Restoration Hardware Holdings Inc
Form 10-Q
June 11, 2015

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended May 2, 2015

or

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

For the transition period from __________ to __________

Commission file number: 001-35720

RESTORATION HARDWARE HOLDINGS, INC.

(Exact name of registrant as specified in its charter)

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

Registrant s telephone number, including area code: (415) 924-1005

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 x 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 x No ¨

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 x	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 x

As of June 5, 2015, 39,953,934 shares of registrant s common stock were outstanding.

RESTORATION HARDWARE HOLDINGS, INC.

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PART I

Item 1. Financial Statements

RESTORATION HARDWARE HOLDINGS, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except share amounts)

(Unaudited)

	May 2, 2015	January 31, 2015
ASSETS		
Current assets:		
Cash and cash equivalents	$ 103,767	$ 148,934
Short-term investments	75,507	62,168
Accounts receivable net	25,509	25,965
Merchandise inventories	601,739	559,297
Current deferred tax assets	27,935	27,904
Prepaid expense and other current assets	99,925	87,976
Total current assets	934,382	912,244
Long-term investments	9,277	18,338
Property and equipment net	458,113	390,844
Goodwill	124,483	124,424
Trademarks and other intangible assets	48,535	48,554
Non-current deferred tax assets	8,654	8,689
Other non-current assets	18,858	22,906
Total assets	$ 1,602,302	$ 1,525,999
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable and accrued expenses	$ 240,422	$ 235,159
Deferred revenue and customer deposits	76,596	73,550
Other current liabilities	36,054	35,720
Total current liabilities	353,072	344,429
Convertible senior notes net	287,799	284,388
Financing obligations under build-to-suit lease transactions	172,174	124,770
Deferred rent and lease incentives	41,893	40,552
Other non-current obligations	28,855	28,944
Total liabilities	883,793	823,083

Commitments and contingencies (Note 15)

Stockholders equity:		
Preferred stock, $0.0001 par value per share, 10,000,000 shares authorized, no shares issued or outstanding as of May 2, 2015 and January 31, 2015		
Common stock, $0.0001 par value per share, 180,000,000 shares authorized, 40,246,689 shares issued and 39,954,426 shares outstanding as of May 2, 2015; 40,184,803 shares issued and 39,892,540 shares outstanding as of January 31, 2015	4	4
Additional paid-in capital	677,208	668,989
Accumulated other comprehensive loss	(284)	(502)
Retained earnings	60,866	53,710
Treasury stock at cost, 292,263 shares as of May 2, 2015 and January 31, 2015	(19,285)	(19,285)
Total stockholders equity	718,509	702,916
Total liabilities and stockholders equity	$ 1,602,302	$ 1,525,999

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

RESTORATION HARDWARE HOLDINGS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF INCOME

(In thousands, except share and per share amounts)

(Unaudited)

	Three Months Ended	
	May 2, 2015	May 3, 2014
Net revenues	$ 422,445	$ 366,254
Cost of goods sold	279,027	241,905
Gross profit	143,418	124,349
Selling, general and administrative expenses	126,389	119,571
Income from operations	17,029	4,778
Interest expense	5,649	2,056
Income before income taxes	11,380	2,722
Income tax expense	4,224	927
Net income	$ 7,156	$ 1,795
Weighted-average shares used in computing basic net income per share	39,913,946	39,152,923
Basic net income per share	$ 0.18	$ 0.05
Weighted-average shares used in computing diluted net income per share	41,959,718	40,787,726
Diluted net income per share	$ 0.17	$ 0.04

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

RESTORATION HARDWARE HOLDINGS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

(In thousands)

(Unaudited)

	Three Months Ended	
	May 2, 2015	**May 3, 2014**
Net income	$ 7,156	$ 1,795
Net gains (losses) from foreign currency translation	220	64
Net unrealized holding gains (losses) on available-for-sale investments	(2)	
Total comprehensive income	$ 7,374	$ 1,859

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

RESTORATION HARDWARE HOLDINGS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(Unaudited)

	Three Months Ended May 2, 2015	Three Months Ended May 3, 2014
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	$ 7,156	$ 1,795
Adjustments to reconcile net income to net cash used in operating activities:		
Depreciation and amortization	9,979	7,640
Amortization of debt discount	3,250	
Excess tax benefit from exercise of stock options	(1,075)	(5,364)
Stock-based compensation expense	5,299	2,231
Other non-cash interest expense	536	168
Change in assets and liabilities:		
Accounts receivable	472	3,106
Merchandise inventories	(42,253)	(29,631)
Prepaid expense and other assets	(11,189)	(19,665)
Accounts payable and accrued expenses	7,673	4,346
Deferred revenue and customer deposits	3,046	338
Other current liabilities	1,444	(22,822)
Deferred rent and lease incentives	1,266	593
Other non-current obligations	17	46
Net cash used in operating activities	(14,379)	(57,219)
CASH FLOWS FROM INVESTING ACTIVITIES		
Capital expenditures	(29,227)	(16,515)
Purchase of investments	(19,471)	
Maturities of investments	15,000	
Net cash used in investing activities	(33,698)	(16,515)
CASH FLOWS FROM FINANCING ACTIVITIES		
Gross borrowings under revolving line of credit		469,594
Gross repayments under revolving line of credit		(405,873)
Payments on capital leases	(83)	(985)
Proceeds from exercise of stock options	2,221	3,500
Excess tax benefit from exercise of stock options	1,075	5,364
Tax withholdings related to issuance of stock-based awards	(376)	(317)
Net cash provided by financing activities	2,837	71,283

Effects of foreign currency exchange rate translation	73	4
Net decrease in cash and cash equivalents	(45,167)	(2,447)
Cash and cash equivalents		
Beginning of period	148,934	13,389
End of period	$ 103,767	$ 10,942
Non-cash transactions:		
Property and equipment additions due to build-to-suit lease transactions	$ 47,404	$ 12,587
Property and equipment additions in accounts payable and accrued expenses at period-end	8,380	11,944
Property and equipment additions from use of construction related deposits	2,942	
Issuance of non-current notes payable related to share repurchases from former employees		15,682

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

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RESTORATION HARDWARE HOLDINGS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

NOTE 1 THE COMPANY

Nature of Business

Restoration Hardware Holdings, Inc., a Delaware corporation, together with its subsidiaries (collectively, the Company), is a luxury home furnishings retailer that offers a growing number of categories including furniture, lighting, textiles, bathware, décor, outdoor and garden, tableware and children s furnishings. These products are sold through the Company s stores, catalogs and websites. As of May 2, 2015, the Company operated a total of 67 retail stores and 17 outlet stores in 28 states, the District of Columbia and Canada, and had sourcing operations in Shanghai and Hong Kong.

Basis of Presentation

The accompanying unaudited interim condensed consolidated financial statements have been prepared from the Company s records and, in management s opinion, include all adjustments necessary to fairly state the Company s financial position as of May 2, 2015, and the results of operations for the three months ended May 2, 2015 and May 3, 2014. The Company s current fiscal year ends on January 30, 2016 (fiscal 2015).

Certain information and disclosures normally included in the notes to annual consolidated financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted for purposes of these interim condensed consolidated financial statements.

These unaudited interim condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and related notes included in the Company s Annual Report on Form 10-K for the fiscal year ended January 31, 2015 (the 2014 Form 10-K). Certain prior year amounts have been reclassified for consistency with the current period presentation. This reclassification had no effect on the previously reported consolidated results of operations, financial position or cash flows.

The results of operations for the three months ended May 2, 2015 presented herein are not necessarily indicative of the results to be expected for the full fiscal year.

NOTE 2 RECENT ACCOUNTING PRONOUNCEMENTS

Accounting for Leases

The Financial Accounting Standards Board (FASB) is currently working on amendments to existing accounting standards governing a number of areas including, but not limited to, accounting for leases. In May 2013, the FASB issued an Accounting Standards Update (Revised), *Leases (Topic 842)* (the Exposure Draft), which would replace the existing guidance in ASC 840 *Leases* (ASC 840). Under the Exposure Draft, among other changes in practice, a lessee s rights and obligations under most leases, including existing and new arrangements, would be recognized as assets and liabilities, respectively, on the balance sheet. Other significant provisions of the Exposure Draft include (i) defining the lease term to include the noncancellable period together with periods for which there is a significant economic incentive for the lessee to extend or not terminate the lease; (ii) defining the initial lease liability to be recorded on the balance sheet to contemplate only those variable lease payments that depend on an index or that are in substance fixed ; and (iii) a dual approach for determining whether lease expense is recognized on a straight-line or accelerated basis, depending on whether the lessee is expected to consume more than an insignificant portion of the leased asset s economic benefits. The comment period for the Exposure Draft ended on September 13, 2013. If and when effective, this Exposure Draft will likely have a significant impact on the Company s consolidated financial statements. However, as the standard-setting process is still ongoing, the Company is unable to determine the impact this proposed change in accounting standards will have on its consolidated financial statements.

Revenue from Contracts with Customers

In May 2014, the FASB and International Accounting Standards Board issued their converged accounting standard update on revenue recognition, *Accounting Standards Update 2014-09 Revenue from Contracts with Customers (Topic 606)*. This guidance outlines a single comprehensive model for companies to use in accounting for revenue arising from contracts with customers and supersedes most current revenue recognition guidance, including industry-specific guidance. The core principle of the revenue model is that revenue is recognized when a customer obtains control of a good or service. A customer obtains control when it has the ability to direct the use of and obtain the benefits from the good or service. Under the new guidance, transfer of control is no longer the same as transfer of risks and rewards as indicated in the prior guidance. The Company will also need to apply the new guidance to determine whether revenue should be recognized over time or at a point in time. This guidance is effective retrospectively for fiscal years beginning after December 15, 2016 (the Company s first quarter of fiscal 2017), and interim periods within those years. However, on April 28, 2015, the FASB proposed to defer the effective date by one year, and the Company will monitor if or when the deferral is approved. The Company is currently evaluating the accounting, transition and disclosure requirements of the standard and cannot currently estimate the financial statement impact of adoption on its consolidated financial statements.

Consolidation Accounting

In February 2015, the FASB issued *Accounting Standards Update No. 2015-02 Consolidation (Topic 810): Amendments to the Consolidation Analysis*, which improves targeted areas of the consolidation guidance and reduces the number of consolidation models. The amendments to the guidance are effective for fiscal years beginning after December 15, 2015 (the Company s first quarter of fiscal 2016), and interim periods within those years, with early adoption permitted. The Company is currently evaluating the effect this guidance will have on its consolidated financial statements.

Classification of Debt Issuance Costs

In April 2015, the FASB issued Accounting Standards Update 2015-03 *Interest Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs*. The amendments in ASU 2015-03 require that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability, consistent with debt discounts. The update requires retrospective application and represents a change in accounting principle. ASU 2015-03 is effective for fiscal years beginning after December 15, 2015, and interim periods within those years. The Company is currently evaluating the effect this guidance will have on its consolidated financial statements.

Software Licenses in Cloud Computing Arrangements

In April 2015, the FASB issued Accounting Standards Update No. 2015-05 *Intangibles Goodwill and Other Internal-Use Software (Subtopic 350-40): Customer s Accounting for Fees Paid in a Cloud Computing Arrangement*. The amendments in ASU 2015-05 provide guidance to customers about whether a cloud computing arrangement includes a software license. If a cloud computing arrangement includes a software license, the customer should account for the software license element of the arrangement consistent with other software licenses. If a cloud computing arrangement does not include a software license, the customer should account for the arrangement as a service contract. The amendments in ASU 2015-05 are effective for fiscal years beginning after December 15, 2015, and interim periods within those years. Early adoption is permitted. The guidance may be applied either prospectively to all arrangements entered into or materially modified after the effective date or retrospectively. The Company is currently evaluating the effect this guidance will have on its consolidated financial statements.

NOTE 3 PREPAID EXPENSE AND OTHER ASSETS

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

	May 2, 2015	**January 31, 2015**
Capitalized catalog costs	$ 47,697	$ 46,911
Vendor deposits	27,055	21,585
Prepaid expense and other current assets	25,173	19,480

Total prepaid expense and other current assets	$ 99,925	$ 87,976

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

	May 2, 2015	**January 31, 2015**
Construction related deposits	$ 6,308	$ 9,250
Other deposits	6,188	6,193
Deferred financing fees and convertible debt issuance costs	3,444	3,670
Other non-current assets	2,918	3,793
Total other non-current assets	$ 18,858	$ 22,906

NOTE 4 GOODWILL AND INTANGIBLE ASSETS

The following sets forth the goodwill and intangible assets as of May 2, 2015 (*in thousands*):

	Gross Carrying Amount	Accumulated Amortization	Foreign Currency Translation	Net Book Value
Intangible assets subject to amortization				
Fair value of leases (1)				
Fair market write-up	$ 2,562	$ (1,945)	$	$ 617
Fair market write-down (2)	(1,467)	1,169		(298)
Total intangible assets subject to amortization	$ 1,095	$ (776)	$	$ 319
Intangible assets not subject to amortization				
Goodwill	$ 124,461	$	$ 22	$ 124,483
Trademarks and domain names	$ 47,918	$	$	$ 47,918

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

The following sets forth the goodwill and intangible assets as of January 31, 2015 (*in thousands*):

	Gross Carrying Amount	Accumulated Amortization	Foreign Currency Translation	Net Book Value
Intangible assets subject to amortization				
Fair value of leases (1)				
Fair market write-up	$ 3,110	$ (2,419)	$	$ 691
Fair market write-down (2)	(1,467)	1,127		(340)
Customer relationships (3)	80	(80)		
Total intangible assets subject to amortization	$ 1,723	$ (1,372)	$	$ 351
Intangible assets not subject to amortization				
Goodwill	$ 124,461	$	$ (37)	$ 124,424
Trademarks and domain names	$ 47,863	$	$	$ 47,863

(1) The fair value of each lease is amortized over the life of the respective lease.
(2) The fair market write-down of leases is included in other non-current obligations on the condensed consolidated balance sheets.
(3) Customer relationships are amortized over a one-year period.

NOTE 5 ACCOUNTS PAYABLE, ACCRUED EXPENSES AND OTHER CURRENT LIABILITIES

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

	May 2, 2015	January 31, 2015
Accounts payable	$ 146,391	$ 133,063
Accrued compensation	34,119	35,942
Accrued freight and duty	16,982	22,747
Accrued sales taxes	16,770	21,240
Accrued catalog costs	11,198	4,582
Accrued occupancy	8,594	7,530
Accrued professional fees	1,980	2,319
Accrued legal settlements	1,430	4,309
Other accrued expenses	2,958	3,427
Total accounts payable and accrued expenses	$ 240,422	$ 235,159

Accounts payable included negative cash balances due to outstanding checks of $1.4 million and $17.5 million as of May 2, 2015 and January 31, 2015, respectively.

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

	May 2, 2015	January 31, 2015
Unredeemed gift card and merchandise credit liability	$ 22,658	$ 23,004
Allowance for sales returns	9,762	10,235
Federal, state and foreign tax payable	2,793	1,509
Capital lease obligations current	236	255
Other liabilities	605	717
Total other current liabilities	$ 36,054	$ 35,720

NOTE 6 OTHER NON-CURRENT OBLIGATIONS

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

	May 2, 2015	January 31, 2015
Notes payable for share repurchases	$ 19,285	$ 19,285
Capital lease obligations non-current	7,422	7,487
Unrecognized tax benefits	1,123	1,108
Other non-current obligations	1,025	1,064
Total other non-current obligations	$ 28,855	$ 28,944

NOTE 7 CONVERTIBLE SENIOR NOTES

0.00% Convertible Senior Notes due 2019

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

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

Prior to March 15, 2019, the Notes will be convertible only under the following circumstances: (1) during any calendar quarter commencing after September 30, 2014, if, for at least 20 trading days (whether or not consecutive) during the 30 consecutive trading day period ending on the last trading day of the immediately preceding fiscal quarter, the last reported sale price of the Company s common stock on such trading day is greater than or equal to 130% of the applicable conversion price on such trading day; (2) during the five consecutive business day period after any ten consecutive trading day period in which, for each day of that period, the trading price per $1,000 principal amount of Notes for such trading day was less than 98% of the product of the last reported sale price of the Company s common stock and the applicable conversion rate on such trading day; or (3) upon the occurrence of specified corporate transactions. As of May 2, 2015, none of these conditions have occurred and, as a result, the Notes are not convertible as of May 2, 2015. On and after March 15, 2019, until the close of business on the second scheduled trading day immediately preceding the maturity date, holders may convert all or a portion of their Notes at any time, regardless of the foregoing circumstances. Upon conversion, the Notes will be settled, at the Company s election, in cash, shares of the Company s common stock, or a combination of cash and shares of the Company s common stock. If the Company has not delivered a notice of its election of settlement method prior to the final conversion period it will be deemed to have elected combination settlement with a dollar amount per note to be received upon conversion of $1,000.

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

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

Debt issuance costs related to the Notes were comprised of discounts and commissions payable to the initial purchasers of $4.4 million and third party offering costs of $1.0 million. Discounts and commissions payable to the initial purchasers attributable to the liability component were recorded as a contra-liability and are presented net against the convertible senior notes balance on the condensed consolidated balance sheets. Third party offering costs attributable to the liability component were recorded as an asset and are presented in other assets on the condensed consolidated balance sheets. During the three months ended May 2, 2015, the Company recorded $0.2 million related to the amortization of debt issuance costs.

The carrying value of the Notes is as follows (*in thousands*):

	May 2, 2015	**January 31, 2015**
Liability component		
Principal	$ 350,000	$ 350,000
Less: Debt discount	(59,263)	(62,513)
Net carrying amount	$ 290,737	$ 287,487
Equity component (1)	$ 70,482	$ 70,482

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

The Company recorded interest expense of $3.3 million for the amortization of the debt discount related to the Notes during the three months ended May 2, 2015.

Convertible Bond Hedge and Warrant Transactions

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

NOTE 8 LINE OF CREDIT

In August 2011, Restoration Hardware, Inc., along with its Canadian subsidiary, Restoration Hardware Canada, Inc., entered into a credit agreement (the prior credit agreement) with Bank of America, N.A., as administrative agent, and certain other lenders. On November 24, 2014, the Company amended its existing revolving line of credit by entering into an amended and restated credit agreement with the lenders party thereto and Bank of America, N.A. as administrative agent and collateral agent. The amended and restated credit agreement increased the existing revolving line of credit by $182.5 million, while eliminating the $15.0 million term loan facility under the existing revolving line of credit. Under the amended and restated credit agreement, which has a maturity date of November 24, 2019, the Company has the option to increase the amount of the revolving line of credit by up to an additional $200.0 million, subject to satisfaction of certain customary conditions at the time of such increase.

As of May 2, 2015, the Company did not have any amounts outstanding under the revolving line of credit. As of May 2, 2015, the Company had $435.5 million undrawn borrowing availability under the revolving line of credit. As of May 2, 2015 and January 31, 2015, the Company had $12.2 million and $20.2 million in outstanding letters of credit, respectively.

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

The credit agreement contains various restrictive covenants, including, among others, limitations on the ability to incur liens, make loans or other investments, incur additional debt, issue additional equity, merge or consolidate with or into another person, sell assets, pay dividends or make other distributions, or enter into transactions with affiliates, along with other restrictions and limitations typical to credit agreements of this type and size. As of May 2, 2015, the Company was in compliance with all covenants contained in the credit agreement.

NOTE 9 FAIR VALUE OF FINANCIAL INSTRUMENTS

Financial Assets and Liabilities

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

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

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

Level 1 Quoted prices are available in active markets for identical investments as of the reporting date.

Level 2 Pricing inputs are other than quoted prices in active markets, which are either directly or indirectly observable as of the reporting date, and fair value is determined through the use of models or other valuation methodologies.

Level 3 Pricing inputs are unobservable for the investment and include situations where there is little, if any, market activity for the investment. The inputs used in the determination of fair value require significant management judgment or estimation.

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

Fair Value Measurements

All of the Company s investments are classified as available-for-sale and are carried at fair value. Assets measured at fair value were as follows (*in thousands*):

		May 2, 2015			January 31, 2015	
	Level 1	**Level 2**	**Total**	**Level 1**	**Level 2**	**Total**
Cash equivalents						
Money market funds	$ 38	$	$ 38	$ 44	$	$ 44
Commercial paper		14,949	14,949		18,248	18,248
Government agency obligations					1,001	1,001
Total cash equivalents	38	14,949	14,987	44	19,249	19,293
Short-term investments						
Commercial paper		18,357	18,357		13,996	13,996
Government agency obligations		57,150	57,150		48,172	48,172
Total short-term investments		75,507	75,507		62,168	62,168
Long-term investments						
Government agency obligations		9,277	9,277		18,338	18,338
Total long-term investments		9,277	9,277		18,338	18,338
Total	$ 38	$ 99,733	$ 99,771	$ 44	$ 99,755	$ 99,799

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

There were no purchases, sales, issuances, or settlements related to recurring level 3 measurements during the three months ended May 2, 2015 or May 3, 2014. There were no transfers into or out of level 1 and level 2 during the three months ended May 2, 2015 or May 3, 2014.

Fair Value of Financial Instruments

Amounts reported as cash and equivalents, receivables, and accounts payable and accrued expenses approximate fair value. The estimated fair value and carrying value of the Notes (carrying value excludes the equity component of the Notes classified in stockholders equity) were as follows (*in thousands*):

	May 2, 2015		January 31, 2015	
	Fair Value	**Carrying Value**	**Fair Value**	**Carrying Value**
Convertible senior notes	$ 272,877	$ 290,737	$ 260,444	$ 287,487

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

As the Company s debt obligations under the revolving line of credit are variable rate, there are no significant differences between the estimated fair value (level 2) and carrying value.

Non-Financial Assets

The Company did not record an impairment charge on long-lived assets during the three months ended May 2, 2015 or May 3, 2014.

NOTE 10 INCOME TAXES

The effective tax rate was 37.11% and 34.04% for the three months ended May 2, 2015 and May 3, 2014, respectively.

As of both May 2, 2015 and January 31, 2015, $0.9 million of the exposures related to unrecognized tax benefits would affect the effective tax rate if realized and are included in other non-current obligations on the condensed consolidated balance sheets. These amounts are primarily associated with foreign tax exposures that would, if realized, reduce the amount of net operating losses that would ultimately be utilized. As of May 2, 2015, the Company does not have any exposures related to unrecognized tax benefits that are expected to decrease in the next 12 months.

Adjustments required upon adoption of accounting for uncertainty in income taxes related to deferred tax assets were offset by the related valuation allowance. Future changes to the Company s assessment of the realizability of those deferred tax assets will impact the effective tax rate. The Company accounts for interest and penalties related to exposures as a component of income tax expense. The Company had an interest accrual of $0.2 million associated with exposures as of both May 2, 2015 and January 31, 2015.

NOTE 11 EARNINGS PER SHARE

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

	Three Months Ended	
	May 2, 2015	**May 3, 2014**
Weighted-average shares basic	39,913,946	39,152,923
Effect of dilutive stock-based awards	2,045,772	1,634,803
Weighted-average shares diluted	41,959,718	40,787,726

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

	Three Months Ended	
	May 2, 2015	**May 3, 2014**
Options	129,508	1,362,462
Restricted stock units	4,855	22,750
Total anti-dilutive stock-based awards	134,363	1,385,212

NOTE 12 SHARE REPURCHASES

Certain options and awards granted under the Company s equity plans contain a repurchase right, which may be exercised at the Company s discretion in the event of the termination of an employee s employment with the Company.

During the three months ended May 2, 2015, the Company did not repurchase any shares of common stock from former employees. During the three months ended May 3, 2014, the Company repurchased 241,322 shares of common stock from former employees pursuant to such repurchase right for fair value at a purchase price of $15.7 million. The repurchases were settled with the issuance of promissory notes bearing interest at 5%, paid annually, with principal due at the end of an 8-year term.

The aggregate unpaid principal amount of the notes payable for share repurchases was $19.3 million as of both May 2, 2015 and January 31, 2015, which is included in other non-current obligations on the condensed consolidated balance sheets. The Company recorded interest expense on the outstanding notes of $0.2 million during both the three months ended May 2, 2015 and May 3, 2014.

NOTE 13 STOCK-BASED COMPENSATION

The Company estimates the value of equity grants based upon an option-pricing model and recognizes this estimated value as compensation expense over the vesting periods. The Company recognizes expense associated with performance-based awards when it becomes probable that the performance condition will be met. Once it becomes probable that an award will vest, the Company recognizes compensation expense equal to the number of shares which are probable to vest multiplied by the fair value of the related shares measured at the grant date.

Stock-based compensation expense is included in selling, general and administrative expenses on the condensed consolidated statements of income. The Company recorded stock-based compensation expense of $5.3 million and $2.2 million in the three months ended May 2, 2015 and May 3, 2014, respectively. No stock-based compensation cost has been capitalized in the accompanying condensed consolidated financial statements.

2012 Stock Option Plan and 2012 Stock Incentive Plan

As of May 2, 2015, 6,789,562 options were outstanding with a weighted-average exercise price of $52.15 per share and 5,135,927 options were vested with a weighted-average exercise price of $48.30 per share. The aggregate intrinsic value of options outstanding, options vested or expected to vest, and options exercisable as of May 2, 2015 was $239.5 million, $236.0 million, and $190.0 million, respectively. Stock options exercisable as of May 2, 2015 had a weighted-average remaining contractual life of 7.68 years. As of May 2, 2015, the total unrecognized compensation expense related to unvested options was $32.7 million, which is expected to be recognized on a straight-line basis over a weighted-average period of 3.84 years.

As of May 2, 2015, the Company had 744,852 restricted stock and restricted stock unit awards outstanding with a weighted-average grant date fair value of $65.80 per share. During the three months ended May 2, 2015, 10,428 restricted stock and restricted stock unit awards with a weighted-average grant date fair value of $48.70 per share vested. As of May 2, 2015, there was $34.2 million of total unrecognized compensation expense related to unvested restricted stock and restricted stock unit awards which is expected to be recognized over a weighted-average period of 3.61 years.

NOTE 14 RELATED PARTY TRANSACTIONS

In February 2015, the Company purchased an aircraft for a total purchase price of $9.5 million in order to facilitate more efficient business travel by the Company s management team in development of the Company s business.

On March 27, 2015, Restoration Hardware, Inc. (RHI), a wholly-owned subsidiary of the Company and the operator of the aircraft, entered into an Aircraft Time Sharing Agreement (the Time Sharing Agreement) with Gary Friedman, our Chief Executive Officer. The Time Sharing Agreement governs any use of the aircraft by Mr. Friedman for personal trips and provides that Mr. Friedman will lease the aircraft and pay RHI an amount equal to the aggregate actual expenses of each personal use flight based on the variable costs of the flight, with the amount of such lease payments not to exceed the maximum payment level established under the Federal Aviation Administration rules. Mr. Friedman maintains a deposit with the Company, to be used towards payment of amounts due under the Time Sharing Agreement.

NOTE 15 COMMITMENTS AND CONTINGENCIES

Commitments

The Company had no material off balance sheet commitments as of May 2, 2015.

Contingencies

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

The Company reviews the need for any loss contingency reserves and establishes reserves when, in the opinion of management, it is probable that a matter would result in liability, and the amount of loss, if any, can be reasonably estimated. Generally, in view of the inherent difficulty of predicting the outcome of those matters, particularly in cases in which claimants seek substantial or indeterminate damages, it is not possible to determine whether a liability has been incurred or to reasonably estimate the ultimate or minimum amount of that liability until the case is close to resolution, in which case no reserve is established until that time. As of May 2, 2015, the Company has recorded a liability for the estimated loss related to these disputes. There is a possibility that additional losses may be incurred in excess of the amounts that the Company has accrued. However, the Company believes that the ultimate resolution of these current matters will not have a material adverse effect on its consolidated financial statements.

In fiscal 2014 and the first quarter of fiscal 2015, material developments occurred in an ongoing legal proceeding involving the Company. On October 21, 2008, Mike Hernandez, individually and on behalf of others similarly situated, filed a class action in the Superior Court of the State of California for the County of San Diego against Restoration Hardware, Inc. alleging principally 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. On May 23, 2014, in response to a directive from the Court, the parties filed a joint statement as to the parties agreed-upon claims process for the class members as well as to other matters related to this proceeding. On September 5, 2014, the Court granted plaintiffs motion for attorneys fees, costs, and awards, and awarded $9.5 million in fees and costs to plaintiffs attorneys. The Court entered judgment on September 29, 2014 and, on November 21, 2014, a class member filed a notice of appeal from the judgment. As a result of the appeal, the judgment was stayed until January 10, 2015. The appeal remains pending but the judgment is enforceable. As a result of these developments, during fiscal 2014, the Company recorded a $9.5 million charge related to this matter that was subsequently decreased to approximately $8 million. The decrease of approximately $1.5 million was based on a revision of estimated class member response. On March 16, 2015, the Company, through the third party claims administrator, began mailing the class action award to class members. The Company, through the third party claims administrator, paid approximately $2.4M in cash awards to the class members and mailed 33% discount coupons, good for one year, on purchases up to $10,000, to class members that did not request the cash award. During a hearing on April 16, 2015, the Court provided additional guidance regarding the manner in which class members can use the 33% merchandise discount coupon. Specifically, the court ordered that the 33% coupons may be combined with the Company s other promotional offers.

NOTE 16 SEGMENT REPORTING

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

The Company classifies its sales into furniture and non-furniture product lines. Furniture includes both indoor and outdoor furniture. Non-furniture includes lighting, textiles, accessories and home décor. During the first quarter of fiscal 2015, the Company recategorized as furniture certain products within its Bath and Contract categories, which were previously included in the non-furniture category. The Company has determined that such recategorization provides a more meaningful disclosure and is better aligned with the Company s internal reporting. Such recategorizations are reflected in the table below.

Net revenues in each category were as follows (*in thousands*):

	Three Months Ended	
	May 2, 2015	**May 3, 2014**
Furniture	$ 272,275	$ 228,035
Non-furniture	150,170	138,219
Total net revenues	$ 422,445	$ 366,254

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

No single customer accounted for more than 10% of the Company s revenues in the three months ended May 2, 2015 or May 3, 2014.

Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

The following discussion and analysis of the financial condition and results of our operations should be read together with our condensed consolidated financial statements and the related notes included in Item 1 of Part I of this Quarterly Report on Form 10-Q and with our audited consolidated financial statements and the related notes included in our 2014 Form 10-K.

FORWARD-LOOKING STATEMENTS AND MARKET DATA

This quarterly 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 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 include those factors disclosed under the sections entitled *Risk Factors* in Part II of this quarterly report, in our Annual Report on Form 10-K for the fiscal year ended January 31, 2015 (2014 Form 10-K), and *Management s Discussion and Analysis of Financial Condition and Results of Operations* in Part I of this quarterly report and in our 2014 Form 10-K. All forward-looking statements are expressly qualified in their entirety by these cautionary factors contained in this quarterly report and in our 2014 Form 10-K. You should evaluate all forward-looking statements made in this quarterly report in the context of these cautionary factors.

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 quarterly 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.

Overview

We are a leading luxury retailer in the home furnishings marketplace. Our collections of timeless, updated classics and reproductions are presented consistently across our sales channels in sophisticated and unique lifestyle settings that we believe are on par with world-class interior designers. We offer dominant merchandise assortments across a growing number of categories, including furniture, lighting, textiles, bathware, décor, outdoor and garden, tableware and children s furnishings. Our business is fully integrated across our multiple channels of distribution, consisting of our stores, Source Books and websites. We position our stores as showrooms for our brand, while our Source Books and websites act as virtual extensions of our stores. As of May 2, 2015, we operated a total of 67 retail galleries throughout the United States and Canada, consisting of 57 Legacy Galleries, 6 larger format Galleries, 1 next generation Design Gallery and 3 Baby & Child Galleries, as well as 17 outlet stores.

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

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

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

- Growing our merchandise assortment;
- Introducing new products and categories;
- Expanding our service offerings;
- Exploring and testing new business opportunities complementary to our core business; and
- Increasing brand awareness and customer loyalty through our circulation strategy, our digital marketing initiatives and our advertising and public relations activities and events.

Increase Operating Margins. Key areas in which we believe we will increase operating margins include:

- Occupancy leverage;
- Advertising cost leverage;
- Improved product margin and shipping efficiencies; and
- Other selling, general and administrative expenses.

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

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. In response to some of our new business initiatives, we have recently experienced substantial increases in revenue and strong improvements in financial performance on a quarter by quarter comparison basis. The rate of growth in our revenue and the extent of improvements in our financial performance have changed from quarter to quarter based upon a range of business factors. We expect fluctuations in our rate of revenue growth and in our financial performance will continue in future periods as we continue to pursue a large number of new business initiatives. 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.

Basis of Presentation and Results of Operations

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

	Three Months Ended May 2, 2015	Three Months Ended May 3, 2014
	(dollars in thousands, excluding per square foot store data)	
Consolidated Statements of Income:		
Net revenues	$ 422,445	$ 366,254
Cost of goods sold	279,027	241,905
Gross profit	143,418	124,349
Selling, general and administrative expenses	126,389	119,571
Income from operations	17,029	4,778
Interest expense	5,649	2,056
Income before income taxes	11,380	2,722
Income tax expense	4,224	927
Net income	$ 7,156	$ 1,795
Other Financial and Operating Data:		
Direct as a percentage of net revenues (1)	49%	48%
Growth in net revenues:		
Stores (2)	13%	19%