RH
Form 10-K
March 29, 2017

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 January 28, 2017

or

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from to

Commission file number: 001-35720

RH

(Exact name of registrant as specified in its charter)

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

(Address of principal executive offices)
Registrant's telephone number, including area code: (415) 924-1005

Securities registered pursuant to Section 12(b) of the Act:

Common Stock, $0.0001 par value	New York Stock Exchange, Inc.
(Title of class)	(Name of each exchange on which registered)

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

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

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

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

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

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

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

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

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

As of July 29, 2016, 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 $850,170,955. 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 24, 2017, 35,902,419 shares of registrant's common stock were outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's Proxy Statement for its 2017 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 January 28, 2017.

RH

INDEX TO FORM 10-K

SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS AND MARKET DATA

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

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

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

PART I

Item 1. Business

Overview

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

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

On May 27, 2016, we acquired a controlling interest in Design Investors WW Acquisition Company, LLC, which owns the business operating under the name "Waterworks," for consideration consisting of approximately $119.9 million, consisting of $118.4 million funded with available cash and $1.5 million representing the fair value of rollover units, which amount is subject to adjustment for changes in working capital and other items. After the transaction, and giving effect to equity interests acquired by management in the business, we own in excess of 90% of the total equity interests in Waterworks.

Our business is fully integrated across our multiple channels of distribution, consisting of our stores, Source Books, and websites. As of January 28, 2017, we operated a total of 85 retail Galleries, consisting of 50 legacy Galleries, 6 larger format Design Galleries, 8 next generation Design Galleries, 1 RH Modern Gallery and 5 RH Baby & Child Galleries throughout the United States and Canada, and 15 Waterworks showrooms in the United States and in the U.K. In addition, as of January 28, 2017, we operated 28 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, catalogs and websites. We believe the level of integration among all of our channels and our approach to the market distinguishes us from most other retailers. For fiscal 2016, sales of products originating in our stores represented 55% of our net revenues, while sales from our direct business represented 45% of our net revenues. We believe our channels complement each other and our customers' buying decisions are influenced by their experiences across more than one of our sales channels. We encourage our customers to shop across our channels and have aligned our business and internal organization to be channel agnostic. Our integrated distribution and product delivery network serves all of our channels. We believe the key advantage of our multiple sales channels is our ability to leverage the unique attributes of each channel in our approach to the market.

Stores

Retail Galleries

Our retail Galleries are located primarily in upscale malls and street locations, as well as in iconic locations. We believe situating our Galleries in desirable locations with high visibility is critical to the success of our business, and we identify Gallery locations based on several store specific aspects including geographic location, demographics, and proximity to other high-end specialty retail stores. We pursue a market-based sales strategy, whereby we assess each market's overall sales potential and how best to approach the market across all of our channels. We customize square footage and catalog circulation to maximize each market's sales potential and increase our return on invested capital.

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, because less than 10% of our merchandise assortment is displayed in our legacy Galleries, our store associates use iPads and other devices to allow customers to shop our entire merchandise assortment while in the Gallery.

We currently operate the following distinct store types, as of January 28, 2017:

1) Next generation Design Galleries; which include our Galleries in Atlanta, Chicago, Denver, Tampa, Leawood, Austin, Las Vegas and Seattle, which average approximately 41,000 leased selling square feet;
2) Larger format Design Galleries; which include our Galleries in Houston, Scottsdale, Boston, Indianapolis, Greenwich, and Los Angeles, which average approximately 19,000 leased selling square feet;
3) Legacy Galleries, which average approximately 8,000 leased selling square feet;
4) Waterworks Showrooms, which average approximately 4,000 leased selling square feet
5) The RH Modern Gallery, which is located in Los Angeles and is approximately 13,000 leased selling square feet; and
6) RH Baby & Child Galleries, which average approximately 4,000 leased selling square feet.

We continue to evaluate potential opportunities for stand-alone RH Baby & Child, RH Teen and RH Modern Galleries in key markets.

In fiscal 2016, we opened four next generation Design Galleries:

1) RH Leawood, The Gallery at Town Center Plaza;
2) RH Austin, The Gallery at the Domain;
3) RH Las Vegas, The Gallery at Tivoli Village; and
4) RH Seattle, The Gallery at University Village.

In each of these markets the Company closed a legacy Gallery simultaneously with the opening of the new next generation Design Gallery, other than Las Vegas which was a new market for RH.

In fiscal 2015, RH unveiled its initial foray into hospitality at RH Chicago, The Gallery at the Three Arts Club. This first of its kind retail concept provides a seamlessly integrated culinary offering, including the 3Arts Club Café, the 3Arts Club Wine Vault & Tasting Room, and the 3Arts Club Panty & Espresso Bar. Building on the success in Chicago, RH plans to introduce an integrated hospitality experience in our Galleries in select markets beginning in 2017.

Retail Gallery Metrics [1]

	Twelve Months Ended January 28, 2017		January 30, 2016	
	Store Count	Total Leased Selling Square Footage [2] (in thousands)	Store Count	Total Leased Selling Square Footage [2] (in thousands)
Beginning of period	69	725	67	607
Waterworks Showrooms acquired	15	51.0	—	—
Retail Galleries opened:				
Leawood next generation Design Gallery	1	33.5	—	—
Waterworks San Francisco Showroom	1	5.8	—	—
Austin next generation Design Gallery	1	39.6	—	—
Las Vegas next generation Design Gallery	1	47.6	—	—
Seattle next generation Design Gallery	1	35.7	—	—
Pittsburgh Gallery	1	6.0	—	—
Tampa temporary Gallery	—	—	1	4.3
Baby & Child West Palm Beach Gallery	—	—	1	2.5
Baby & Child Greenwich Gallery	—	—	1	4.2
Chicago next generation Design Gallery	—	—	1	44.8
Denver next generation Design Gallery	—	—	1	46.4
Los Angeles RH Modern Gallery	—	—	1	12.8
Tampa next generation Design Gallery	—	—	1	36.1
San Diego temporary Gallery	—	—	1	5.7
Retail Galleries closed:				
Kansas City legacy Gallery	(1)	(9.9)	—	—
Waterworks San Francisco (Kansas Street) Showroom	(1)	(2.0)	—	—
Austin legacy Gallery	(1)	(6.2)	—	—
Seattle legacy Gallery	(1)	(8.1)	—	—
Pittsburgh legacy Gallery	(1)	(5.7)	—	—

Tampa legacy Gallery	—	—	(1)	(6.1)
Chicago (Deer Park) legacy Gallery	—	—	(1)	(6.1)
Chicago (Lincoln Park) legacy Gallery	—	—	(1)	(8.4)
Denver legacy Gallery	—	—	(1)	(7.5)
Tampa temporary Gallery	—	—	(1)	(4.3)
San Diego legacy Gallery	—	—	(1)	(6.8)
End of period	85	912	69	725
Total leased square footage at end of period (3)		1,242		1,011
Weighted-average leased square footage (4)		1,108		904
Weighted-average leased selling square footage (4)		802		641
Retail sales per leased selling square foot (5)		$ 1,271		$ 1,463

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

(2) Leased selling square footage is retail space at our stores used to sell our products. Leased selling square footage excludes backrooms at retail stores used for storage, office space 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 2016 and fiscal 2015 includes approximately 13,000 square feet related to two owned store locations.

(3) Total leased square footage for fiscal 2016 and fiscal 2015 includes approximately 24,000 square feet related to two owned store locations.

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

(5) Retail sales per leased selling square foot is calculated by dividing total net revenues for all retail stores, comparable and non-comparable, by the weighted-average leased selling square footage for the period.

As of January 28, 2017, we operated a total of 85 retail Galleries, consisting of 50 legacy Galleries, 6 larger format Design Galleries, 8 next generation Design Galleries, 1 RH Modern Gallery and 5 RH Baby & Child Galleries throughout the United States and Canada, and 15 Waterworks showrooms in the United States and in the U.K. The following list shows the number of retail Galleries in each U.S. state, each Canadian province and in the U.K. where we operate as of January 28, 2017:

Location	Store	Location	Store	Location	Store
Alabama	1	Massachusetts	2	Tennessee	1
Arizona	2	Michigan	1	Texas	7
California	19	Minnesota	1	Utah	1
Colorado	2	Missouri	1	Virginia	2
Connecticut	4	Nevada	1	Washington	1
Florida	6	New Jersey	2	District of Columbia	2
Georgia	2	New York	5	Alberta	2
Illinois	3	North Carolina	2	British Columbia	1
Indiana	1	Ohio	3	Ontario	2
Kansas	1	Oklahoma	1	London	1
Louisiana	1	Oregon	1		
Maryland	1	Pennsylvania	2	Total	85

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

Outlet Stores

As of January 28, 2017, we operated 28 outlet stores in 20 states in the United States and Canada. Of the 12 outlets opened in fiscal 2016, seven have short-term lease agreements with terms of 24 months or less. Our outlet stores are branded as Restoration Hardware Outlet or RH Outlet and are typically located in large outlet malls. Our outlet stores serve as an efficient means to sell second quality, discontinued and overstock inventory outside of our core sales channels. In addition, we periodically hold warehouse sales to liquidate inventory. These net revenues are included in our outlet channel.

E-Commerce

Our primary websites, www.rh.com, www.restorationhardware.com, www.rhbabyandchild.com, www.rhteen.com and www.rhmodern.com, provide our customers with the ability to purchase our merchandise online. On May 27, 2016, we acquired a controlling interest in Waterworks, which sells products online through www.waterworks.com.

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

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

Source Books

We produce a series of catalogs, which we refer to as Source Books, to showcase our merchandise assortment. In fiscal 2016, these included our Interiors, Outdoor, RH Modern, RH TEEN, RH Baby & Child, Rugs, Lighting and Holiday Source Books. Our Source Books are one of our primary branding and advertising vehicles. We have found that merchandise assortments displayed in our Source Books contribute to increased sales of those products across all of our channels. As in our retail stores, our Source Books present our merchandise in lifestyle settings that reflect our unique design aesthetic. Our Source Books also feature profiles of select artisan vendors and other compelling editorial content regarding home décor. All creative work on our Source Books is coordinated in-house in our RH Center of Innovation & Product Leadership, providing us greater control over the brand image presented to our customers, while also reducing our Source Book production costs.

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

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

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

Trade and Contract

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

Phone Orders

In addition to making purchases in our stores or online, customers, including those from our Trade and Contract businesses, can place orders over the phone by calling our customer service associates. In fiscal 2016, phone orders represented approximately 11% of net revenues.

Marketing and Advertising

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

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

In March 2016, we introduced the RH Members Program, an exclusive new membership program that reimagines and simplifies the shopping experience. For an annual fee, the RH Members Program provides a set discount every day across all RH brands in addition to other benefits including complimentary interior design services through the RH Interior Design program and eligibility for preferred financing plans on the RH Credit Card, among other benefits. We have introduced the RH Members Program as an alternative to prior practices involving numerous event-driven promotions, which has changed the promotional cadence of our business from historical norms. Our business has evolved from a product based business to a project based business. The RH Members Program allows our customers to shop for what they want, when they want, and receive the greatest value. We believe that our shift from a promotional event model to a membership model has enhanced the customer experience, rendered our brand more valuable, improved operational execution and reduced costs.

Sourcing

We primarily contract with third-party vendors for the manufacture of our merchandise. Our sourcing strategy focuses on identifying and using vendors that can provide the quality materials and fine craftsmanship that our customers expect of our brand. To ensure that our high standards of quality and timely delivery of merchandise are met, we work closely with vendors and manufacturers. Our products are generally made from readily available raw materials. We seek to ensure the consistent quality of our manufacturers' products by selectively inspecting pre-production samples, conducting periodic site visits to certain of our vendors' production facilities and selectively inspecting inbound shipments at our distribution facilities. In fiscal 2016, we sourced approximately 75% of our purchase dollar volume from approximately 28 vendors. In fiscal 2016, one vendor accounted for approximately 13% of our purchase dollar volume. Based on total dollar volume of purchases for fiscal 2016, approximately 78% of our products were sourced in Asia, the majority of which originated from China, 12% from the United States and the remainder from other regions.

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

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

Distribution and Delivery

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

We offer a white glove home delivery service for our larger merchandise and furniture categories, where third-party delivery personnel assist our customers by delivering fully assembled items to the location of their choice. We operate portions of our home delivery services in eleven 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.

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

We intend to continue to strengthen our supply chain operations through a number of key initiatives in fiscal 2017 designed to improve our fulfillment and delivery logistics performance and to achieve greater efficiencies in the management of our inventories which includes investing 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.

Competition

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

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

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

Employees

As of January 28, 2017, we had approximately 5,000 employees, of which approximately 800 were part-time employees. As of that date, approximately 2,400 of our employees were based in our stores. None of our employees are represented by a union, and we have had no labor-related work stoppages. We believe our relations with our employees are good.

Intellectual Property

The “RH”, “Restoration Hardware,” “RH Baby & Child,” “RH Modern,” “RH Teen,” “Waterworks,” and “Waterworks 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,” “rhbabyandchild.com,” “rhmodern.com,” “rhteen.com,” and “waterworks.com” and others that include our trademarks. These domain names are perpetually renewable. We own design patents or pending applications to protect the ornamental appearance of several of our products. These design patents are valid for 14 years from the date of issuance. We own copyrights, including copyright registrations or pending applications, for our website and for several of our Source Books. We believe that our trademarks, design patents, and copyrights have significant value and we will vigorously protect them against infringement.

Fluctuation in Quarterly Results

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

Regulation and Legislation

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

Where You Can Find More Information

We are required to file annual, quarterly and current reports, proxy statements and other information required by the Securities Exchange Act of 1934, as amended, with the SEC. You may read and copy the reports and other information we file with the SEC at the SEC’s Public Reference Room at 100 F Street, N.E., Room 1580, Washington, D.C. 20549. You may also obtain copies of this information by mail from the public reference section of the SEC, 100 F Street, N.E., Washington, D.C. 20549, at prescribed rates. You may obtain information regarding the operation of the public reference room by calling 1-800-SEC-0330. The SEC also maintains a website that contains reports, proxy statements and other information about issuers, like us, who file electronically with the SEC. The address of that website is http://www.sec.gov.

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

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

Item 1A. Risk Factors

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

Risks Related to Our Business

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

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

We attribute recent negative impacts on our sales and earnings during fiscal 2016 to several temporal issues, including the costs related to the launch of RH Modern; the timing of recognizing membership revenues related to the transition from a promotional to a membership model; efforts to reduce inventories and rationalize our SKU count; and the decision to push our 2016 Source Book mailing from the Spring to the Fall. We are seeking to address the impact of all of these temporal factors on our business, and while we are optimistic that we can move beyond these temporal issues during fiscal 2017 we can provide no assurances as to the exact degree of any success that we may have with these initiatives. In addition, some of the efforts to address these issues may continue to have an impact on financial results. For example, efforts to sell slower moving, discontinued and other inventory through markdowns and our outlet channel may drive higher sales and lower margins and earnings during some periods during fiscal 2017 as we expect these initiatives to continue during fiscal 2017.

Some factors affecting our business are not within our control including macroeconomic conditions. In prior periods, our results of operations have been adversely affected by weakness in the overall economic environment including during 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 recent 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 such as promotional events, store openings, shifts in the timing of holidays and the timing of Source Book releases, among other things. The 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.

Numerous other factors affect period-to-period comparisons in our revenue and comparable brand revenue growth, including:

- the overall economic and general retail sales environment, including the effects of uncertainty or stock market volatility on consumer spending;
- consumer preferences and demand;

- the number, size and location of stores we open, close, remodel or expand in any period;
- changes in Source Book circulation, and the number of pages in our Source Books and timing of mailing;
- our ability to efficiently source and distribute products;
- changes in our product offerings and the introduction and timing of introduction of new products and new product categories;
- promotional events;
- 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.

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

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

We are undertaking a large number of new business initiatives in order to support our future growth. For example, we have developed and continue to refine and enhance our Gallery format, which involves larger store square footage. We also continue to add new product categories and to expand product assortments. For example, in fiscal 2015 we introduced our new RH Modern and RH Teen categories. We are currently contemplating other new product lines and extensions and complementary brand-enhancing businesses, such as the expansion of our product sales to international markets and providing brand-enhancing offerings in hospitality including an integrated food and beverage experience. For example, in fiscal 2015 we unveiled our initial foray into hospitality at RH Chicago, The Gallery at the Three Arts Club, offering the 3Arts Club Café, the 3Arts Club Wine Vault & Tasting Room, and the 3Arts Club Panty & Expresso Bar. We plan to provide integrated food and beverage offerings in several of the new Gallery locations that we anticipate opening in the next several years. If we are not successful in managing the large number of new initiatives that are underway, we might experience an adverse impact on our financial performance and results of operations.

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

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

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

In addition, we are continuing a number of new initiatives to improve the operations of our business, including elevating the customer experience which includes architecting a new fully integrated back-end operating platform, inclusive of the supply chain network, the home delivery experience as well as a new metric driven quality system and company-wide decision data, transitioning from a promotional to a membership model, rationalizing our SKU count and optimizing inventory which includes selling slower moving, discontinued and other inventory through markdowns and our outlet channel, enhancing and optimizing our product sourcing capabilities, improving our distribution and delivery of products to our customers, including architecting a new fully integrated back-end operating platform, and adding new management information systems. For example, in the early part of fiscal 2016, we introduced the RH Members Program, which provides a range of benefits to our customers in return for payment of an annual membership fee. We have introduced the RH Members Program, an alternative to prior practices involving numerous event-driven promotional programs. The RH Members Program is new to our business and has not been tested prior to its introduction. Given that this concept is new and untested, there can be no certainty as to exactly how our customers may react to this program over time or how the RH Members Programs' rollout will affect our financial results from quarter to quarter.

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

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

As part of exploring growth opportunities, we may acquire from time to time value-creating, add-on businesses that broaden our existing position and market reach. For example, in fiscal 2016, we acquired a controlling interest in Waterworks. However, there can be no assurance that in the future we will be able to find suitable businesses to purchase, 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 our acquisition efforts, then our ability to continue to grow at rates we anticipate could be adversely affected. In addition, we face the risk that an acquired business may not be successful on the RH platform and may underperform relative to expectations. We may be unable to achieve synergies originally anticipated, we may be exposed to unexpected liabilities or we may be unable to sufficiently integrate completed acquisitions into our current business model and platform. The success of any completed acquisition will depend on our ability to effectively manage the business after the acquisition. The process of maintaining the right incentives for management of acquired businesses and integrating the acquired businesses may involve unforeseen difficulties and may require a disproportionate amount of our managerial and financial resources. Our failure to incorporate acquired businesses into our existing operations successfully or to minimize any unforeseen operational difficulties could have a material adverse effect on our financial condition and results of operations. Further, if we fail to allocate our capital appropriately, in respect of either our acquisitions or organic growth in our operations, we could be overexposed in certain markets and geographies and unable to expand into adjacent products or markets.

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

We target consumers of high-end home furnishings as customers for our products. As a result, we believe that our sales are sensitive to a number of factors that influence consumer spending generally, but are particularly affected by the health of the higher end customer and demand levels from that customer demographic. In addition, not all macroeconomic factors are highly correlated in their impact on lower end housing versus the higher end customer.

Demand for lower priced homes and first time home buying may be influenced by factors such as employment levels, interest rates, demographics of new household formation and the affordability of homes for the first time home buyer. The higher end of the housing market may be disproportionately influenced by other factors including the number of foreign buyers in higher end real estate markets in the U.S., the number of second and third homes being sold, stock market prices and volatility and the perceived prospect for capital appreciation in higher end real estate. Although employment levels in the U.S. were reasonably strong at the beginning of 2017, 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 have also affected our business and results. These factors may make it difficult for us to accurately predict our operating and financial results for future periods and some of these factors could contribute to a material adverse effect on our business and results of operations.

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

Our business depends in part on a strong brand image, and we continue to invest in the development of our brand and the marketing of our business. We believe that the brand image we have developed, and the lifestyle image associated with our brand, have contributed significantly to the success of our business to date. We also believe that maintaining and enhancing our brand is integral to the future of our business and to the implementation of our strategies for expanding our business. This will require us to continue to make investments in areas such as marketing and advertising, as well as the day-to-day investments required for store operations, Source Book mailings, website operations and employee training. Our brand image may be diminished if new products, services or other businesses, including our food and beverage operations at the 3 Arts Club Café in the RH Gallery in Chicago, and Ma(i)sonry in Yountville, California, fail to maintain or enhance our distinctive brand image.

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

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

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

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

We have historically experienced fluctuations in customer response to our Source Books. Customer response depends substantially on product assortment, product availability and creative presentation, the selection of customers to whom the catalogs are mailed, changes in mailing strategies, page size, page count, frequency and timing of delivery of catalogs, as well as the general retail sales environment and current domestic and global economic conditions. The failure to effectively produce or distribute our catalogs could affect the timing of catalog delivery. The timing of catalog delivery has also been and can be affected by shipping service delays. Any delays in the timing of catalog delivery could cause customers to forgo or defer purchases. If the performance of our catalogs declines, if we misjudge the correlation between our catalog circulation and net 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. However, 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. In addition, such competitors may also be able to adapt to changes in customer preferences more quickly than we can due to their greater financial or marketing resources. Further, increased catalog mailings by our competitors may adversely affect response rates to our own Source Book mailings. There can be no assurance that such competitors will not be more successful than us, based on imitation or otherwise, or that we will be able to continue to maintain a leadership position in style and innovation in the future.

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

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

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

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

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

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

Based on total volume dollar purchases, in fiscal 2016 we sourced approximately 88% of our merchandise from outside the United States, including 78% from Asia, the majority of which originated from China. In addition, some of the merchandise we purchase from vendors in the United States also depends, in whole or in part, on vendors located outside the United States. As a result, our business highly depends on global trade, as well as trade and cost factors that impact the specific countries where our vendors are located, particularly Asia. Our future success will depend in large part upon our ability to maintain our existing foreign vendor relationships and to develop new ones as well as the ability of our vendors to scale their operations commensurate with demand from our customers, which in some cases will require substantial ongoing investments to support additional capacity. While we rely on our long-term relationships with our foreign vendors, we have no long-term contracts with them and transact business on an order-by-order basis.

Recent events, including the U.S. presidential election and Brexit in the U.K., have resulted in substantial regulatory uncertainty regarding international trade and trade policy. For example, President Trump and members of the U.S. Congress have called for substantial changes to tax policies, including the possible implementation of a border tax. The Trump administration has also raised the possibility of other initiatives that may affect importation of goods including renegotiation of trade agreements with other countries and the possible introduction of import duties or tariffs. Many of our imported products are subject to existing duties, tariffs, anti-dumping duties and quotas that may limit the quantity of some types of goods that we import into the United States. The possible implementation of a border tax or tariff could materially increase our cost of goods sold with respect to merchandise that we purchase from vendors who manufacture products outside the United States, which could in turn require us to increase our prices and, in the event consumer demand declines as a result, negatively impact our financial performance. Furthermore, certain of our competitors may be better positioned than us to withstand or react to border taxes, tariffs or other restrictions on global trade and as a result we may lose market share to such competitors. Due to broad uncertainty regarding the timing, content and extent of any regulatory changes in the U.S. or abroad, we cannot predict the impact, if any, that these changes could have to our business, financial condition and results of operations.

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

An interruption or delay in supply from our foreign sources, or the imposition of additional duties, taxes or other charges on these imports, could have a material adverse effect on our business, financial condition and results of operations unless and until alternative supply arrangements are secured.

In addition, there is a risk that compliance lapses by our vendors could occur, which could lead to investigations by U.S. government agencies responsible for international trade compliance. Any resulting penalty or enforcement action could delay future imports/exports or otherwise negatively impact our business. In addition, there can be no assurance that our vendors outside the United States will adhere to applicable legal requirements or our global compliance standards such as fair labor standards, prohibitions on child labor and other product safety or manufacturing safety standards. The violation of applicable legal requirements by any of our vendors or the failure to adhere to labor, manufacturing safety and other laws by any of our vendors, or the divergence of the labor practices followed by any of our vendors from those generally accepted in the United States, could disrupt our supply of products from our vendors or the shipment of products to us, result in potential liability to us and harm our reputation and brand and subject us to boycotts by our customers or activist groups, any of which could negatively affect our business and results of operations.

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

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

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

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

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

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

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

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

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

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

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

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

Increases in the prices of the components and raw materials used in our products could negatively affect the sales of our merchandise and our product margins. Alternatively, the strength of the U.S. dollar may negatively impact the ability of some of our customers to purchase our goods. We believe some portion of our business depends on non US 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 degree of visitors from other countries who purchase goods from us while visiting the United States.

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

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

We are subject to risks associated with occupying substantial amounts of space, including future increases in occupancy costs. We own certain properties, and we may choose in the future to acquire further properties, including store locations, which subject us to additional risks.

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

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

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

We are focused on sizing our assortments and our stores to the potential of the market by adjusting the square footage and number of stores on a geographic market-by-market basis. We plan to optimize our real estate by continuing to open larger square footage Galleries in key markets and relocating or closing selected stores in these or adjacent markets. When we address the introduction of new stores in a particular market or changes to, or closure of, existing stores, we must make a series of decisions regarding the size and location of new stores (or the existing stores slated to undergo changes or closure) and the impact on our other existing stores in the area or being without presence or “out of the market”.

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

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

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

- maintain adequate distribution facilities, information systems and other operational systems to serve our new stores and remodeled stores; and
- address competitive, merchandising, marketing, distribution and other challenges encountered in connection with expansion into new geographic areas and markets.

We have experienced delays in opening some new stores within the time frames we initially targeted, and may experience such delays again in the future. Any of the above challenges or other similar challenges could delay or prevent us from completing store openings or the additional remodeling of existing stores or hinder the operations of stores we open or remodel. If any of these challenges delays the opening of a store, our results of operations will be negatively affected as we will incur leasing and other costs during the delay without associated store revenue at such location. New or remodeled stores may also not be profitable or achieve our target return on investment. Unfavorable economic and business conditions and other events could also interfere with our plans to expand or modify store footprints. Our failure to effectively address challenges such as those listed above could adversely affect our ability to successfully open new stores or change our store footprint in a timely and cost-effective manner and could have a material adverse effect on our business, results of operations and financial condition.

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

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

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

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

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

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

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

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

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

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

We have historically relied on the availability of some amount of debt financing. Although currently there are no amounts outstanding under Restoration Hardware, Inc.'s revolving line of credit, we completed debt financings in fiscal 2014 and fiscal 2015 through the issuance of two series of convertible senior notes for an aggregate principal amount of $650 million. As a result of the availability under our revolving line of credit and the proceeds we received from our convertible senior note financings, we currently have sufficient capital for the operation of our business in the near term.

On the other hand, we may expend some significant portion of our capital on investments in our business, 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 next generation Design Galleries, which may require us to undertake upgrades to historical buildings or construction of new buildings. During fiscal 2016, we spent $157.6 million for capital expenditures. Additionally, we made payments of $23.4 million in fiscal 2016 to escrow accounts for future construction of next generation Design Galleries. We anticipate our gross capital expenditures to be approximately $140 million to $160 million for fiscal 2017. We expect our fiscal 2017 capital expenditures will be offset by proceeds from sales of assets of approximately $15 million to $25 million. We plan to continue opening next generation Design Galleries in select major metropolitan markets, pursuing category extensions of our brand, and exploring new business areas. We own the building and land for our Gallery in San Francisco and for one of our Toronto Galleries, as well as the location of our wine tasting room in Yountville, California, which is expected to be the location of a Design Gallery in the future, but to date we have principally relied upon leases with landlords for our other locations. As we develop new Galleries, as well as potentially other strategic initiatives in the future like our integrated hospitality experience; we may explore other models for our real estate, which could include longer lease terms or further purchases of, or joint ventures or other forms of equity ownership in, real estate interests associated with new sites and buildings. These approaches might require greater capital investment than a traditional store lease with a landlord. In the event that such capital and other expenditures require us to pursue additional funding sources, we can provide no assurances that we will be successful in securing additional funding on attractive terms or at all.

In certain circumstances, we may be required to repay the two series of convertible senior notes that we issued in fiscal 2014 and fiscal 2015 with cash payments. See Item 7—Management's Discussion and Analysis of Financial

Condition and Results of Operations—Liquidity and Capital Resources—Convertible Senior Notes. Additionally, at the time the notes become due, the trading price of our common stock may be such that we may find it necessary to settle the notes in cash.

There can be no assurance that we will have sufficient financial resources, or will be able to arrange financing, 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 such convertible senior notes could cause us to incur additional borrowings or the sale of additional notes to investors. We may also experience cash flow shortfalls in the future, and we may otherwise require additional external funding, or we may need to raise funds to take advantage of unanticipated opportunities, to make acquisitions of other businesses or companies or to respond to changing business conditions or unanticipated competitive pressures. Any weakening of, or other adverse developments in, the U.S. or global credit markets could affect our ability to manage our debt obligations and our ability to access future debt. We cannot assure you that we will be able to raise necessary funds on favorable terms, if at all, or that future financing requirements would not be dilutive to holders of our capital stock. If we fail to raise sufficient additional funds, we may be required to delay or abandon some of our planned future expenditures or aspects of our current operations.

If we lose key personnel or are unable to hire additional qualified personnel, our business may be harmed.

The success of our business depends upon the continued service of our key personnel, including our Chairman and Chief Executive Officer, Gary Friedman, as well as other members of our senior management responsible for merchandise assortment and other business operations. The loss of the services of our key personnel could make it more difficult to successfully operate our business and achieve our business goals. Our key officers and directors periodically travel together while on company business. We do not have a policy that prohibits key officers and directors from flying together, whether flying commercially or in our corporate aircraft. In addition, we do not maintain key man life insurance policies on any of our key personnel. As a result, we may not be able to cover the financial loss we may incur in losing the services of any of our key personnel.

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

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

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

We depend largely upon our information technology systems in the conduct of all aspects of our operations, many of which we have only adopted and implemented within the past several years or are in the midst of implementing in connection with rebuilding our supply chain and infrastructure. Our operations are also dependent on the information technology systems of our third party vendors. Such systems are subject to damage or interruption from power outages, computer and telecommunications failures, computer viruses, security breaches and natural disasters. In addition, damage or interruption can also occur as a result of non-technical issues, including vandalism, catastrophic events, and human error. If a computer hacker or other third party is able to circumvent our security measures, he or she could destroy or steal valuable information or disrupt our operations. Because techniques used to obtain unauthorized access or to sabotage systems change frequently and often are not recognized until launched against a target, we may be unable to anticipate these techniques or to implement adequate preventative measures. Damage or interruption to our information systems may require a significant investment to fix or replace the affected system, and we may suffer interruptions in our operations in the interim. Any material interruptions or failures in our systems or the systems of our third party vendors may have a material adverse effect on our business or results of operations.

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

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

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

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

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

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

We face product liability, product safety and product compliance risks relating to the design, manufacturing, raw material sourcing, testing, contents, importation, sale, use and performance of some of our products. The products we sell must be designed and manufactured to be safe for their intended purposes. Some of our products must comply with certain federal and state laws and regulations. For example, some of our products are subject to the Consumer Product Safety Act, the Federal Hazardous Substances Act and the Consumer Product Safety Improvement Act, or the

"CPSIA", which empower the Consumer Product Safety Commission, or 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, or the "CARB", regarding formaldehyde emissions from composite wood products (e.g., plywood and medium density fiberboard).

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

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

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

There are claims made against us and/or our management from time to time that can result in litigation or regulatory proceedings, which could distract management from our business activities and result in significant liability.

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

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

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

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

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

We are subject to numerous regulations, including labor and employment, customs, truth-in-advertising, consumer protection, e-commerce, privacy, safety, real estate, environmental and zoning and occupancy laws, and other laws and regulations that regulate retailers generally or govern our business. If these regulations were to change or were violated by us or our vendors or buying agents, the costs of certain goods could increase, or we could experience delays in shipments of our goods, be subject to fines or penalties, or suffer reputational harm, which could reduce demand for our products and harm our business and results of operations.

In addition to increased regulatory compliance requirements, changes in laws could make ordinary conduct of our business more expensive or require us to change the way we do business. For example, as a retail business, changes in laws related to employee benefits and treatment of employees, including laws related to limitations on employee hours, supervisory status, leaves of absence, mandated health benefits or overtime pay, could negatively impact us by increasing compensation and benefits costs for overtime and medical expenses. In addition, relatively new United States health care laws and potential global and domestic greenhouse gas emission requirements and other environmental legislation and regulations could result in increased direct compliance costs for us (or may cause our vendors to raise the prices they charge us in order to maintain profitable operations because of increased compliance costs), increased transportation costs or reduced availability of raw materials.

In fiscal 2016 we sourced 88% of our products from outside the United States, and we are increasing the level of our international sourcing activities in an effort to obtain more of our products directly from vendors located outside the United States. Additionally, we have expanded our business-to-business sales. The foreign and U.S. laws and regulations that are applicable to our operations are complex and may increase the costs of regulatory compliance, or limit or restrict the products or services we sell or subject our business to the possibility of regulatory actions or proceedings. The United States Foreign Corrupt Practices Act, and other similar laws and regulations, generally prohibit companies and their intermediaries from making improper payments to foreign governmental officials for the purpose of obtaining or retaining business. While our policies mandate compliance with applicable laws and regulations, including anti-bribery laws and other anti-corruption laws, we cannot assure you that we will be successful in preventing our employees or other agents from taking actions in violation of these laws or regulations. Such violations, or allegations of such violations, could disrupt our business and result in a material adverse effect on our financial condition, results of operations and cash flows.

Labor organizing and other activities could negatively impact us.

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

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

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

We are subject to income taxes in the United States and certain foreign jurisdictions. We record income tax expense based on our estimates of future payments, which include reserves for uncertain tax positions in multiple tax jurisdictions, and valuation allowances related to certain net deferred tax assets, including net operating loss carryforwards. At any one time, many tax years are subject to audit by various taxing jurisdictions. The results of these audits and negotiations with taxing authorities may affect the ultimate settlement of these issues. Under United States federal and state income tax laws, if over a rolling three-year period, the cumulative change in our ownership exceeds 50%, our ability to utilize our net operating loss carryforwards to offset future taxable income may be limited. Changes in ownership can occur due to transactions in our stock or the issuance of additional shares of our common stock or, in certain circumstances, securities convertible into our common stock. It is possible that transactions in our stock that may not be within our control may cause us to exceed the 50% cumulative change threshold and may impose a limitation on the utilization of our net operating loss carryforwards in the future. Any such limitation on the timing of utilizing our net operating loss carryforwards would increase the use of cash to settle our tax obligations. We expect that throughout the year there could be ongoing variability in our quarterly tax rates as events occur and exposures are evaluated.

In addition, our effective tax rate in a given financial statement period may be materially impacted by changes in the mix and level of earnings, timing of the utilization of net operating loss carryforwards, changes in the valuation allowance for deferred taxes or by changes to existing accounting rules or regulations. Further, tax legislation may be enacted in the future that could negatively impact our current or future tax structure and effective tax rates.

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

New accounting rules or regulations and varying interpretations of existing accounting rules or regulations have occurred and may occur in the future. A change in accounting rules or regulations may even affect our reporting of transactions completed before the change is effective, and future changes to accounting rules or regulations or the questioning of current accounting practices may adversely affect our results of operations.

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

Our total assets include intangible assets with an indefinite life, goodwill and trademarks, and substantial amounts of property and equipment. We make certain estimates and projections in connection with impairment analyses for these long-lived assets. We also review the carrying value of these assets for impairment whenever events or changes in circumstances indicate that the carrying value of the asset may not be recoverable. We will record an impairment loss when the carrying value of the underlying asset, asset group or reporting unit exceeds its fair value. These calculations require us to make a number of estimates and projections of future results. If these estimates or projections change, we may be required to record additional impairment charges on certain of these assets. If these impairment charges were significant, our results of operations would be adversely affected. 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. No such related charges were recorded in fiscal 2015 or fiscal 2014.

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 January 28, 2017. However, if we identify in the future one or more material weaknesses in our internal control over financial reporting, we will be unable to assert that our internal control over financial reporting is effective. In addition, our independent registered public accounting firm is required to attest to the effectiveness of our internal control over financial reporting. Therefore, even if our management concludes in the future that our internal control over financial reporting is effective, our independent registered public accounting firm may issue a report that is qualified if they are not satisfied with our controls or the level at which our controls are documented, designed, operated, or reviewed. Material weaknesses and significant deficiencies may be identified during the audit process or at other times.

Our reporting obligations as a public company place a significant strain on our management and our operational and financial resources and systems and will continue to do so for the foreseeable future. If we fail to timely achieve and maintain the adequacy of our internal control over financial reporting, we may not be able to produce reliable financial reports. Our failure to achieve and maintain effective internal control over financial reporting could prevent us from filing our periodic reports on a timely basis, which could result in the loss of investor confidence in the reliability of our financial statements, harm our business, and negatively impact the trading price of our common stock.

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

Our business operations depend on our ability to maintain and protect our facilities, computer systems and personnel. Our operations and consumer spending may be affected by natural disasters or other similar events, including floods, hurricanes, earthquakes, widespread illness or fires. In particular, our corporate headquarters is located in Northern California, certain of our distribution centers are located in California and other parts of our operations are located in Northern and Southern California, each of which is vulnerable to the effects of disasters, including fires and earthquakes that could disrupt our operations and affect our results of operations. Many of our vendors are also located in areas that may be affected by such events. Moreover, geopolitical or public safety conditions which affect consumer behavior and spending may impact our business. Terrorist attacks in the United States or threats of terrorist attacks in the United States in the future, as well as future events occurring in response to or in connection with them, could again result in reduced levels of consumer spending. Any of these occurrences could have a significant impact on our results of operations, revenue and costs.

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

Risks Related to Ownership of Our Common Stock

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

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

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

In addition, stock markets have experienced extreme price and volume fluctuations that have affected and continue to affect the market prices of equity securities of many retail companies. Stockholders can institute securities class action litigation following periods of market volatility, and we are currently subject to such a class action securities lawsuit. Such securities litigation can incur substantial costs and our resources and the attention of management could be diverted from our business.

We cannot guarantee that our share repurchase program will be successful or enhance stockholder value, and our share repurchase program may negatively affect the volatility of our common stock price.

On February 21, 2017, our Board of Directors authorized a stock repurchase program of up to $300 million. Such repurchase program may be implemented through open market purchases, privately negotiated transactions or other means, including through Rule 10b5-1 trading plans or through the use of other techniques such as accelerated share repurchases. We can provide no assurances of the exact impact of any share repurchases on our business. The use of capital to repurchase shares may yield beneficial impact on earnings per share but may divert capital from other purposes including other investments that we might undertake with respect to the business.

The repurchase program has no expiration date, does not require the purchase of any minimum number of shares and may be suspended, modified or discontinued at any time without prior notice. Any such suspension, modification or discontinuance of our stock repurchase program could result in a decrease in the trading price of our common stock. In addition, the existence of the repurchase program, repurchases of our common stock pursuant to such program, or a decision not to purchase shares under such program could affect the trading price of our common stock or increase its volatility. For example, the existence of a share repurchase program could cause our stock price to be higher than it would be in the absence of such a program and could potentially reduce the market liquidity for our common stock. Conversely, a prolonged delay in repurchasing shares under the authorized stock repurchase program could negatively impact our reputation and investor confidence in us and may negatively impact our stock price.

In addition, although our stock repurchase program is intended to enhance long-term stockholder value by representing an attractive investment and use of capital by the Company, there can be no assurance that any stock repurchases under the program will in fact enhance stockholder value. For example, the market price of our common stock may subsequently decline below the levels at which any repurchases are made. Short-term fluctuations in the market price of our common stock could reduce the program's effectiveness. Furthermore, any strategy of this kind regarding capital allocation may have unanticipated effects on our business and financial results. While we will seek to target capital toward investments that we believe will achieve good 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.

Although our Board of Directors has approved the share repurchase program, we are not obligated to repurchase any specific dollar amount or to acquire any specific number of shares. In addition, although we are not obligated to repurchase any shares under our existing program, we may decide to pursue additional repurchase programs in the future. We may incur debt in connection with our business in the event that we use other cash resources to purchase shares, which may affect the financial performance of our business during future periods or our liquidity and the availability of capital for other needs of the business.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Item 1B. Unresolved Staff Comments

None.

Item 2. Properties

We have approximately 1,200,000 leased gross square feet for 48 legacy Galleries, 6 larger format Design Galleries, 8 next generation Design Galleries, 1 RH Modern Gallery, 5 RH Baby & Child Galleries, and 15 Waterworks showrooms. The initial lease term of our retail Galleries generally ranges from 10 to 15 years, and certain leases contain renewal options for up to an additional 25 years. We have approximately 800,000 leased gross square feet for 28 outlet stores that were open as of January 28, 2017.

Most leases for our retail Galleries and outlets provide for a minimum rent, typically including escalating rent increases. In addition, certain leases have a percentage rent based upon sales after minimum thresholds are achieved. Leases generally require us to pay insurance, utilities, real estate taxes, repair and maintenance expenses, and common area maintenance.

Leased Properties

The following table summarizes the location and size of our leased distribution centers and corporate facilities occupied as of January 28, 2017:

Location	Leased Square Footage (Approximate)
RH Furniture Fulfillment Centers	
Patterson, California	1,501,000
Baltimore (North East), Maryland	1,195,000
Mira Loma, California	886,000
Grand Prairie, Texas (1) (2)	859,000
Baltimore (Essex), Maryland (2)	508,000
Home delivery locations (3)	1,148,000
RH Small Parcel Fulfillment Center	
West Jefferson, Ohio (1)	1,224,000
Waterworks Fulfillment Center	
Brookfield, Connecticut	160,000
Corporate Facilities	
Corte Madera, California (4)	265,000
Richmond, California (5)	259,000
Danbury, Connecticut (6)	26,000
Other	18,000

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

Owned Properties

We currently own two Galleries: the approximately 9,000 square foot property which is the location of our Gallery in San Francisco’s Design District and the approximately 19,000 square foot property which is the location of our Gallery on Yonge Street in Toronto, Canada.

Additionally, we own properties in Yountville, California, including the building occupying our wine tasting room and the adjacent parcel of land, which is expected to be the location of a future Design Gallery.

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

Item 3. Legal Proceedings

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

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

Item 4. Mine Safety Disclosures
Not applicable.

PART II

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

Market Information and Dividend Policy

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

	Highest	Lowest
Fiscal 2015		
First Quarter	$99.19	$84.85
Second Quarter	$105.63	$86.93
Third Quarter	$103.69	$91.06
Fourth Quarter	$105.64	$60.22
Fiscal 2016		
First Quarter	$59.49	$36.65
Second Quarter	$42.77	$25.39
Third Quarter	$36.38	$28.13
Fourth Quarter	$38.99	$26.09

The number of stockholders of record of our common stock as of January 28, 2017 was 40. This number excludes stockholders whose stock is held in nominee or street name by brokers.

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

Stock Performance Graph

This performance graph shall not be deemed “soliciting material” or to be “filed” with the SEC for purposes of Section 18 of the Securities Exchange Act of 1934, as amended (the “Exchange Act”), or otherwise subject to the liabilities under that Section, and shall not be deemed to be incorporated by reference into any filing of RH under the Securities Act of 1933, as amended, or the Exchange Act.

The following graph and table compare the cumulative total stockholder return for our common stock during the period from November 2, 2012 (the date our common stock commenced trading on the NYSE) through January 28, 2017 in comparison to the NYSE Composite Index and the S&P Retailing Select Index, our peer group index. The graph and the table below assume that $100 was invested at the market close on November 2, 2012 in the common stock of RH, the NYSE Composite Index and the S&P Retailing Select Index. Data for the NYSE Composite Index and the S&P Retailing Select Index assumes reinvestments of dividends. The comparisons in the graph and table are required by the SEC and are not intended to be indicative of possible future performance of our common stock.

	11/2/2012	2/1/2013	1/31/2014	1/30/2015	1/29/2016	01/27/2017
RH	100.00	116.50	182.44	281.45	198.14	83.89
NYSE Composite Index	100.00	108.87	121.04	127.96	116.97	137.02
S&P Retailing Select Index	100.00	107.88	128.22	149.53	132.53	137.97

30

Repurchases of Common Stock during the Three Months Ended January 28, 2017

During the three months ended January 28, 2017, we repurchased the following shares of our common stock:

	Number of Shares	Average Purchase Price Per Share
October 30, 2016 to November 26, 2016		
No activity	—	$ —
November 27, 2016 to December 31, 2016		
Shares withheld from delivery (1)	7,291	34.96
January 1, 2017 to January 28, 2017		
No activity	—	—
Total	7,291	$ 34.96

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

On February 21, 2017, our Board of Directors authorized a stock repurchase program of up to $300 million. For additional information, refer to Note 22—Subsequent Event in our consolidated financial statements within Part II of this Annual Report on Form 10-K.

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.

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

The selected consolidated financial data as of January 28, 2017 and January 30, 2016 and for the fiscal years ended January 28, 2017, January 30, 2016, and January 31, 2015, were derived from consolidated financial statements included in Item 8—Financial Statements and Supplementary Data. The selected consolidated financial data as of January 31, 2015 and as of and for the periods ended February 1, 2014 and February 2, 2013 were derived from consolidated financial statements for such years not included herein.

The fiscal years ended January 28, 2017, January 30, 2016, January 31, 2015 and February 1, 2014 each consisted of 52 weeks. The fiscal year ended February 2, 2013 consisted of 53 weeks. The Company's next 53-week fiscal year is the fiscal year ended February 3, 2018.

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 January 28, 2017	January 30, 2016	January 31, 2015	February 1, 2014	February 2, 2013
	(dollars in thousands, except per share amounts)				
Statements of Income:					
Net revenues	$2,134,871	$2,109,006	$1,867,422	$1,550,961	$1,193,046
Cost of goods sold	1,455,084	1,356,314	1,176,648	994,081	756,597
Gross profit	679,787	752,692	690,774	556,880	436,449
Selling, general and administrative expenses	626,751	567,131	525,048	502,029	505,485
Income (loss) from operations	53,036	185,561	165,726	54,851	(69,036)
Interest expense—net	44,482	35,677	17,551	5,733	5,776
Income (loss) before income taxes	8,554	149,884	148,175	49,118	(74,812)
Income tax expense (benefit) [(1)]	3,153	58,781	57,173	30,923	(62,023)
Net income (loss)	$5,401	$91,103	$91,002	$18,195	$(12,789)
Weighted-average shares used in computing basic net income (loss) per share	40,691,483	40,190,448	39,457,491	38,671,564	9,428,828
Basic net income (loss) per share	$0.13	$2.27	$2.31	$0.47	$(1.36)
Weighted-average shares used in computing diluted net income (loss) per share	40,926,840	42,256,559	41,378,210	40,416,630	9,428,828
Diluted net income (loss) per share	$0.13	$2.16	$2.20	$0.45	$(1.36)
Other Financial and Operating Data:					
Direct as a percentage of net revenues [(2)]	45%	49%	50%	47%	46%
Growth in net revenues:					
Stores [(3)]	9%	16%	14%	27%	20%
Direct	(7)%	10%	28%	33%	30%
Total	1%	13%	20%	30%	25%
Comparable brand revenue growth [(4)]	(7)%	11%	20%	31%	28%
Capital expenditures [(5)]	$157,644	$133,460	$110,359	$93,868	$49,058
Construction related deposits [(6)]	$23,380	$20,049	$9,250	$—	$—
Adjusted net income [(7)]	$51,789	$114,772	$97,636	$69,101	$37,739

January 28,	January 30,	January 31,	February 1,

	2017	2016	2015	2014	February 2, 2013
	(in thousands)				
Balance Sheet Data:					
Cash and cash equivalents (as revised)	$87,023	$331,467	$145,686	$13,389	$8,354
Short-term and long-term investments [8]	175,889	152,855	80,506	—	—
Working capital [9]	722,355	861,304	540,299	276,919	239,253
Total assets (as revised)	2,192,520	2,067,944	1,522,036	1,025,103	789,613
Convertible senior notes due 2019—net [10]	314,543	300,711	287,487	—	—
Convertible senior notes due 2020—net [10]	239,876	224,887	—	—	—
Revolving line of credit	—	—	—	85,425	82,501
Financing obligations under build-to-suit lease transactions	203,015	146,621	124,770	33,165	—
Notes payable for share repurchases	19,390	19,523	19,285	2,710	—
Total debt (including current portion) [11]	581,318	552,702	314,514	90,331	87,029
Total stockholders' equity	919,869	886,160	702,916	545,272	451,611

(1) As of the end of fiscal 2012, our U.S. operations achieved a position of cumulative profits (adjusted for permanent differences) for the most recent three-year period. We concluded that this record of cumulative profitability in recent years, coupled with our business plan for profitability in future periods, provided assurance that our future tax benefits more likely than not would be realized. Accordingly, in the year ended February 2, 2013, we released all of our U.S. valuation allowance of $57.2 million against net deferred tax assets.

(2) Direct revenues include sales through our Source Books, websites, and Trade and Contract businesses.

(3) Stores data represents retail stores, including Waterworks showrooms, plus outlet stores.
(4) Comparable brand revenue growth includes direct net revenues and retail comparable store sales, including RH Baby & Child and RH Modern Galleries. Comparable brand revenue growth excludes retail non-comparable store sales, closed store sales and outlet store net revenues. Comparable store sales have been calculated based upon retail stores, excluding outlet stores, that were open at least fourteen full months as of the end of the reporting period and did not change square footage by more than 20% between periods. If a store is closed for seven days during a month, that month will be excluded from comparable store sales. Waterworks revenue is excluded from comparable brand revenue growth and will be added in the first full month following the anniversary of the acquisition. Membership revenue is excluded from comparable brand revenue growth and will be added in the first full month following the anniversary of the program launch. The impact on net revenues related to the product recalls in fiscal 2016 has been excluded from comparable brand revenue growth. Because fiscal 2012 was a 53-week year, comparable brand revenue growth percentage for fiscal 2012 excludes the extra week of revenue.
(5) Capital expenditures include the acquisition of buildings and land in fiscal 2015. There was no acquisition of buildings and land in any of the other periods presented.
(6) Construction related deposits relate to payments to escrow accounts for future construction of next generation Design Galleries.
(7) 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 (loss), adjusted for the impact of certain non-recurring and other items that we do not consider representative of our ongoing operating performance. Adjusted net income is included in this filing because management believes that adjusted net income provides meaningful supplemental information for investors regarding the performance of our business and facilitates a meaningful evaluation of actual results on a comparable basis with historical results. Our management uses this non-GAAP financial measure in order to have comparable financial results to analyze changes in our underlying business from quarter to quarter. The following table presents a reconciliation of net income (loss), the most directly comparable GAAP financial measure, to adjusted net income for the periods indicated below.

	Year Ended				
	January 28, 2017	January 30, 2016	January 31, 2015	February 1, 2014	February 2, 2013
	(in thousands)				
Net income (loss)	$5,401	$91,103	$91,002	$18,195	$(12,789)
Adjustments pre-tax:					
Amortization of debt discount (a)	26,404	19,803	6,852	—	—
Product line impairments (b)	12,743	—	—	—	—
Legal claim (c)	8,701	19,046	7,700	—	—
Impact of inventory step-up (d)	6,835	—	—	—	—
Reorganization related costs (e)	5,698	—	—	—	—
Aircraft impairment (f)	4,767	—	—	—	—
Recall accrual (g)	4,615	—	—	—	—
Non-cash and other one-time compensation (h)	3,672	—	—	63,155	115,055
Acquisition related costs (i)	2,847	—	—	—	—
Initial public offering costs (j)	—	—	—	—	10,755
Special committee investigation and remediation (k)	—	—	—	—	4,778
Management and pre-IPO board fees (l)	—	—	—	—	4,258
Anti-dumping exposure (m)	—	—	—	—	3,250
Lease termination costs (n)	—	—	—	—	(386)

Follow-on offering fees [o]	—	—	—	2,895	—
Subtotal adjusted items	76,282	38,849	14,552	66,050	137,710
Impact of income tax items [p]	(29,894)	(15,180)	(7,918)	(15,144)	(87,182)
Adjusted net income	$51,789	$114,772	$97,636	$69,101	$37,739

(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") and for the $300 million aggregate principal amount of convertible senior notes that were issued in June and July 2015 (the "2020 Notes"), we separated the 2019 Notes and 2020 Notes into liability (debt) and equity (conversion option) components and we are amortizing as debt discount an amount equal to the fair value of the equity components as interest expense on the 2019 Notes and 2020 Notes over their respective terms. The equity components represent the difference between the proceeds from the issuance of the 2019 Notes and 2020 Notes and the fair value of the liability components of the 2019 Notes and 2020 Notes, respectively.

Amounts are presented net of interest capitalized for capital projects of $2.4 million, $2.3 million and $1.1 million during fiscal 2016, fiscal 2015 and fiscal 2014, respectively.

(b) Represents the impairments associated with RH Contemporary Art and RH Kitchen. RH Contemporary Art has been integrated into the broader RH platform and no longer operates as a separate division. This resulted in cost of goods sold of $1.1 million which represents impairment of inventory, and selling, general and administrative expenses of $10.6 million which represents lease related charges, property and equipment disposals, and donations. The impairment related to RH Kitchen is a result of the alignment with the Waterworks Kitchen product line strategy. This resulted in cost of goods sold of $1.0 million which represents impairment of inventory.

(c) 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. Refer to Note 19—Commitments and Contingencies in our consolidated financial statements.

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

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

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

(g) In the fourth quarter of fiscal 2016, we initiated a product recall of certain of our products. The recall, which affected our results for fiscal 2016, had the following effect on our income before taxes:

	Year Ended January 28, 2017 (in thousands)
Reduction of net revenues	$ 3,441
Incremental cost of goods sold	535
Impact on gross profit	3,976
Incremental selling, general and administrative expenses	639
Impact on income before income taxes	$ 4,615

(h) The adjustment for fiscal 2016 represents a non-cash compensation charge related to one-time, fully vested option grants made in connection with our acquisition of Waterworks. Fiscal 2013 includes a $33.7 million non-cash compensation charge related to the one-time, fully vested option granted to Mr. Friedman upon his reappointment as Chairman and Co-Chief Executive Officer in July 2013 and a $29.5 million non-cash compensation charge related to the performance-based vesting of certain shares granted to Mr. Friedman. Fiscal 2012 includes a $92.0 million non-cash compensation charge related to equity grants at the time of the Reorganization, as well as a non-cash compensation charge of $23.1 million related to the performance-based vesting of certain shares granted to Mr. Alberini and Mr. Friedman.

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

(j) Represents costs incurred in connection with our initial public offering, including a fee of $7.0 million to Catterton Management Company, LLC, Tower Three Partners LLC and GJK Capital Advisors, LLC in accordance with our management services agreement, payments of $2.2 million to certain former executives and bonus payments to employees of $1.3 million.

(k)

Represents legal and other professional fees incurred in connection with the investigation conducted by the special committee of the board of directors relating to our Chief Executive Officer, Gary Friedman, and our subsequent remedial actions.

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

(m) Represents expense incurred as a result of increased tariff obligations of one of our foreign suppliers following the U.S. Department of Commerce's review of the anti-dumping duty order on wooden bedroom furniture from China for the period from January 1, 2011 through December 31, 2011.

(n) Includes lease termination costs for retail stores that were closed prior to their respective lease termination dates. The lease termination amount in fiscal 2012 includes changes in estimates regarding liabilities for future lease payments for closed stores.

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

(p) As of the end of fiscal 2012, our U.S. operations achieved a position of cumulative profits for the most recent three-year period. We concluded that this record of cumulative profitability in recent years, coupled with our business plan for profitability in future periods provided assurance that our future tax benefits more likely than not would be realized. Accordingly, in fiscal 2012, we released all of our U.S. valuation allowance against net deferred tax assets. In addition, income tax items exclude the tax benefit related to the resolution of our Canada Revenue Agency examination in fiscal 2012, exclude the tax benefit from the utilization of federal and state net operating losses, and assume a normalized tax rate of 40% for fiscal 2012 through fiscal 2014. The adjustment for fiscal 2015 represents the tax effect of the adjusted items based on our effective tax rate of 39.2%. Fiscal 2016 assumes a normalized tax rate of 39%.

(8) As of fiscal 2016, fiscal 2015 and fiscal 2014, $142.7 million, $130.8 million and $62.2 million, respectively, of our investments are due within one year. As of fiscal 2016, fiscal 2015 and fiscal 2014, $33.2 million, $22.1 million and $18.3 million, respectively, of our investments are due within two years.

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

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

(11) Total debt (including current portion) includes the 2019 Notes and 2020 Notes, net of debt discount, revolving line of credit, term loan, notes payable for share repurchases and capital lease obligations.

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

Overview

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

Our business is fully integrated across our multiple channels of distribution, consisting of our stores, Source Books and websites. As of January 28, 2017, we operated a total of 85 retail Galleries, consisting of 50 legacy Galleries, 6 larger format Design Galleries, 8 next generation Design Galleries, 1 RH Modern Gallery and 5 RH Baby & Child Galleries throughout the United States and Canada, and 15 Waterworks showrooms in the United States and in the U.K. In addition, as of January 28, 2017, we operated 28 outlet stores throughout the United States and Canada.

In fiscal 2016, we have experienced a slowdown in sales and substantially lower level of profits than in prior periods. We have undertaken initiatives to specifically address the temporal factors affecting our results in fiscal 2016, in addition to the other numerous initiatives we are undertaking to improve our business and financial performance in fiscal 2017 and beyond. If these initiatives are successful, we may return to rates of growth in revenues and improvements in margins and profitability that are more in line with our historical growth patterns prior to the downturn that we experienced in fiscal 2016. However, there can be no assurance that these efforts will be successful or that we will not encounter other operational difficulties during fiscal 2017 and future time periods that may have a negative impact on growth and profitability. For further information on the temporal factors affecting our results and our initiatives, see Item 7—Management's Discussion and Analysis of Financial Condition and Results of Operations—Overview—Key Value Driving Strategies and Item 7—Management's Discussion and Analysis of Financial Condition and Results of Operations—Factors Affecting our Results of Operations.

We have also decided to lower our new Gallery opening cadence to three to five Galleries per year, which we believe will drive high-quality, sustainable growth and lower our capital requirements and execution risk over the course of our real estate transformation. We also believe the slower opening cadence will put less pressure on our infrastructure, enabling greater capital discipline throughout the organization.

Acquisition of Waterworks

On May 27, 2016, we acquired a controlling interest in Design Investors WW Acquisition Company, LLC, which owns the business operating under the name "Waterworks," for consideration consisting of approximately $119.9 million, consisting of $118.4 million funded with available cash and $1.5 million representing the fair value of rollover units, which amount is subject to adjustment for changes in working capital and other items. After the transaction, and giving effect to equity interests acquired by management in the business, we own in excess of 90% of the total equity interests in Waterworks.

Waterworks has long been the definition of the well-appointed bath, and is the only complete bath and kitchen business offering fittings, fixtures, furniture, furnishings, accessories, lighting, hardware and surfaces under one brand in the market. Waterworks is composed of the Waterworks, Waterworks Kitchen and Waterworks Studio brands, all built on a foundation of impeccable style, design integrity, quality and craftsmanship. Waterworks prides itself on its deep relationships in the design community and the technical expertise and tenure of its people.

Waterworks products are sold through its 15 showrooms in the United States and in the U.K., as well as through its boutique retail partners, hospitality division and online.

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 next generation Design Galleries that are sized to the potential of each market and the size of our assortment. New next generation Design Gallery sites are identified based on a variety of factors, including timing of legacy Gallery lease expiration, availability of suitable new site locations, the negotiation of favorable economic terms to the Company for the new location, as well as satisfactory and timely completion of real estate development including procurement of permits and completion of construction. The number of next generation Design Galleries we open in any fiscal year is highly dependent upon these variables and individual new Design Galleries may be subject to delay or postponement depending on the circumstances of specific projects.

Based on recent trends and our plans for product assortment expansion and new businesses, we are generally targeting a range of 25,000 to 60,000 leased selling square feet for new locations. Landlords are currently offering us leases that accommodate these space requirements and that have favorable terms, which are typically available only to anchor tenants. Based on our analysis, we believe we have the opportunity to operate next generation Design Galleries in 60 to 70 locations in the United States and Canada.

- Expand Our Offering and Increase Our Market Share. We believe we have a significant opportunity to increase our market share by:
  - growing our merchandise assortment;
  - introducing new products and categories, including our introduction of RH Modern, RH TEEN and the addition of the Waterworks business;
  - expanding our service offerings, including the introduction of the RH Interior Design program and cafes, wine vaults and coffee bars at our next generation 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, our digital marketing initiatives and our advertising and public relations activities and events.
- 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 improvements in product quality and enhancements in sourcing, product availability, in-home delivery and all aspects of customer care and service. We plan to invest significant time in fiscal 2017 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 also believe that the introduction of experiential brand-enhancing products and services, such as expanded design ateliers, the RH Interior Design program and the planned launch of an integrated food and beverage experience in a number of our new Galleries, will further enhance our customers' in-store experience, in addition to allowing us to further disrupt the highly fragmented home furnishings landscape and achieve market share gains.
- Increase Operating Margins. We have the opportunity to continue to improve our operating margins by leveraging our fixed occupancy, advertising and corporate general and administrative costs, as well as leveraging our scalable infrastructure. Key areas in which we believe we will increase operating margins include:
  - Occupancy Leverage—We believe that our real estate transformation will allow us to better leverage our fixed occupancy costs. Our next generation Design Galleries are expected to generate increased sales volumes in each market. We expect that these increased sales volumes, coupled with the favorable economics and lower rent per square foot, as compared to our legacy Galleries, will provide significant leverage of our retail occupancy costs. We also expect leverage in our supply chain network design as we optimize our inventory investments over time and further leverage our distribution center infrastructure.
  - Advertising Cost Leverage—We believe the physical expression and retail experience in our next generation Design Galleries serve as the best form of advertising for RH. Our next generation Design Galleries are expected to generate increased sales volumes in each market as compared to the legacy Gallery in that market. As a result, the higher sales volumes achieved will leverage our fixed advertising expenditures in each market. We also continue to explore opportunities to further optimize our Source Book strategy and enhance our online marketing initiatives.
  - Improved Product Margin & Shipping Efficiencies—We believe we can obtain additional operating margin expansion from improved product margins and shipping efficiencies. We believe we have pricing power that should continue to improve as we continue to take market share in the highly-fragmented luxury home furnishings market. As our newer categories and products gain scale, we also expect improved vendor pricing. In addition, we anticipate further efficiencies of in-sourcing our home delivery locations and opportunities to optimize our shipping model over time and plan to invest significant time in fiscal 2017 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.

- Other Selling, General and Administrative Expenses—We believe that as we increase our sales we have significant opportunity to leverage our fixed corporate and other general and administrative expenses.

- Optimize the Allocation of Capital in the Business. We believe that our operations and current initiatives present a significant opportunity to optimize the allocation of capital in our business, including generating free cash flow and optimizing cash on our balance sheet. Our current efforts to optimize the allocation of capital in our business include taking steps such as seeking to rationalize our SKU count and reduce overall levels of inventory, which includes selling slower moving, discontinued and other inventory through markdowns and our outlet channel, and optimizing our distribution network that is used to move merchandise to achieve greater efficiency and lower requirements for carrying inventory to meet customer demand. We plan to lower our new Gallery opening cadence to three to five Galleries per year, which we believe will result in improved deal economics, lower build out costs and higher returns. We also believe the slower opening cadence will put less pressure on our infrastructure, enabling greater capital discipline throughout the organization. In addition, we have a number of assets that can be sold to third parties in order to generate cash. We may enter into sale and leaseback transactions with respect to certain real estate that we own, for example, and may enter into capital or operating leases in lieu of purchasing or holding certain assets that are used in our business. We intend to continue to seek out and evaluate opportunities for effectively managing and deploying capital in ways that support and enhance our business initiatives and strategies.
- Pursue International Expansion. We plan to strategically expand our business into select countries outside of the United States, Canada and the U.K. in the future. We believe that our luxury brand positioning and unique aesthetic will have strong international appeal.

In fiscal 2016, we made several strategic investments and changes to our business model that we believe will strengthen our brand and position the business for growth in the future. However, our fiscal 2016 results also reflect the effect of temporal issues that we have faced, including the costs related to the launch of RH Modern; the timing of recognizing membership revenues related to the transition from a promotional to a membership model; efforts to reduce inventories and rationalize our SKU count; and the decision to move our 2016 Source Book mailing from the spring 2016 to the fall. We continue to believe that we are making the necessary investments and changes to position our business for the long-term. In fiscal 2017, we expect to anniversary the costs related to the launch of RH Modern; benefit from the deferral of membership revenue, plus capture additional revenue from new members and renewals; cycle our efforts to reduce inventories and rationalize our SKU count; and build revenues from the mailing strategy of our 2016 Source Books. We also expect incremental revenues from the four new Design Galleries opened in 2016, our successful hospitality experience at RH Chicago, The Gallery at the Three Arts Club, and new Design Galleries expected to open in 2017.

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” including the following:

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, including the launch of RH Modern, RH TEEN and the acquisition of Waterworks;
- efforts to reduce inventories and rationalize our SKU count;
- the transition from a promotional to a membership model;
- changes in our Source Book circulation strategy including the depth, frequency and timing of mailings as well as the scope of product offerings displayed in our Source Books;
- changes in the Gallery opening cadence;
- the development of our new larger format Design Galleries, which we refer to as next generation Design Galleries, in a number of new locations;
- the optimization of our store sizes to better fit anticipated demand in a given market;
-

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

- the introduction of an integrated hospitality experience, including the roll out of an integrated food and beverage experience in a number of our new Galleries.

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.

Our fiscal 2016 results were negatively impacted by several factors, including:

- Costs Related to the Launch of RH Modern. We experienced incremental costs related to the launch of RH Modern in fiscal 2016. Although there has been considerable demand for RH Modern products, we encountered initial difficulties in ramping up production in response to this demand. Due in part to these difficulties, we implemented initiatives to elevate the customer experience during the first and second quarters of fiscal 2016. We invested approximately $16 million of customer accommodations that were a direct offset to net revenues, as well as $4 million of expedited shipping charges and other product costs. These efforts resulted in substantial customer accommodations and related expenses which negatively affected our financial results during these periods.
- Timing of Recognizing RH Members Program Revenues. Our fiscal 2016 financial results were negatively impacted by the timing of recognizing membership revenues related to our transition from a promotional to a membership model via the introduction of the RH Members Program. The RH Members Program fee is amortized on a monthly basis over the annual membership period and therefore at the time of launching the program these fees negatively impact margin in the short-term. We introduced the RH Members Program as an alternative to prior practices involving numerous event-driven promotions, which has changed the promotional cadence of our business from historical norms. The multiple sale events and email communications during the year did not reflect the brand we are building, nor were those promotions aligned with how our customers shop with us. Our business has evolved from a “product” based business to a “project” based business. The RH Members Program allows our customers to shop for what they want, when they want, and receive the greatest value. Since the launch of the RH Members Program, we have learned that the selling cycle with members is longer, as transactions are not closed with the urgency of artificially imposed sale deadlines, and the timing of recognizing membership revenues evenly over the membership period will depress margins in the short term.
- Efforts to Reduce Inventories and Rationalize SKU Count. In fiscal 2016, we commenced initiatives to streamline and optimize our inventory levels and to refine and rationalize our merchandise assortment through markdowns in an effort to forego adding a planned furniture distribution center to the network in fiscal 2017.
- Decision to Push Our 2016 Source Book Mailing from Spring to Fall. We believe our decision to move the mailing of our annual Source Books from spring to the fall in fiscal 2016 had a negative impact on our net revenues. The Fall 2016 mailing was not complete until mid-December and therefore was not as meaningful a contributor to net revenues in fiscal 2016 as in fiscal 2015 where sales benefited from a longer build of the Spring 2015 Source Books.

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

Consumer Preferences and Demand. Our ability to maintain our appeal to existing customers and attract new customers depends on our ability to originate, develop and offer a compelling product assortment responsive to customer preferences and design trends. We have successfully introduced a large number of new products during recent periods, which we believe has been a contributing factor in our sales and results of operations. We also acquired Waterworks in fiscal 2016 and have added Waterworks product offerings to our platform. Periods in which our products have achieved strong customer acceptance generally have had more favorable results. If we misjudge the market for our products or the product lines that we acquire, we may be faced with excess inventories for some products and may be required to become more promotional in our selling activities, which would impact our net revenues and gross profit.

The Waterworks Acquisition. We acquired a controlling interest in Design Investors WW Acquisition Company, LLC, which owns the business operating under the name “Waterworks,” on May 17, 2016. For fiscal 2016, the increase in our net revenues was primarily due to the acquisition of Waterworks, which contributed $74.8 million, or 4%, to our net revenues. Despite contributing to our net revenues, in fiscal 2016, Waterworks had an operating loss of $12.9 million, which had a substantial negative impact on our net income and earnings. The Waterworks operating loss included non-cash amortization of $6.8 million related to the inventory fair value adjustment recorded in connection with our acquisition of Waterworks, as well as a non-cash compensation charge of $3.7 million related to the one-time, fully vested option grants made in connection with our acquisition of Waterworks.

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

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

In fiscal 2016, the vast majority of our product newness was introduced in the fall of fiscal 2016, primarily due to the decision to move the mailing of our annual Interiors Source Book to the fall, whereas our Interiors Source Book was circulated in the spring in the prior years. The timing and cadence of new product introductions is an important factor when comparing quarter and year over year results.

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

Product Recalls. In fiscal 2016, we initiated product recalls on certain of our products. These recalls impacted our results for the fourth quarter of fiscal 2016. We established a reserve for the product recalls after considering various factors including estimates for future returns, logistics for managing product returns, as well as legal fees.

The recalls had the following effect on our income before income taxes:

	Year Ended January 28,

	2017 (in thousands)
Reduction of net revenues	$ 3,441
Incremental cost of goods sold	535
Impact on gross profit	3,976
Incremental selling, general and administrative expenses	639
Impact on income before income taxes	$ 4,615

How We Assess the Performance of Our Business

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

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

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

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

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

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

In recent periods we have experienced increased selling, general and administrative expenses, excluding certain one-time and non-cash items discussed in “Basis of Presentation and Results of Operations” below. The most significant components of these increases are employment costs due to company growth and expansion, an increase in professional fees and other corporate costs, an increase in corporate occupancy costs associated with our corporate office expansion and upgraded technology systems, as well as an increase in credit card fees due to increased revenues. We expect certain of these expenses to continue to increase as we continue to open new stores, develop new product categories and otherwise pursue our current business initiatives.

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

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

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

Comparable brand revenue growth includes direct net revenues and retail comparable store sales, including RH Baby & Child and RH Modern Galleries. Comparable brand revenue growth excludes retail non-comparable store sales, closed store sales and outlet store net revenues. Comparable store sales have been calculated based upon retail stores, excluding outlet stores, that were open at least fourteen full months as of the end of the reporting period and did not change square footage by more than 20% between periods. If a store is closed for seven days during a month, that month will be excluded from comparable store sales. Waterworks revenue is excluded from comparable brand revenue growth and will be added in the first full month following the anniversary of the acquisition. Membership revenue is excluded from comparable brand revenue growth and will be added in the first full month following the anniversary of the program launch. The impact on net revenues related to the product recalls in fiscal 2016 has been excluded from comparable brand revenue growth.

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 January 28, 2017	January 30, 2016	January 31, 2015
	(dollars in thousands)		
Statements of Income:			
Net revenues	$2,134,871	$2,109,006	$1,867,422
Cost of goods sold	1,455,084	1,356,314	1,176,648
Gross profit	679,787	752,692	690,774
Selling, general and administrative expenses	626,751	567,131	525,048
Income from operations	53,036	185,561	165,726
Interest expense—net	44,482	35,677	17,551
Income before income taxes	8,554	149,884	148,175
Income tax expense	3,153	58,781	57,173
Net income	$5,401	$91,103	$91,002
Other Financial and Operating Data:			
Direct as a percentage of net revenues (1)	45 %	49 %	50 %
Growth in net revenues:			
Stores (2)	9 %	16 %	14 %
Direct	(7)%	10 %	28 %
Total	1 %	13 %	20 %
Comparable brand revenue growth (3)	(7)%	11 %	20 %
Capital expenditures (4)	$157,644	$133,460	$110,359
Construction related deposits (5)	$23,380	$20,049	$9,250

(1) Direct revenues include sales through our Source Books, websites, and phone orders, including our Contract business and a portion of our Trade business.
(2) Stores data represents retail stores, including Waterworks showrooms, plus outlet stores. Net revenues for outlet stores, which includes warehouse sales, for fiscal 2016, fiscal 2015 and fiscal 2014 were $144.6 million, $142.8 million and $121.6 million, respectively.

(3) Comparable brand revenue growth includes direct net revenues and retail comparable store sales, including RH Baby & Child and RH Modern Galleries. Comparable brand revenue growth excludes retail non-comparable store sales, closed store sales and outlet store net revenues. Comparable store sales have been calculated based upon retail stores, excluding outlet stores, that were open at least fourteen full months as of the end of the reporting period and did not change square footage by more than 20% between periods. If a store is closed for seven days during a month, that month will be excluded from comparable store sales. Waterworks revenue is excluded from comparable brand revenue growth and will be added in the first full month following the anniversary of the acquisition. Membership revenue is excluded from comparable brand revenue growth and will be added in the first full month following the anniversary of the program launch. The impact on net revenues related to the product recalls in fiscal 2016 has been excluded from comparable brand revenue growth.

(4) Capital expenditures include the acquisition of buildings and land in fiscal 2015. There was no acquisition of buildings and land in fiscal 2016 or fiscal 2014.

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

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

	Year Ended January 28, 2017	January 30, 2016	January 31, 2015
Statements of Income:			
Net revenues	100.0 %	100.0 %	100.0 %
Cost of goods sold	68.2	64.3	63.0
Gross profit	31.8	35.7	37.0
Selling, general and administrative expenses	29.3	26.9	28.1
Income from operations	2.5	8.8	8.9
Interest expense—net	2.1	1.7	1.0
Income before income taxes	0.4	7.1	7.9
Income tax expense	0.1	2.8	3.0
Net income	0.3 %	4.3 %	4.9 %

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

	Year Ended January 28, 2017	January 30, 2016	January 31, 2015
	(in thousands)		
Stores	$1,178,860	$1,083,600	$933,179
Direct	956,011	1,025,406	934,243
Net revenues	$2,134,871	$2,109,006	$1,867,422

Fiscal 2016 Compared to Fiscal 2015

The following table sets forth financial results for each of our reportable segments for fiscal 2016. The Waterworks results presented below represent financial results for the period subsequent to our acquisition on May 27, 2016.

	Year Ended January 28, 2017		
	RH Segment	Waterworks (a)	Total
	(dollars in thousands)		
Net revenues	$2,060,044	$ 74,827	$2,134,871

Cost of goods sold	1,403,853	51,231	1,455,084
Gross profit	656,191	23,596	679,787
Selling, general and administrative expenses	590,288	36,463	626,751
Income (loss) from operations	$65,903	$ (12,867)	$53,036

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

Net revenues

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

On May 27, 2016, we acquired a controlling interest in Waterworks. As a result of this acquisition, we acquired 15 Waterworks showrooms and included such additional retail stores in our weighted-average leased selling square footage for fiscal 2016. Waterworks net revenues were $74.8 million, which represented 4% of our net revenues for fiscal 2016.

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

In addition, our transition from a promotional model to the RH Members Program, which recognizes the membership fee over an annual period, had a negative impact on the timing of our revenue recognition.

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

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

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

The above factors and other current and future operational initiatives of the Company may create additional uncertainty with respect to our net revenues and profit in the near term.

Gross profit

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

Waterworks gross profit was $23.6 million, or 31.5%, for fiscal 2016, which was negatively impacted by $6.8 million of amortization related to the inventory fair value adjustment recorded in connection with the acquisition.

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

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

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

19—Commitments and Contingencies in our consolidated financial statements.

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

Selling, general and administrative expenses

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

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

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

Excluding the one-time charges recorded in in fiscal 2016 and fiscal 2015 mentioned above, RH Segment selling, general and administrative expenses were 27.4% and 26.8% of net revenues in fiscal 2016 and fiscal 2015, respectively. The increase in selling, general and administrative expenses as a percentage of net revenues was primarily driven by increased employment and employment related costs, an increase in corporate occupancy costs primarily related to depreciation associated with upgrades in our technology infrastructure and an increase in professional fees and other corporate costs. These increases were partially offset by decreases in advertising and marketing costs.

Interest expense—net

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

	Year Ended	
	January 28, 2017	January 30, 2016
	(in thousands)	
Amortization of convertible senior notes debt discount	$28,822	$22,114
Build-to-suit lease transactions	13,447	10,766
Other interest expense	7,620	7,052
Capitalized interest for capital projects	(2,418)	(2,311)
Interest income	(2,989)	(1,944)

Total interest expense—net	$44,482	$35,677

Income tax expense

Income tax expense was $3.2 million in fiscal 2016 compared to $58.8 million in fiscal 2015. Our effective tax rate was 36.9% in fiscal 2016 compared to 39.2% in fiscal 2015.

Fiscal 2015 Compared to Fiscal 2014

Net revenues

Net revenues increased $241.6 million, or 12.9%, to $2,109.0 million in fiscal 2015 compared to $1,867.4 million in fiscal 2014. Comparable brand revenue growth was 11% in fiscal 2015. We had 69 and 67 retail stores open at January 30, 2016 and January 31, 2015, respectively. Stores sales increased $150.4 million, or 16.1%, to $1,083.6 million in fiscal 2015 compared to $933.2 million in fiscal 2014. Direct sales increased $91.2 million, or 9.8%, to $1,025.4 million in fiscal 2015 compared to $934.2 million in fiscal 2014. The increase in net revenues was due to a combination of the expansion of existing product assortment and the introduction of new products. In addition, we believe the increase in our weighted-average leased selling square footage from 572,000 square feet in fiscal 2014 to 641,000 square feet in fiscal 2015 contributed to our net revenue growth. We believe the introduction of experiential brand enhancing products and services, such as expanded design ateliers, the RH Interior Design program and an integrated culinary experience, is increasing our brand awareness, and has allowed us to further disrupt the highly fragmented home furnishings landscape and achieve market share gains.

The growth in our net revenues was negatively impacted by the timing of our new product introductions during fiscal 2015 as compared to fiscal 2014. In fiscal 2015, more than half of our product newness was introduced in the fall of 2015, primarily with the launch of RH Modern and RH Teen, whereas in fiscal 2014 the majority of our new product introductions coincided with our Spring Source Book mailing. Further, there was a significant reduction in total circulated pages in fiscal 2015 as compared to fiscal 2014.

Gross profit

Gross profit increased $61.9 million, or 9.0%, to $752.7 million in fiscal 2015 from $690.8 million in fiscal 2014. As a percentage of net revenues, gross margin decreased 1.3% to 35.7% of net revenues in fiscal 2015 from 37.0% of net revenues in fiscal 2014.

Gross profit for fiscal 2015 was negatively impacted by $17.2 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. Refer to Note 19—Commitments and Contingencies in our consolidated financial statements.

Excluding the impact of the coupons redeemed in connection with the legal claim mentioned above, gross margin would have decreased 0.5% due primarily to higher shipping costs, lower merchandise margins associated with additional warehouse sales, and deleverage in occupancy costs due to the addition of a new distribution center. These increased costs were partially offset by improvements in other product related costs and leverage of our fixed supply chain and retail occupancy costs.

Selling, general and administrative expenses

Selling, general and administrative expenses increased $42.1 million, or 8.0%, to $567.1 million in fiscal 2015 compared to $525.0 million in fiscal 2014.

Selling, general and administrative expenses in fiscal 2015 included $1.8 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. Selling, general and administrative expenses in fiscal 2014 included an approximately $8 million charge incurred in connection with the legal claim.

Excluding the impact of coupons redeemed and the charge incurred in connection with the legal claim mentioned above, the increase in selling, general and administrative expenses of $47.9 million in fiscal 2015 compared to fiscal 2014 was primarily related to an increase in employment and employment related costs of $32.8 million due to company growth and expansion, an increase in professional fees and other corporate costs, an increase in corporate occupancy costs associated with our corporate office expansion and upgraded technology systems, as well as an increase in credit card fees due to increased revenues. These increases were partially offset by a decrease in advertising and marketing costs of $7.0 million.

Selling, general and administrative expenses were 26.8% and 27.7% of net revenues in fiscal 2015 and fiscal 2014, respectively, excluding the impact of coupons redeemed and the charge incurred in connection with the legal claim mentioned above. The improvement in selling, general and administrative expenses as a percentage of net revenues was primarily driven by leverage in our advertising and marketing costs.

Interest expense—net

Interest expense increased $18.1 million to $35.7 million in fiscal 2015 compared to $17.6 million in fiscal 2014. Interest expense consisted of the following:

	Year Ended January 30, 2016	January 31, 2015
	(in thousands)	
Amortization of convertible senior notes debt discount	$22,114	$7,969
Build-to-suit lease transactions	10,766	5,465
Other interest expense	7,052	5,817
Capitalized interest for capital projects	(2,311)	(1,639)
Interest income	(1,944)	(61)
Total interest expense—net	$35,677	$17,551

Income tax expense

Income tax expense was $58.8 million in fiscal 2015 compared to $57.2 million in fiscal 2014. Our effective tax rate was 39.2% in fiscal 2015 compared to 38.6% in fiscal 2014.

Quarterly Results

The following table sets forth our historical quarterly consolidated statements of income for each of the last eight fiscal quarters ended through January 28, 2017. This quarterly information has been prepared on the same basis as our annual audited financial statements and includes all adjustments that we consider necessary to fairly state the financial information for the fiscal quarters presented. The quarterly data should be read in conjunction with our consolidated financial statements and the related notes included in Item 8—Financial Statements and Supplementary Data.

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

	Fiscal 2015				Fiscal 2016			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
	(dollars in thousands)							
Net revenues	$422,445	$506,942	$532,411	$647,208	$455,456	$543,381	$549,328	$586,706

Cost of goods sold	279,027	312,679	341,661	422,947	327,981	363,542	373,509	390,052
Gross profit	143,418	194,263	190,750	224,261	127,475	179,839	175,819	196,654
Selling, general, and administrative expenses	126,389	137,840	145,874	157,028	138,950	157,824	160,433	169,544
Income (loss) from operations	17,029	56,423	44,876	67,233	(11,475)	22,015	15,386	27,110
Interest expense—net	5,649	7,406	11,003	11,619	10,528	10,909	11,091	11,954
Income (loss) before income taxes	11,380	49,017	33,873	55,614	(22,003)	11,106	4,295	15,156
Income tax expense (benefit)	4,224	19,082	13,163	22,312	(8,533)	4,188	1,778	5,720
Net income (loss)	$7,156	$29,935	$20,710	$33,302	$(13,470)	$6,918	$2,517	$9,436
Adjusted net income (loss) (1)	$9,842	$36,022	$27,736	$41,172	$(2,066)	$17,908	$8,019	$27,928
Comparable brand revenue growth (2)	15 %	16 %	7 %	9 %	4 %	(3)%	(6)%	(18)%

47

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

	Fiscal 2015				Fiscal 2016			
	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	First Quarter	Second Quarter	Third Quarter	Fourth Quarter
	(in thousands)							
Net income (loss)	$7,156	$29,935	$20,710	$33,302	$(13,470)	$6,918	$2,517	$9,436
Adjustments pre-tax:								
Product line impairments [a]	—	—	—	—	—	—	—	12,743
Amortization of debt discount [b]	2,702	4,493	6,415	6,193	6,442	6,479	6,629	6,854
Aircraft impairment [c]	—	—	—	—	—	—	—	4,767
Recall accrual [d]	—	—	—	—	—	—	—	4,615
Impact of inventory step-up [e]	—	—	—	—	—	3,401	1,786	1,648
Legal claim [f]	1,568	5,474	5,076	6,928	8,701	—	—	—
Acquisition related costs [g]	—	—	—	—	2,069	778	—	—
Reorganization related costs [h]	—	—	—	—	1,415	3,309	974	—
Non-cash compensation [i]	—	—	—	—	—	3,672	—	—
Subtotal adjusted items	4,270	9,967	11,491	13,121	18,627	17,639	9,389	30,627
Impact of income tax items [j]	(1,584)	(3,880)	(4,465)	(5,251)	(7,223)	(6,649)	(3,887)	(12,135)
Adjusted net income (loss)	$9,842	$36,022	$27,736	$41,172	$(2,066)	$17,908	$8,019	$27,928

(a) The adjustment for the fourth quarter of fiscal 2016 represents the impairments associated with the RH Contemporary Art and RH Kitchen. RH Contemporary Art has been integrated into the broader RH platform and no longer operates as a separate division. This resulted in cost of goods sold of $1.1 million which represents impairment of inventory and selling, general and administrative expenses of $10.6 million which represents lease related charges, property and equipment disposals, and donations. The impairment related to RH Kitchen is a result of the alignment with the Waterworks Kitchen product line strategy. This resulted in cost of goods sold of $1.0 million which represents impairment of inventory.

(b) Under GAAP, certain convertible debt instruments that may be settled in cash on conversion are required to be separately accounted for as liability and equity components of the instrument in a manner that reflects the issuer's non-convertible debt borrowing rate. Accordingly, in accounting for GAAP purposes for the $350 million aggregate principal amount of convertible senior notes that were issued in June 2014 (the "2019 Notes") and for the $300 million aggregate principal amount of convertible senior notes that were issued in June and July 2015 (the "2020 Notes"), we separated the 2019 Notes and 2020 Notes into liability (debt) and equity (conversion option) components and we are amortizing as debt discount an amount equal to the fair value of the equity components as interest expense on the 2019 Notes and 2020 Notes over their respective terms. The equity components represent the difference between the proceeds from the issuance of the 2019 Notes and 2020 Notes and the fair value of the liability components of the 2019 Notes and 2020 Notes, respectively. Amounts are presented net of interest capitalized for capital projects of $0.5 million, $0.6 million, $0.4 million and $0.8 million during the first, second, third and fourth quarters of fiscal 2015, respectively. Amounts are presented net of interest capitalized for capital projects of $0.6 million, $0.7 million, $0.6 million and $0.5 million during the first, second, third and fourth quarters of fiscal 2016, respectively.

(c) The adjustment for the fourth quarter of fiscal 2016 represents the impairment recorded upon reclassification of aircraft as asset held for sale.

(d) The adjustment for the fourth quarter of fiscal 2016 represents the reduction of net revenues and costs associated with product recalls.

(e) The adjustments for the second, third and fourth quarters of fiscal 2016 represent the non-cash amortization of the inventory fair value adjustment recorded in connection with our acquisition of Waterworks.

(f) The adjustments in the first, second, third and fourth quarters of fiscal 2015 and the first quarter of fiscal 2016 represent 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. Refer to Note 19—Commitments and Contingencies in our consolidated financial statements.

(g) The adjustments for the first and second quarters of fiscal 2016 represent costs incurred in connection with our acquisition of Waterworks including professional fees.

(h) The adjustments for the first, second and third quarters of fiscal 2016 represent costs associated with a reorganization, which include severance costs and related taxes, partially offset by a reversal of stock-based compensation expense related to unvested equity awards.
(i) The adjustment for the second quarter of fiscal 2016 represents a non-cash compensation charge related to one-time, fully vested option grants made in connection with our acquisition of Waterworks.
(j) The adjustments for the first, second, third and fourth quarters of fiscal 2015 represent the tax effect of the adjusted items based on our effective tax rates of 37.1%, 38.9%, 38.9% and 39.2%, respectively. The adjustments for the first, second and third quarters of fiscal 2016 represent the tax effect of the adjusted items based on our effective tax rates of 38.8%, 37.7% and 41.4%, respectively. The fourth quarter of fiscal 2016 assumes a normalized tax rate of 39%.

(2) Comparable brand revenue growth includes direct net revenues and retail comparable store sales, including RH Baby & Child and RH Modern Galleries. Comparable brand revenue growth excludes retail non-comparable store sales, closed store sales and outlet store net revenues. Comparable store sales have been calculated based upon retail stores, excluding outlet stores, that were open at least fourteen full months as of the end of the reporting period and did not change square footage by more than 20% between periods. If a store is closed for seven days during a month, that month will be excluded from comparable store sales. Waterworks revenue is excluded from comparable brand revenue growth and will be added in the first full month following the anniversary of the acquisition. Membership revenue is excluded from comparable brand revenue growth and will be added in the first full month following the anniversary of the program launch. The impact on net revenues related to the product recalls in the fourth quarter of fiscal 2016 has been excluded from comparable brand revenue growth.

Liquidity and Capital Resources

General

Our business relies on cash flows from operations, net cash proceeds from the issuance of the convertible senior notes, as well as the revolving line of credit as our primary sources of liquidity. Our primary cash needs are for merchandise inventories, payroll, Source Books and other catalogs, store rent, capital expenditures associated with opening new stores and updating existing stores, as well as infrastructure and information technology. We seek out and evaluate opportunities for effectively managing and deploying capital in ways that improve working capital and support and enhance our business initiatives and strategies. The most significant components of our working capital are cash and cash equivalents, merchandise inventories, accounts payable and other current liabilities. Our working capital varies as a result of changes in our inventory levels, which may fluctuate based on the timing of new product introductions and based on progress made towards our efforts to optimize inventories and rationalize our SKU count, and changes in prepaid costs related to our Source Books. We believe that cash expected to be generated from operations, net cash proceeds from the issuance of the convertible senior notes and borrowing availability under the revolving line of credit or other financing arrangements will be sufficient to meet working capital requirements, anticipated capital expenditures and other capital needs for the next 12 months.

We may pursue additional strategies to generate additional liquidity for our operations, including through the strategic sale of assets, utilization of our revolving line of credit, and entry into debt financing arrangements that present attractive terms, and to deploy cash in ways that enhance shareholder value, including through our share repurchase program (refer to “Share Repurchase Program” below). In addition, we have $650 million in aggregate principal amount of convertible notes that mature in June 2019 and June 2020, respectively. We may need to access additional financing in order to repay such convertible notes in cash at their respective maturity dates and there can be no assurance as to the availability of capital to fund such repayments, or that if capital is available through additional debt issuances or refinancing of the convertible notes, that such capital will be available on terms that are favorable to us.

Our investments in capital expenditures for fiscal 2016 totaled $157.6 million and we made payments of $23.4 million in fiscal 2016 to escrow accounts for future construction of next generation Design Galleries. We expect to have gross capital expenditures of approximately $140 million to $160 million in fiscal 2017, primarily related to our efforts to continue our growth and expansion, including construction of our new Galleries and infrastructure investments. We expect our fiscal 2017 capital expenditures will be offset by proceeds from sales of assets of approximately $15 million to $25 million. The majority of the current lease arrangements for our new Galleries require the landlord to fund a portion of the construction related costs directly to third parties, rather than through traditional construction allowances and accordingly, we do not expect to receive significant contributions directly from our landlords related to the building of our larger format and next generation Design Galleries in fiscal 2017.

Cash Flow Analysis

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

	Year Ended		
	January 28, 2017	January 30,	January 31,