Restoration Hardware Holdings Inc
Form 10-Q
December 10, 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 October 31, 2015

or

o 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 o

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 o

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

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

As of December 4, 2015, 40,480,241 shares of registrant's common stock were outstanding.

RESTORATION HARDWARE HOLDINGS, INC.

INDEX TO FORM 10-Q

		Page
	PART I. FINANCIAL INFORMATION	
Item 1.	Financial Statements	3
	Condensed Consolidated Balance Sheets (Unaudited) as of October 31, 2015, and January 31, 2015	3
	Condensed Consolidated Statements of Income (Unaudited) for the three and nine months ended October 31, 2015, and November 1, 2014	4
	Condensed Consolidated Statements of Comprehensive Income (Unaudited) for the three and nine months ended October 31, 2015, and November 1, 2014	5
	Condensed Consolidated Statements of Cash Flows (Unaudited) for the nine months ended October 31, 2015, and November 1, 2014	6
	Notes to Condensed Consolidated Financial Statements (Unaudited)	7
Item 2.	Management's Discussion and Analysis of Financial Condition and Results of Operations	20
Item 3.	Quantitative and Qualitative Disclosures about Market Risk	33
Item 4.	Controls and Procedures	34
	PART II. OTHER INFORMATION	
Item 1.	Legal Proceedings	35
Item 1A.	Risk Factors	35
Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds	35
Item 3.	Defaults Upon Senior Securities	35
Item 4.	Mine Safety Disclosures	36
Item 5.	Other Information	36
Item 6.	Exhibits	37
Signatures		38

PART I

Item 1. Financial Statements

RESTORATION HARDWARE HOLDINGS, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except share amounts)

(Unaudited)

	October 31, 2015	January 31, 2015
ASSETS		
Current assets:		
Cash and cash equivalents	$226,979	$148,934
Short-term investments	160,670	62,168
Accounts receivable—net	32,366	25,965
Merchandise inventories	760,854	559,297
Current deferred tax assets	27,072	27,904
Prepaid expense and other current assets	89,772	87,976
Total current assets	1,297,713	912,244
Long-term investments	2,005	18,338
Property and equipment—net	556,594	390,844
Goodwill	124,382	124,424
Trademarks and other intangible assets	48,442	48,554
Non-current deferred tax assets	3,626	8,689
Other non-current assets	26,348	22,906
Total assets	$2,059,110	$1,525,999
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable and accrued expenses	$300,888	$235,159
Deferred revenue and customer deposits	88,844	73,550
Current deferred tax liabilities	130	133
Other current liabilities	39,269	35,587
Total current liabilities	429,131	344,429
Convertible senior notes due 2019—net	294,739	284,388
Convertible senior notes due 2020—net	217,774	—
Financing obligations under build-to-suit lease transactions	206,180	124,770
Deferred rent and lease incentives	42,703	40,552
Other non-current obligations	29,273	28,944
Total liabilities	1,219,800	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 October 31, 2015 and January 31, 2015	—	—
Common stock, $0.0001 par value per share, 180,000,000 shares authorized, 40,689,746 shares issued and 40,394,858 shares outstanding as of October 31, 2015; 40,184,803 shares issued and 39,892,540 shares outstanding as of January 31, 2015	4	4
Additional paid-in capital	748,710	668,989
Accumulated other comprehensive loss	(1,392)	(502)
Retained earnings	111,511	53,710
Treasury stock—at cost, 294,888 shares as of October 31, 2015 and 292,263 shares as of January 31, 2015	(19,523)	(19,285)
Total stockholders’ equity	839,310	702,916
Total liabilities and stockholders’ equity	$2,059,110	$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		Nine Months Ended	
	October 31, 2015	November 1, 2014	October 31, 2015	November 1, 2014
Net revenues	$532,411	$484,675	$1,461,798	$1,284,695
Cost of goods sold	341,661	304,302	933,367	812,064
Gross profit	190,750	180,373	528,431	472,631
Selling, general and administrative expenses	145,874	143,685	410,103	382,230
Income from operations	44,876	36,688	118,328	90,401
Interest expense	11,003	5,210	24,058	11,612
Income before income taxes	33,873	31,478	94,270	78,789
Income tax expense	13,163	12,049	36,469	30,312
Net income	$20,710	$19,429	$57,801	$48,477
Weighted-average shares used in computing basic net income per share	40,282,734	39,507,272	40,080,843	39,260,458
Basic net income per share	$0.51	$0.49	$1.44	$1.23
Weighted-average shares used in computing diluted net income per share	42,413,657	41,392,831	42,237,967	40,954,249
Diluted net income per share	$0.49	$0.47	$1.37	$1.18

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		Nine Months Ended	
	October 31, 2015	November 1, 2014	October 31, 2015	November 1, 2014
Net income	$20,710	$ 19,429	$57,801	$ 48,477
Net gains (losses) from foreign currency translation	(18)	(167)	(872)	(92)
Net unrealized holding gains (losses) on available-for-sale investments	(13)	—	(18)	—
Total comprehensive income	$20,679	$ 19,262	$56,911	$ 48,385

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)

	Nine Months Ended October 31, 2015	Nine Months Ended November 1, 2014
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	$57,801	$48,477
Adjustments to reconcile net income to net cash used in operating activities:		
Depreciation and amortization	32,105	24,995
Amortization of debt discount	15,153	4,754
Excess tax benefit from exercise of stock options	(6,564)	(7,937)
Stock-based compensation expense	17,655	11,660
Other non-cash interest expense	2,070	1,103
Change in assets and liabilities:		
Accounts receivable	(6,405)	(5,626)
Merchandise inventories	(201,674)	(156,660)
Prepaid expense and other assets	(3,679)	4,396
Accounts payable and accrued expenses	48,015	44,818
Deferred revenue and customer deposits	15,295	16,332
Other current liabilities	10,317	(10,808)
Deferred rent and lease incentives	2,208	2,203
Other non-current obligations	73	(465)
Net cash used in operating activities	(17,630)	(22,758)
CASH FLOWS FROM INVESTING ACTIVITIES		
Capital expenditures	(76,801)	(69,690)
Acquisition of buildings and land	(13,999)	—
Construction related deposits	(8,855)	—
Purchase of trademarks and domain names	(218)	(423)
Purchase of investments	(156,055)	—
Maturities of investments	73,087	—
Net cash used in investing activities	(182,841)	(70,113)
CASH FLOWS FROM FINANCING ACTIVITIES		
Gross borrowings under revolving line of credit	—	749,945
Gross repayments under revolving line of credit	—	(835,370)
Proceeds from issuance of convertible senior notes	296,250	350,000
Proceeds from issuance of warrants	30,390	40,390
Purchase of convertible note hedges	(68,250)	(73,325)
Debt issuance costs related to convertible senior notes	(2,382)	(5,385)
Payments on capital leases	(202)	(1,655)
Proceeds from exercise of stock options	20,465	6,220
Excess tax benefit from exercise of stock options	6,564	7,937
Tax withholdings related to issuance of stock-based awards	(4,295)	(2,115)

Net cash provided by financing activities	278,540	236,642
Effects of foreign currency exchange rate translation	(24)	(33)
Net increase in cash and cash equivalents	78,045	143,738
Cash and cash equivalents		
Beginning of period	148,934	13,389
End of period	$226,979	$157,127
Non-cash transactions:		
Property and equipment additions due to build-to-suit lease transactions	$81,333	$54,181
Property and equipment additions in accounts payable and accrued expenses at period-end	28,440	18,405
Property and equipment additions from use of construction related deposits	8,000	—
Property and equipment acquired under capital lease	—	6,836
Issuance of non-current notes payable related to share repurchases from former employees	238	16,575

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

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 child and teen furnishings. These products are sold through the Company's stores, catalogs and websites. As of October 31, 2015, the Company operated a total of 68 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 October 31, 2015, and the results of operations for the three and nine months ended October 31, 2015 and November 1, 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 and nine months ended October 31, 2015 presented herein are not necessarily indicative of the results to be expected for the full fiscal year.

Convertible Senior Notes

In June 2015, the Company issued in a private offering $250 million principal amount of 0.00% convertible senior notes due 2020 and, in July 2015, the Company issued an additional $50 million principal amount pursuant to the exercise of the overallotment option granted to the initial purchasers as part of its June 2015 offering (collectively, the "2020 Notes"). In connection with the issuance of these notes, the Company entered into convertible note hedge transactions for which it paid an aggregate amount of $68.3 million. In addition, the Company sold warrants for which it received aggregate proceeds of $30.4 million. Taken together, the Company received total cash proceeds of $256.0 million, net of discounts upon original issuance and offering costs of $6.1 million. Refer to Note 7—Convertible Senior Notes.

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. In November 2015, the FASB announced the final lease standard will be effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. As of the date of this report, the final standard has not yet been issued. 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. In August 2015, the FASB issued Accounting Standards Update 2015-14—Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date, which amends Accounting Standards Update 2014-09. As a result, the effective date was deferred by one year, to annual reporting periods beginning after December 15, 2017, including interim reporting periods, with early adoption permitted as of the original effective date of December 15, 2016. The Company is unable to currently estimate the impact of this guidance on its consolidated financial statements and is evaluating its accounting, transition and disclosure requirements.

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 impact 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 impact 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 impact this guidance will have on its consolidated financial statements.

Measurement of Inventory

In July 2015, the FASB issued Accounting Standards Update 2015-11—Inventory (Topic 330): Simplifying the Measurement of Inventory, which changes the measurement principle for inventory from the lower of cost or market to the lower of cost and net realizable value. ASU 2015-11 defines net realizable value as estimated selling prices in the ordinary course of business, less reasonably predictable costs of completion, disposal, and transportation. The guidance must be applied on a prospective basis and is effective for periods beginning after December 15, 2016, with early adoption permitted. The Company is currently evaluating the impact this guidance will have on its consolidated financial statements.

Classification of Deferred Taxes

In November 2015, the FASB issued Accounting Standards Update 2015-17—Income Taxes (Topic 740): Balance Sheet Classification of Deferred Taxes, to simplify the presentation of deferred income taxes. The amendments in ASU 2015-17 require that deferred tax liabilities and assets be classified as non-current in a classified statement of financial position. The current requirement that deferred tax liabilities and assets of a tax-paying component of an entity be offset and presented as a single amount is not affected by the amendments in the update. ASU 2015-17 is effective for fiscal years beginning after December 15, 2016, and interim periods within those years, and may be applied either prospectively to all deferred tax liabilities and assets or retrospectively to all periods presented. The Company is currently evaluating the impact this guidance will have on its consolidated financial statements, which will impact the classification of deferred taxes on its consolidated balance sheets.

NOTE 3—PREPAID EXPENSE AND OTHER ASSETS

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

	October 31, 2015	January 31, 2015
Capitalized catalog costs	$57,261	$46,911
Vendor deposits	10,870	21,585
Prepaid expense and other current assets	21,641	19,480
Total prepaid expense and other current assets	$89,772	$87,976

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

	October 31, 2015	January 31, 2015
Construction related deposits	$10,105	$9,250
Other deposits	7,447	6,193
Deferred financing fees and convertible debt issuance costs	4,622	3,670
Other non-current assets	4,174	3,793
Total other non-current assets	$26,348	$22,906

NOTE 4—GOODWILL AND INTANGIBLE ASSETS

The following sets forth the goodwill and intangible assets as of October 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	$1,924	$ (1,655)	$ —	$269
Fair market write-down [2]	(1,467)	1,247	—	(220)
Total intangible assets subject to amortization	$457	$ (408)	$ —	$49
Intangible assets not subject to amortization				
Goodwill	$124,461	$ —	$ (79)	$124,382
Trademarks and domain names	$48,173	$ —	$ —	$48,173

(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.

9

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):

	October 31, 2015	January 31, 2015
Accounts payable	$188,233	$133,063
Accrued compensation	33,326	35,942
Accrued freight and duty	23,325	22,747
Accrued sales taxes	17,058	21,240
Accrued catalog costs	15,028	4,582
Accrued occupancy	12,257	7,530
Accrued professional fees	3,202	2,319
Accrued legal settlements	3,136	4,309
Other accrued expenses	5,323	3,427
Total accounts payable and accrued expenses	$300,888	$235,159

Accounts payable included negative cash balances due to outstanding checks of $20.3 million and $17.5 million as of October 31, 2015 and January 31, 2015, respectively.

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

	October 31, 2015	January 31, 2015
Unredeemed gift card and merchandise credit liability	$25,093	$23,004
Allowance for sales returns	9,851	10,235
Federal and state tax payable	4,144	1,509
Other liabilities	181	839
Total other current liabilities	$39,269	$35,587

NOTE 6—OTHER NON-CURRENT OBLIGATIONS

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

	October 31, 2015	January 31, 2015
Notes payable for share repurchases	$19,523	$19,285
Capital lease obligations—non-current	7,359	7,487
Unrecognized tax benefits	1,181	1,108
Other non-current obligations	1,210	1,064
Total other non-current obligations	$29,273	$28,944

NOTE 7—CONVERTIBLE SENIOR NOTES

0.00% Convertible Senior Notes due 2020

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

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

Prior to March 15, 2020, the 2020 Notes will be convertible only under the following circumstances: (1) during any calendar quarter commencing after September 30, 2015, if, for at least 20 trading days (whether or not consecutive) during the 30 consecutive trading day period ending on the last trading day of the immediately preceding fiscal quarter, the last reported sale price of the Company's common stock on such trading day is greater than or equal to 130% of the applicable conversion price on such trading day; (2) during the five consecutive business day period after any ten consecutive trading day period in which, for each day of that period, the trading price per $1,000 principal amount of 2020 Notes for such trading day was less than 98% of the product of the last reported sale price of the Company’s common stock and the applicable conversion rate on such trading day; or (3) upon the occurrence of specified corporate transactions. As of October 31, 2015, none of these conditions have occurred and, as a result, the 2020 Notes are not convertible as of October 31, 2015. On and after March 15, 2020, until the close of business on the second scheduled trading day immediately preceding the maturity date, holders may convert all or a portion of their 2020 Notes at any time, regardless of the foregoing circumstances. Upon conversion, the 2020 Notes will be settled, at the Company’s election, in cash, shares of the Company’s common stock, or a combination of cash and shares of the Company’s common stock. If the Company has not delivered a notice of its election of settlement method prior to the final conversion period it will be deemed to have elected combination settlement with a dollar amount per note to be received upon conversion of $1,000.

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

In accounting for the debt issuance costs related to the issuance of the 2020 Notes, the Company allocated the total amount incurred to the liability and equity components based on their relative values. Debt issuance costs attributable to the liability component are amortized to interest expense using the effective interest method over the term of the 2020 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 2020 Notes were comprised of discounts upon original issuance of $3.8 million and third party offering costs of $2.3 million. Discounts were recorded as a contra-liability and are presented net against the convertible senior notes due 2020 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 and nine months ended October 31, 2015, the Company recorded $0.2 million and $0.3 million, respectively, related to the amortization of debt issuance costs.

The carrying value of the 2020 Notes is as follows (in thousands):

	October 31, 2015
Liability component	
Principal	$300,000
Less: Debt discount	(78,712)
Net carrying amount	$221,288
Equity component (1)	$84,003

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

The Company recorded interest expense of $3.6 million and $5.3 million for the amortization of the debt discount related to the 2020 Notes during the three and nine months ended October 31, 2015, respectively.

2020 Notes—Convertible Bond Hedge and Warrant Transactions

In connection with the offering of the 2020 Notes in June 2015 and the exercise in full of the overallotment option in July 2015, the Company entered into convertible note hedge transactions whereby the Company has the option to purchase a total of approximately 5.1 million shares of its common stock at a price of approximately $118.13 per share. The total cost of the convertible note hedge transactions was $68.3 million. In addition, the Company sold warrants whereby the holders of the warrants have the option to purchase a total of approximately 5.1 million shares of the Company’s common stock at a price of $189.00 per share. The Company received $30.4 million in cash proceeds from the sale of these warrants. Taken together, the purchase of the convertible note hedges and sale of the warrants are intended to offset any actual earnings dilution from the conversion of the 2020 Notes until the Company’s common stock is above approximately $189.00 per share. As these transactions meet certain accounting criteria, the convertible note hedges and warrants are recorded in stockholders’ equity, 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.

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

0.00% Convertible Senior Notes due 2019

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

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

Prior to March 15, 2019, the 2019 Notes will be convertible only under the following circumstances: (1) during any calendar quarter commencing after September 30, 2014, if, for at least 20 trading days (whether or not consecutive) during the 30 consecutive trading day period ending on the last trading day of the immediately preceding fiscal quarter, the last reported sale price of the Company’s common stock on such trading day is greater than or equal to 130% of the applicable conversion price on such trading day; (2) during the five consecutive business day period after any ten consecutive trading day period in which, for each day of that period, the trading price per $1,000 principal amount of 2019 Notes for such trading day was less than 98% of the product of the last reported sale price of the Company’s common stock and the applicable conversion rate on such trading day; or (3) upon the occurrence of specified corporate transactions. As of October 31, 2015, none of these conditions have occurred and, as a result, the 2019 Notes are not convertible as of October 31, 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 2019 Notes at any time, regardless of the foregoing circumstances. Upon conversion, the 2019 Notes will be settled, at the Company’s election, in cash, shares of the Company’s common stock, or a combination of cash and shares of the Company’s common stock. If the Company has not delivered a notice of its election of settlement method prior to the final conversion period it will be deemed to have elected combination settlement with 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 2019 Notes, the Company separated the 2019 Notes into liability and equity components. The carrying amount of the liability component was calculated by measuring the fair value of a similar liability that does not have an associated convertible feature. The carrying amount of the equity component, which is recognized as a debt discount, represents the difference between the proceeds from the issuance of the 2019 Notes and the fair value of the liability component of the 2019 Notes. The excess of the principal amount of the liability component over its carrying amount (“debt discount”) will be amortized to interest expense using an effective interest rate of 4.51% over the term of the 2019 Notes. The equity component is not remeasured as long as it continues to meet the conditions for equity classification.

In accounting for the debt issuance costs related to the issuance of the 2019 Notes, the Company allocated the total amount incurred to the liability and equity components based on their relative values. Debt issuance costs attributable to the liability component are amortized to interest expense using the effective interest method over the term of the 2019 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 2019 Notes were comprised of discounts and commissions payable to the initial purchasers of $4.4 million and third party offering costs of $1.0 million. Discounts 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 due 2019 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 October 31, 2015 and November 1, 2014, the

Company recorded $0.2 million and $0.2 million related to the amortization of debt issuance costs, respectively. During the nine months ended October 31, 2015 and November 1, 2014, the Company recorded $0.6 million and $0.3 million related to the amortization of debt issuance costs, respectively.

The carrying value of the 2019 Notes is as follows (in thousands):

	October 31, 2015	January 31, 2015
Liability component		
Principal	$350,000	$350,000
Less: Debt discount	(52,651)	(62,513)
Net carrying amount	$297,349	$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 and $3.2 million for the amortization of the debt discount related to the 2019 Notes during the three months ended October 31, 2015 and November 1, 2014, respectively. The Company recorded interest expense of $9.9 million and $4.8 million for the amortization of the debt discount related to the 2019 Notes during the nine months ended October 31, 2015 and November 1, 2014, respectively.

2019 Notes—Convertible Bond Hedge and Warrant Transactions

In connection with the offering of the 2019 Notes, the Company entered into convertible note hedge transactions whereby the Company has the option to purchase a total of approximately 3.0 million shares of its common stock at a price of approximately $116.09 per share. The total cost of the convertible note hedge transactions was $73.3 million. In addition, the Company sold warrants whereby the holders of the warrants have the option to purchase a total of approximately 3.0 million shares of the Company's common stock at a price of $171.98 per share. The Company received $40.4 million in cash proceeds from the sale of these warrants. Taken together, the purchase of the convertible note hedges and sale of the warrants are intended to offset any actual dilution from the conversion of the 2019 Notes and to effectively increase the overall conversion price from $116.09 per share to $171.98 per share. As these transactions meet certain accounting criteria, the convertible note hedges and warrants are recorded in stockholders' equity, 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.

On August 12, 2015, Restoration Hardware, Inc. and Restoration Hardware Canada, Inc. entered into a First Amendment (the “Amendment”) to the amended and restated credit agreement. The Amendment changes the amended and restated credit agreement definition of “Change of Control” (the occurrence of which triggers a default under the amended and restated credit agreement) so that changes in the composition of the board of directors due to actual or threatened proxy solicitations are treated in the same way as other changes in the composition of the board of directors.

As of October 31, 2015, the Company did not have any amounts outstanding under the revolving line of credit. As of October 31, 2015, the Company had $586.6 million undrawn borrowing availability under the revolving line of credit. As of October 31, 2015 and January 31, 2015, the Company had $13.4 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 October 31, 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):

	October 31, 2015			January 31, 2015		
	Level 1	Level 2	Total	Level 1	Level 2	Total

Cash equivalents						
Money market funds	$5	$—	$5	$44	$—	$44
Commercial paper	—	36,931	36,931	—	18,248	18,248
Government agency obligations	—	—	—	—	1,001	1,001
Total cash equivalents	5	36,931	36,936	44	19,249	19,293
Short-term investments						
Commercial paper	—	22,084	22,084	—	13,996	13,996
Government agency obligations	—	138,586	138,586	—	48,172	48,172
Total short-term investments	—	160,670	160,670	—	62,168	62,168
Long-term investments						
Government agency obligations	—	2,005	2,005	—	18,338	18,338
Total long-term investments	—	2,005	2,005	—	18,338	18,338
Total	$5	$199,606	$199,611	$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 and nine months ended October 31, 2015 or November 1, 2014. There were no transfers into or out of level 1 and level 2 during the three and nine months ended October 31, 2015 or November 1, 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 2019 Notes and 2020 Notes (carrying value excludes the equity component of the 2019 Notes and 2020 Notes classified in stockholders' equity) were as follows (in thousands):

	October 31, 2015	January 31,