnitude based on their impact. 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;
- the timing and progress of the opening of new Design Galleries that are under development;
- the pursuit of our multi-tier market approach to our real estate transformation;
- the redesign of our distribution center network;
- 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;
- 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;
- changes in our reverse logistics model resulting in transferring customer returns direct from our home delivery hubs to Outlets;
- efforts to elevate the customer experience including architecting a new fully integrated back-end operating platform, inclusive of the supply chain network, the home delivery experience as well as a new metric driven quality system and company-wide decision data, vendor product initiatives and changes to the way we operate our distribution centers, home delivery hubs and customer service centers; and
- leveraging the above strategic initiatives across both our RH Segment and Waterworks to drive the performance of each business.

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

While we anticipate that these initiatives will support the growth of our business, costs and timing issues associated with pursuing these initiatives can negatively affect our growth rates in the short term and may amplify fluctuations in our growth rates from quarter to quarter. In addition, we anticipate that our net revenues, adjusted net income and other performance metrics will remain variable as our business model continues to emphasize high growth and numerous, concurrent and evolving business initiatives.

**Our Ability to Source and Distribute Products Effectively.** Our net revenues and gross profit are affected by our ability to purchase our merchandise in sufficient quantities at competitive prices. Our current and anticipated demand, and our level of net revenues have been adversely affected in prior periods by constraints in our supply chain, including the inability of our vendors to produce sufficient quantities of some merchandise in a manner that was able to match market demand from our customers, leading to higher levels of customer back orders and lost sales. For example, some of our vendors experienced difficulty in producing goods in sufficient quantity to meet initial customer demand for RH Modern when it was launched in October 2015.

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

**Overall Economic Trends.** The industry in which we operate is cyclical, and consequently our net revenues are affected by general economic conditions including conditions that affect the housing market. We target consumers of high-end home furnishings. As a result, we believe that our sales are sensitive to a number of macroeconomic factors that influence consumer spending generally, but that our sales are particularly affected by the health of the higher end customer and demand levels from that customer demographic. While the overall home furnishings market may be influenced by factors such as employment levels, interest rates, demographics of new household formation and the affordability of homes for the first time home buyer, the higher end of the housing market may be disproportionately influenced by other factors, including stock market prices, the number of second and third homes being bought and sold, the number of foreign buyers in higher end real estate markets in the U.S., tax policies and interest rates, and the perceived prospect for capital appreciation in higher end real estate. We have in the past experienced volatility in our sales trends related to many of these factors and believe our sales may be impacted by these economic factors in future periods. 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 vary depending upon a variety of factors, including our product offerings, store openings, shifts in the timing of holidays and the timing of Source Book releases, promotional events and the timing and extent of our realization of the costs and benefits of our numerous strategic initiatives, among other things. As a result of these factors, our working capital requirements and demands on our product distribution and delivery network may fluctuate during the year. Unique factors in any given quarter may affect period-to-period comparisons between the quarters being compared, and the results for any quarter are not necessarily indicative of the results that we may achieve for a full fiscal year.

#### How We Assess the Performance of Our Business

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

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

when collected from customers and recognized as revenue based on expected product revenues over the annual membership period.

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

Our gross profit can be favorably impacted by sales volume increases, as occupancy and certain other costs that are largely fixed do not necessarily increase proportionally with volume increases. Changes in the mix of our products may also impact our gross profit. We review our inventory levels on an ongoing basis in order to identify slow-moving merchandise and use product markdowns and our outlet stores to efficiently sell these products. The timing and level of markdowns are driven primarily by customer acceptance of our merchandise. The primary drivers of the costs of individual goods are raw materials costs, which fluctuate based on a number of factors beyond our control, including commodity prices, changes in supply and demand, general economic conditions, competition, import duties, tariffs and government regulation, logistics costs (which may increase in the event of, for example, expansions of or interruptions in the operation of our distribution centers, furniture home delivery 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. We expect certain of these expenses to continue to increase as we continue to open new stores, develop new product categories and otherwise pursue our current business initiatives. Selling, general and administrative expenses as a percentage of net revenues are usually higher in lower-volume quarters and lower in higher-volume quarters because a significant portion of the costs are relatively fixed.

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

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

We define adjusted EBITDA as consolidated net income before depreciation and amortization, interest expense, provision for income taxes and non-cash compensation, adjusted for the impact of certain non-recurring and other items that we do not consider representative of our underlying operating performance. Because adjusted EBITDA omits non-cash items, we feel that it is less susceptible to variances in actual performance resulting from depreciation, amortization and other non-cash charges and can be more reflective of our operating performance.

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

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 RH 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 2018, 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 2, 2019	February 3, 2018	January 28, 2017
<b>Consolidated Statements of Income:</b>			
Net revenues	\$2,505,653	\$2,440,174	\$2,134,871
Cost of goods sold	1,504,806	1,591,107	1,455,084
Gross profit	1,000,847	849,067	679,787
Selling, general and administrative expenses	711,617	717,766	626,751
Income from operations	289,230	131,301	53,036
<b>Other expenses</b>			
Interest expense—net	75,074	62,570	44,482
Goodwill and tradename impairment	32,086	33,700	—
Loss on extinguishment of debt	917	4,880	—
Total other expenses	108,077	101,150	44,482
Income before income taxes	181,153	30,151	8,554
Income tax expense	30,514	27,971	3,153
Net income	\$150,639	\$2,180	\$5,401
<b>Other Financial and Operating Data:</b>			
<b>Net revenues:</b>			
Stores <sup>(1)</sup>	\$1,412,105	\$1,371,342	\$1,178,860
Direct <sup>(2)</sup>	\$1,093,548	\$1,068,832	\$956,011
Direct as a percentage of net revenues <sup>(2)</sup>	44	% 44	% 45
<b>Growth in net revenues:</b>			
Stores <sup>(1)</sup>	3	% 16	% 9
Direct <sup>(2)</sup>	2	% 12	(7)%
Total	3	% 14	1%
Comparable brand revenue growth <sup>(3)</sup>	4	% 6	(7)%

(1) Stores data represents sales originating in retail stores, including Waterworks showrooms, and outlet stores. Net revenues for outlet stores, which include warehouse sales, were \$179.0 million, \$205.7 million and \$144.6 million, for fiscal 2018, fiscal 2017 and fiscal 2016, respectively.

(2) Direct net revenues include sales originating from 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 RH 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 2018, 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.

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

	Year Ended					
	February 2,	February 3,	January 28,			
	2019	2018	2017			
<b>Consolidated Statements of Income:</b>						
Net revenues	100.0%	100.0	%	100.0	%	
Cost of goods sold	60.1	65.2		68.2		
Gross profit	39.9	34.8		31.8		
Selling, general and administrative expenses	28.4	29.4		29.3		
Income from operations	11.5	5.4		2.5		
<b>Other expenses</b>						
Interest expense—net	3.0	2.6		2.1		
Goodwill and tradename impairment	1.3	1.4		—		
Loss on extinguishment of debt	—	0.2		—		
Total other expenses	4.3	4.2		2.1		
Income before income taxes	7.2	1.2		0.4		
Income tax expense	1.2	1.1		0.1		
Net income	6.0	%	0.1	%	0.3	%

### Fiscal 2018 Compared to Fiscal 2017

Fiscal 2018 includes results for fifty-two weeks and fiscal 2017 includes results for fifty-three weeks for both the RH Segment and Waterworks.

	Year Ended					
	February 2,			February 3,		
	2019			2018		
	RH Segment	Waterworks <sup>(1)</sup>	Total	RH Segment	Waterworks <sup>(1)</sup>	Total
	(in thousands)					
Net revenues	\$2,375,472	\$ 130,181	\$2,505,653	\$2,319,332	\$ 120,842	\$2,440,174
Cost of goods sold	1,426,165	78,641	1,504,806	1,517,333	73,774	1,591,107
Gross profit	949,307	51,540	1,000,847	801,999	47,068	849,067
Selling, general and administrative expenses	658,542	53,075	711,617	666,055	51,711	717,766
Income (loss) from operations	\$290,765	\$ (1,535)	\$289,230	\$135,944	\$ (4,643)	\$131,301

(1)

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

#### Net revenues

Consolidated net revenues increased \$65.5 million, or 2.7%, to \$2,505.7 million in fiscal 2018 compared to \$2,440.2 million in fiscal 2017. Stores net revenues increased \$40.8 million, or 3.0%, to \$1,412.1 million in fiscal 2018 compared to \$1,371.3 million in fiscal 2017. Direct net revenues increased \$24.7 million, or 2.3%, to \$1,093.5 million in fiscal 2018 compared to \$1,068.8 million in fiscal 2017. Comparable brand revenue was 4% for fiscal 2018.

#### RH Segment net revenues

RH Segment net revenues increased \$56.1 million, or 2.4%, to \$2,375.5 million in fiscal 2018 compared to \$2,319.3 million in fiscal 2017. The below discussion highlights several significant factors that resulted in increased RH Segment net revenues. Given the overall increase in RH Segment net revenues, our discussion below first lists, which we believe are in order of magnitude, all factors that contributed to the increase and then lists the factors that partially offset the overall increase.

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

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

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

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

#### Waterworks net revenues

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

#### Gross profit

Consolidated gross profit increased \$151.8 million, or 17.9%, to \$1,000.8 million in fiscal 2018 compared to \$849.1 million in fiscal 2017. As a percentage of net revenues, gross margin increased 5.1% to 39.9% of net revenues in fiscal 2018 compared to 34.8% of net revenues in fiscal 2017.

RH Segment gross profit for fiscal 2018 was negatively impacted by \$2.6 million related to acceleration of depreciation due to a change the estimated useful life of certain assets, \$1.5 million related to costs associated with distribution center closures, \$1.2 million due to inventory impairment related to Holiday merchandise and \$0.6 million related to product recalls, including (i) the reduction of revenue, (ii) incremental costs and (iii) inventory charges, partially offset by (iv) insurance reimbursements.

RH Segment gross profit for fiscal 2017 was negatively impacted by \$7.5 million related to product recalls, including (i) the reduction of revenue, (ii) incremental costs and (iii) inventory charges, and \$1.7 million related to costs associated with distribution center closures. RH Segment gross profit for fiscal 2017 was positively impacted by \$2.2 million related to the release of the remaining reserve for potential claims regarding anti-dumping duties which we believe have lapsed.

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

Excluding the accelerated asset depreciation, costs associated with the distribution center closures, inventory impairment, product recall adjustments, impact of the amortization related to the inventory fair value adjustment and release of the anti-dumping duty reserve mentioned above, consolidated gross margin would have increased 5.0% to 40.1% of net revenues in fiscal 2018 compared to 35.1% of net revenues in fiscal 2017.

### RH Segment gross profit

RH Segment gross profit increased \$147.3 million, or 18.4%, to \$949.3 million in fiscal 2018 compared to \$802.0 million in fiscal 2017. As a percentage of net revenues, RH Segment gross margin increased 5.4% to 40.0% of net revenues in fiscal 2018 compared to 34.6% of net revenues in fiscal 2017.

Excluding the accelerated asset depreciation, costs associated with distribution center closures, inventory impairment, product recall adjustments and release of the anti-dumping duty reserve mentioned above, RH Segment gross margin would have increased 5.3% to 40.1% of net revenues in fiscal 2018 compared to 34.8% of net revenues in fiscal 2017. The increase was related to improvements in our core merchandise margins as our SKU rationalization efforts had a reduced impact on our margins this year compared to last year, as well as increased outlet product margins due to higher outlet and warehouse sales during fiscal 2017 driven by increased promotions and higher discounts versus fiscal 2018. In addition, we achieved leverage in our occupancy costs primarily related to our distribution center network redesign. The overall increase in gross margin was partially offset by higher delivery costs and our investment in the ramping of our new RH Hospitality locations.

### Waterworks gross profit

Waterworks gross profit increased \$4.5 million, or 9.5%, to \$51.5 million in fiscal 2018 compared to \$47.1 million in fiscal 2017. As a percentage of net revenues, Waterworks gross margin increased 0.6% to 39.6% of net revenues in fiscal 2018 compared to 39.0% of net revenues in fiscal 2017. Excluding the impact of the amortization related to the inventory fair value adjustment mentioned above, Waterworks gross margin would have decreased 1.1% to 39.9% of net revenues in fiscal 2018 compared to 41.0% of net revenues in fiscal 2017. The decrease in gross margin is primarily due to SKU rationalization efforts in fiscal 2018, as well as deleverage in occupancy costs resulting from lower than expected revenue growth.

### Selling, general and administrative expenses

Consolidated selling, general and administrative expenses decreased \$6.1 million, or 0.9%, to \$711.6 million in fiscal 2018 compared to \$717.8 million in fiscal 2017.

### RH Segment selling, general and administrative expenses

RH Segment selling, general and administrative expenses decreased \$7.5 million, or 1.1%, to \$658.5 million in fiscal 2018 compared to \$666.1 million in fiscal 2017.

RH Segment selling, general and administrative expenses for fiscal 2018 included a \$10.0 million charge related to reorganizations primarily due to streamlining and realigning our home office operations, as well as due to distribution center closures, \$3.4 million related to remeasurement of RH Contemporary Art lease loss liability, \$1.0 million related to product recalls, \$0.3 million related to costs associated with distribution center closures and a favorable \$5.3 million legal settlement, net of related legal expenses.

RH Segment selling, general and administrative expenses for fiscal 2017 included \$23.9 million related to a fully vested option grant made to Mr. Friedman in May 2017, \$4.4 million related to remeasurement of RH Contemporary Art lease loss liability, \$3.1 million costs associated with distribution center closures, \$0.9 million reorganization charges, \$0.2 million incremental costs associated with product recalls and a gain of \$2.1 million related to the sale of building and land.

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

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

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

RH Segment selling, general and administrative expenses were 27.3% and 27.4% of net revenues for fiscal 2018 and fiscal 2017, respectively, excluding the reorganizations, the remeasurement of the lease liability associated with RH Contemporary Art, the product recalls, the distribution center closures, the legal settlement, the fully vested option grant made to Mr. Friedman in May 2017 and the gain related to the sale of building and land mentioned above. The decrease in selling, general and administrative expenses as a percentage of net revenues was primarily driven by advertising and marketing, partially offset by preopening expense associated with our Design Gallery openings.

#### Waterworks selling, general and administrative expenses

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

#### Interest expense—net

Interest expense increased \$12.5 million to \$75.1 million in fiscal 2018 compared to \$62.6 million in fiscal 2017. Interest expense consisted of the following:

	Year Ended	
	February 2, 2019	February 3, 2018
	(in thousands)	
Amortization of convertible senior notes debt discount	\$41,868	\$30,457
Build-to-suit lease transactions	22,667	16,781
Asset based credit facility	6,192	7,042
Amortization of debt issuance costs and deferred financing fees	3,640	4,705
Term loans	1,649	4,526
Other interest expense	3,031	2,877
Capitalized interest for capital projects	(3,139 )	(3,304 )
Interest income	(834 )	(514 )
Total interest expense—net	\$75,074	\$62,570

#### Goodwill and tradename impairment

We incurred a \$32.1 million goodwill and tradename impairment charge in fiscal 2018 and a \$33.7 million goodwill impairment charge in fiscal 2017 for our Waterworks reporting unit. Refer to “Impairment” within Note 3—Significant Accounting Policies in our consolidated financial statements for details regarding the impairment.

#### Loss on extinguishment of debt

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



term loan in October 2017, which 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 \$30.5 million in fiscal 2018 compared to \$28.0 million in fiscal 2017. Our effective tax rate was 16.8% in fiscal 2018 compared to 92.8% in fiscal 2017. The effective tax rate in fiscal 2018 was significantly impacted by discrete tax benefits related to net excess tax windfalls from stock-based compensation of \$15.9 million resulting from increased option exercise activity and appreciation of the stock price, the Waterworks reporting unit goodwill impairment, as well as the reduction in the U.S. corporate income tax rate from 35% to 21% effective January 1, 2018 due to the passage of the Tax Cuts and Jobs Act (the “Tax Act”). 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 fiscal 2017 effective tax rate was favorably impacted by net excess tax benefits from stock-based compensation of \$7.0 million.

The United States enacted the Tax Cuts and Jobs Act (the “Tax Act”) on December 22, 2017. The new legislation contains several key tax provisions that affect us and, as required, we have included reasonable estimates of the income tax effects of the changes in tax law and tax rate in our fiscal 2017 financial results. Since the Tax Act was passed in the fourth quarter of fiscal 2017, we considered the accounting for the transition tax, deferred tax re-measurements, and other items to be provisional. As of February 2, 2019, we finalized our estimates within the one-year measurement period allowed by the SEC and completed our accounting for the tax effects of enactment of the Tax Act.

Our provision for income taxes in fiscal 2017 included \$7.0 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. We completed our accounting for re-measurement of our deferred tax assets and recorded \$0.5 million of income tax expense as a result. No additional income tax expense or benefit was recorded relating to the completion of our transition tax liability.

## 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 (in thousands)	Waterworks (1)	Total	RH Segment	Waterworks (1)	Total
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
	666,055	51,711	717,766	590,288	36,463	626,751

Selling, general and administrative  
expenses

Income (loss) from operations	\$ 135,944	\$ (4,643	) \$ 131,301	\$ 65,903	\$ (12,867	) \$ 53,036
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(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. 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 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 \$40.6 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 compared to \$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 compared to 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 compared to 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 compared to \$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 compared to 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 compared to 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 compared to \$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 compared to 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 compared to 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 to \$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, \$3.1 million costs associated with distribution center closures, \$0.9 million reorganization charges, \$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 and tradename 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 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.

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 included reasonable estimates of the income tax effects of the changes in tax law and tax rate in our fiscal 2017 financial results. Since the Tax Act was passed in the fourth quarter of fiscal 2017, we considered the accounting for the transition tax, deferred tax re-measurements, and other items to be provisional 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. As of February 2, 2019, we finalized 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.

## 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 2, 2019. This quarterly information has been prepared on the same basis as our annual audited financial statements and includes all adjustments that we consider necessary to fairly state the financial information for the fiscal quarters presented. The quarterly data should be read in conjunction with our consolidated financial statements and the related notes included in Item 8—Financial Statements and Supplementary Data.

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

	Fiscal 2017				Fiscal 2018			
	First	Second	Third	Fourth	First	Second	Third	Fourth
	Quarter	Quarter	Quarter	Quarter	Quarter	Quarter	Quarter	Quarter
	(dollars in thousands)							
Net revenues	\$562,080	\$615,326	\$592,473	\$670,295	\$557,406	\$640,798	\$636,558	\$670,891
Cost of goods sold	391,824	409,513	378,148	411,622	345,371	369,198	382,047	408,190
Gross profit	170,256	205,813	214,325	258,673	212,035	271,600	254,511	262,701
Selling, general and administrative expenses	163,360	193,690	171,163	189,553	158,434	186,225	207,495	159,463

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Income from operations	6,896	12,123	43,162	69,120	53,601	85,375	47,016	103,238
Other expenses								
Interest expense—net	12,179	14,402	18,915	17,074				