RH
Form 10-Q
September 07, 2017

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended July 29, 2017

or

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

Commission file number: 001-35720

(Exact name of registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation or organization)	45-3052669 (I.R.S. Employer Identification Number)
15 Koch Road, Suite K	
Corte Madera, CA (Address of principal executive offices)	94925 (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 No

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

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

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

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

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

As of September 1, 2017, 21,152,191 shares of registrant's common stock were outstanding.

RH

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PART I

Item 1. Financial Statements

RH

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except share amounts)

(Unaudited)

	July 29, 2017		January 28, 2017	
ASSETS				
Current assets:				
Cash and cash equivalents	$	21,637	$	87,023
Short-term investments		—		142,677
Accounts receivable—net		34,752		34,191
Merchandise inventories		608,048		752,304
Asset held for sale		—		4,900
Prepaid expense and other current assets		77,679		117,162
Total current assets		742,116		1,138,257
Long-term investments		—		33,212
Property and equipment—net		744,460		682,056
Goodwill		175,592		173,603
Trademarks and other intangible assets		100,750		100,757
Deferred tax assets		29,394		28,466
Other non-current assets		27,097		36,169
Total assets	$	1,819,409	$	2,192,520
LIABILITIES AND STOCKHOLDERS' EQUITY (DEFICIT)				
Current liabilities:				
Accounts payable and accrued expenses	$	271,837	$	226,980
Deferred revenue and customer deposits		176,310		145,918
Other current liabilities		47,602		43,271
Total current liabilities		495,749		416,169
Asset based credit facility		283,000		—
Term loans—net		176,363		—
Convertible senior notes due 2019—net		319,969		312,379
		244,342		235,965

Convertible senior notes due 2020—net						
Financing obligations under build-to-suit lease transactions		226,231			203,015	
Deferred rent and lease incentives		63,887			60,439	
Other non-current obligations		56,652			44,684	
Total liabilities		1,866,193			1,272,651	
Commitments and contingencies (Note 17)		—			—	
Stockholders' equity (deficit):						
Preferred stock, $0.0001 par value per share, 10,000,000 shares authorized, no shares issued or outstanding as of July 29, 2017 and January 28, 2017		—			—	
Common stock, $0.0001 par value per share, 180,000,000 shares authorized, 41,372,123 shares issued and 21,151,991 shares outstanding as of July 29, 2017; 41,123,521 shares issued and 40,828,633 shares outstanding as of January 28, 2017		2			4	
Additional paid-in capital		834,885			790,866	
Accumulated other comprehensive loss		(804	)		(1,692	)
Retained earnings		138,982			150,214	
Treasury stock—at cost, 20,220,132 shares as of July 29, 2017 and 294,888 shares as of January 28, 2017		(1,019,849	)		(19,523	)
Total stockholders' equity (deficit)		(46,784	)		919,869	
Total liabilities and stockholders' equity (deficit)	$	1,819,409		$	2,192,520	

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

RH

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except share and per share amounts)

(Unaudited)

	Three Months Ended		Six Months Ended	
	July 29, 2017	July 30, 2016	July 29, 2017	July 30, 2016
Net revenues	$615,326	$543,381	$1,177,406	$998,837
Cost of goods sold	409,513	363,542	801,337	691,523
Gross profit	205,813	179,839	376,069	307,314
Selling, general and administrative expenses	193,690	157,824	357,050	296,774
Income from operations	12,123	22,015	19,019	10,540
Interest expense—net	14,402	10,909	26,581	21,437
Income (loss) before income taxes	(2,279)	11,106	(7,562)	(10,897)
Income tax expense (benefit)	5,583	4,188	3,670	(4,345)
Net income (loss)	$(7,862)	$6,918	$(11,232)	$(6,552)
Weighted-average shares used in computing basic net income (loss) per share	28,398,307	40,646,124	35,667,217	40,617,102
Basic net income (loss) per share	$(0.28)	$0.17	$(0.31)	$(0.16)
Weighted-average shares used in computing diluted net income (loss) per share	28,398,307	40,820,495	35,667,217	40,617,102
Diluted net income (loss) per share	$(0.28)	$0.17	$(0.31)	$(0.16)

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

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CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)

(In thousands)

(Unaudited)

	Three Months Ended		Six Months Ended	
	July 29, 2017	July 30, 2016	July 29, 2017	July 30, 2016
Net income (loss)	$(7,862)	$6,918	$(11,232)	$(6,552)
Net gains (losses) from foreign currency translation	2,069	(1,269)	877	1,400
Net unrealized holding gains on available-for-sale investments	—	51	11	143
Total comprehensive income (loss)	$(5,793)	$5,700	$(10,344)	$(5,009)

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

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CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

(Unaudited)

	Six Months Ended	
	July 29, 2017	July 30, 2016 As Revised
CASH FLOWS FROM OPERATING ACTIVITIES		
Net loss	$(11,232)	$(6,552)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization	32,546	26,212
Net non-cash charges resulting from inventory step-up	1,860	3,401
Amortization of debt discount	15,018	14,213
Excess tax shortfall from exercise of stock options	—	1,769
Stock-based compensation expense	36,166	14,303
Other non-cash interest expense	2,314	2,222
Change in assets and liabilities—net of acquisition:		
Accounts receivable	(617)	(422)
Merchandise inventories	140,331	(52,119)
Prepaid expense and other assets	37,329	(16,403)
Accounts payable and accrued expenses	29,874	(63,483)
Deferred revenue and customer deposits	30,349	15,312
Other current liabilities	2,269	(23,310)
Deferred rent and lease incentives	1,166	2,257
Other non-current obligations	(975)	8,951
Net cash provided by (used in) operating activities	316,398	(73,649)
CASH FLOWS FROM INVESTING ACTIVITIES		
Capital expenditures	(39,362)	(70,999)
Construction related deposits	(5,285)	(3,661)
Purchase of trademarks and domain names	(39)	(164)
Proceeds from sale of assets held for sale—net	15,123	—
Purchase of investments	(16,109)	(136,799)
Maturities of investments	46,890	77,313
Sales of investments	145,020	31,896
Acquisition of business—net of cash acquired	—	(116,100)
Net cash provided by (used in) investing activities	146,238	(218,514)
CASH FLOWS FROM FINANCING ACTIVITIES		
Borrowing under asset based credit facility	323,000	—
Repayments under asset based credit facility	(40,000)	—
Borrowings under term loans	180,000	—
Borrowing under promissory note	14,000	—
Repayments under promissory note	(117)	—
Debt issuance costs	(7,939)	

Repurchases of common stock—including commissions	(1,000,326)	—
Payments on build-to-suit lease transactions	(4,601)	—
Proceeds from exercise of stock options	11,170	288
Excess tax shortfall from exercise of stock options	—	(1,769)
Tax withholdings related to issuance of stock-based awards	(3,106)	(946)
Payments on capital leases	(158)	(166)
Net cash used in financing activities	(528,077)	(2,593)
Effects of foreign currency exchange rate translation	55	452
Net decrease in cash and cash equivalents	(65,386)	(294,304)
Cash and cash equivalents		
Beginning of period	87,023	331,467
End of period	$21,637	$37,163
Non-cash transactions:		
Property and equipment additions due to build-to-suit lease transactions	$27,340	$9,676
Property and equipment additions in accounts payable and accrued expenses at period-end	$23,860	$22,903
Property and equipment additions from use of construction related deposits	$19,338	$2,659
Property and equipment acquired under capital lease	$753	$—

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

RH

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

NOTE 1—THE COMPANY

Nature of Business

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

On May 27, 2016, the Company acquired a controlling interest in Design Investors WW Acquisition Company, LLC, which owns the business operating under the name “Waterworks”. Refer to Note 3—Business Combination.

As of July 29, 2017, the Company operated a total of 85 retail Galleries and 28 outlet stores in 32 states, the District of Columbia and Canada, and includes 15 Waterworks showrooms in the United States and in the U.K., and had sourcing operations in Shanghai and Hong Kong.

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, consisting of normal recurring adjustments, necessary to fairly state the Company’s financial position as of July 29, 2017, and the results of operations for the three and six months ended July 29, 2017 and July 30, 2016. The Company’s current fiscal year, which consists of 53 weeks, ends on February 3, 2018 (“fiscal 2017”).

Certain information and disclosures normally included in the notes to annual consolidated financial statements prepared in accordance with generally accepted accounting principles in the United States (“GAAP”) 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 28, 2017 (the “2016 Form 10-K”). Certain prior year amounts have been reclassified for consistency with the current period presentation. Refer to “Revision” below.

The results of operations for the three and six months ended July 29, 2017 presented herein are not necessarily indicative of the results to be expected for the full fiscal year.

Revision

During the fourth quarter of fiscal 2016, management determined that the Company had incorrectly reported negative cash balances due to outstanding checks in the accounts payable and accrued expenses financial statement line item in its condensed consolidated balance sheets without properly applying the limited right of offset against cash and cash equivalents in accordance with ASC 210—Balance Sheet. This resulted in an overstatement of cash and cash equivalents and an overstatement of accounts payable and accrued expenses on its condensed consolidated balance sheets, as well as a misstatement of the cash provided by operating activities on the condensed consolidated statements of cash flows. There was no impact on the condensed consolidated statements of income or stockholders' equity related to these misstatements.

The Company assessed the materiality of these misstatements on prior periods' financial statements in accordance with SEC Staff Accounting Bulletin ("SAB") No. 99—Materiality, codified in Accounting Standards Codification ("ASC") 250—Presentation of Financial Statements, and concluded that these misstatements were not material to any prior annual or interim periods. Accordingly, in accordance with ASC 250 (SAB No. 108—Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements), the amounts have been revised in the condensed consolidated statements of cash flows.

The following are selected line items from the Company's unaudited condensed consolidated statements of cash flows illustrating the effect of the corrections (in thousands):

	Six Months Ended July 30, 2016		
	As Reported	Adjustment	As Revised
Cash flows from operating activities:			
Change in accounts payable and accrued expenses	$(81,399)	$ 17,916	$(63,483)
Net cash used in operating activities	$(91,565)	$ 17,916	$(73,649)
Cash and cash equivalents:			
Beginning of period	$349,897	$ (18,430)	$331,467
End of period	$37,677	$ (514)	$37,163

NOTE 2—RECENTLY ISSUED ACCOUNTING STANDARDS

Stock-Based Compensation

In March 2016, the Financial Accounting Standards Board ("FASB") issued Accounting Standard Update No. 2016-09—Improvements to Employee Share Based Payment Accounting ("ASU 2016-09"). The new guidance simplifies several aspects of the accounting for employee share-based payment transactions including the accounting for income taxes, forfeitures, and statutory tax withholding requirements, as well as classification in the statement of cash flows. One provision requires that the excess income tax benefits and tax deficiencies related to share-based payments be recognized within income tax expense in the statement of operations, rather than within additional paid-in capital on the balance sheet. The new guidance was effective for the Company beginning on January 29, 2017. As a result of the adoption of this new guidance, the Company recognized an excess tax benefit of $2.5 million and $2.4 million in the provision for income taxes as a discrete item during the three and six months ended July 29, 2017, respectively. These amounts may not necessarily be indicative of future amounts that may be recognized as any excess tax benefits recognized would be dependent on future stock price, employee exercise behavior and applicable tax rates. As permitted, the Company elected to classify excess tax benefits (shortfalls) as an operating activity in the condensed consolidated statements of cash flows instead of as a financing activity on a prospective basis and did not retrospectively adjust prior periods.

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

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 FASB deferred the effective date for the new revenue reporting standard for entities reporting under GAAP for one year from the original effective date. In 2016, the FASB issued several amendments to the standard, including principal versus agent considerations when another party is involved in providing goods or services to a customer, the application of identifying performance obligations, and the recognition of expected breakage amounts.

The Company continues to assess all potential impacts of the standard, and currently believes one of the most significant impacts relates to accounting for gift card breakage. Under the new standard the Company expects to recognize breakage, which is currently recorded as a reduction to selling, general and administrative expenses, as revenue and will be recognized proportional to actual gift card redemptions. Topic 606 is effective for fiscal years beginning after December 15, 2017, including interim periods within that reporting period, with early adoption permitted for annual reporting periods beginning after December 15, 2016. The Company will adopt Topic 606 at the commencement of fiscal 2018. The standard is required to be applied either retrospectively to each prior reporting period presented or retrospectively with the cumulative effect of initially adopting it recognized at the date of initial application. The Company has not yet selected the transition method.

Accounting for Leases

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

Financial Instruments

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

Cash Flow Classification

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

Income Taxes: Intra-Entity Asset Transfers

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

Goodwill and Intangibles

In January 2017, the FASB issued Accounting Standard Update No. 2017-04—Intangibles—Goodwill and Other (Topic 350). The updated guidance simplifies the measurement of goodwill impairment by removing step two of the goodwill impairment test, which requires the determination of the fair value of individual assets and liabilities of a reporting unit. The new guidance requires goodwill impairment to be measured as the amount by which a reporting unit’s carrying value exceeds its fair value; however, the loss recognized should not exceed the total amount of goodwill allocated to that reporting unit. The amendments should be applied on a prospective basis. The new standard is effective for fiscal years beginning after December 15, 2019 with early adoption permitted for interim or annual goodwill impairment tests performed after January 1, 2017. The Company is evaluating the impact of adopting this new accounting standard on its consolidated financial statements.

NOTE 3—BUSINESS COMBINATION

On May 27, 2016, the Company acquired a controlling interest in Design Investors WW Acquisition Company, LLC, which owns the business operating under the name “Waterworks”. The purchase price of the acquisition was approximately $119.9 million consisting of $118.4 million funded with available cash and $1.5 million representing the fair value of rollover units, which amount is subject to adjustment for changes in working capital and other items. The rollover units, which are classified as a liability, are included in non-current liabilities on the condensed consolidated balance sheets (refer to Note 15—Stock-Based Compensation). After the transaction, and giving effect to equity interests acquired by management in the business, the Company owns in excess of 90% of the total equity interest in Waterworks.

During the three and six months ended July 30, 2016, the Company incurred $0.7 million and $2.8 million, respectively, of acquisition-related costs associated with the transaction. These costs and expenses include fees associated with financial, legal and accounting advisors, and employment related costs, and are included in selling, general and administrative expenses on the condensed consolidated statements of operations.

During the six months ended July 29, 2017, the Company recorded a purchase price allocation adjustment of $1.9 million. The adjustment primarily related to a subset of inventory acquired for which the Company completed a fair value analysis based on the facts and circumstances that existed as of the acquisition date. Subsequent to the acquisition date, only a small portion of such inventory had been sold and therefore the impact on the Company's results of operations for historical periods since the acquisition was insignificant. The following table summarizes the purchase price allocation based on the estimated fair value of the acquired assets and assumed liabilities, prior to and after the purchase price allocation adjustments recorded during the six months ended July 29, 2017 (in thousands):

	January 28, 2017	Purchase Price Allocation Adjustments	July 29, 2017
Tangible assets acquired and liabilities assumed	$18,615	$ (1,916)	$16,699
Trademarks	52,100	—	52,100
Goodwill	49,229	1,916	51,145
Total	$119,944	$ —	$119,944

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

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

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

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

NOTE 4—ASSET HELD FOR SALE

Building and Land

During the first quarter of fiscal 2017, the Company committed to a plan to sell the building and land at one of its owned retail Galleries, resulting in a reclassification of building and land of $8.2 million from property and equipment to asset held for sale on the condensed consolidated balance sheets as of April 29, 2017. In May 2017, the Company completed the sale of the building and land for approximately $10.2 million and entered into a short-term five month lease agreement to lease the property. As a result, the gain of $2.0 million associated with the sale of this property is amortized over a five month period. During the three and six months ended July 29, 2017, the Company recorded a gain of $1.3 million which is included as a reduction of selling, general and administrative expenses on the condensed consolidated statements of operations. The remaining gain of $0.7 million is included in deferred rent and lease incentives on the condensed consolidated balance sheets as of July 29, 2017 and will be recognized on the condensed consolidated statements of operations during the three months ended October 28, 2017.

Aircraft

During the fourth quarter of fiscal 2016, the Company committed to a plan to sell an aircraft, which resulted in a reclassification of such aircraft from property and equipment to asset held for sale on the condensed consolidated balance sheets as of January 28, 2017. The asset held for sale had a carrying value of $4.9 million as of January 28, 2017. In April 2017, the sale of the aircraft was completed for a purchase price of $5.2 million and the Company incurred costs of $0.3 million to dispose of the asset.

NOTE 5—PREPAID EXPENSE AND OTHER ASSETS

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

	July 29, 2017	January 28, 2017
Capitalized catalog costs	$42,595	$61,258
Federal and state tax receivable	11,053	13,124
Vendor deposits	8,951	13,276
Prepaid expense and other current assets	15,080	29,504
Total prepaid expense and other current assets	$77,679	$117,162

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

	July 29, 2017	January 28, 2017
Construction related deposits	$13,991	$28,044
Other deposits	4,944	4,706
Deferred financing fees	4,683	1,530
Other non-current assets	3,479	1,889
Total other non-current assets	$27,097	$36,169

NOTE 6—GOODWILL AND INTANGIBLE ASSETS

The following sets forth the goodwill and intangible assets as of July 29, 2017 (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	$1,925	$ (1,838)	$ —	$87
Fair market write-down (2)	(1,467)	1,379	—	(88)
Total intangible assets subject to amortization	$458	$ (459)	$ —	$(1)
Intangible assets not subject to amortization				
Goodwill (3)(4)	$175,605	$ —	$ (13)	$175,592
Trademarks and domain names (4)	$100,663	$ —	$ —	$100,663

(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) Waterworks goodwill increased $1.9 million during the six months ended July 29, 2017 due to purchase price accounting adjustments. Refer to Note 3—Business Combination.
(4) Refer to Note 18—Segment Reporting for goodwill and trademarks and domain names by reportable segment.

The following sets forth the goodwill and intangible assets as of January 28, 2017 (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	$1,925	$ (1,792)	$ —	$133
Fair market write-down (2)	(1,467)	1,350	—	(117)
Total intangible assets subject to amortization	$458	$ (442)	$ —	$16
Intangible assets not subject to amortization				
Goodwill (3)(4)	$173,690	$ —	$ (87)	$173,603
Trademarks and domain names (3)(4)	$100,624	$ —	$ —	$100,624

(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) The Company recorded goodwill and trademarks of $49.2 million and $52.1 million, respectively, in fiscal 2016 related to its acquisition of Waterworks. Refer to Note 3—Business Combination.
(4) Refer to Note 18—Segment Reporting for goodwill and trademarks and domain names by reportable segment.

NOTE 7—ACCOUNTS PAYABLE, ACCRUED EXPENSES AND OTHER CURRENT LIABILITIES

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

	July 29, 2017	January 28, 2017
Accounts payable	$160,452	$134,720
Accrued compensation	34,322	26,886
Accrued freight and duty	20,834	27,955
Accrued sales taxes	15,681	14,908
Accrued occupancy	11,053	8,137
Accrued professional fees	8,414	2,082
Accrued catalog costs	7,597	3,874
Other accrued expenses	13,484	8,418
Total accounts payable and accrued expenses	$271,837	$226,980

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

	July 29, 2017	January 28, 2017
Unredeemed gift card and merchandise credit liability	$23,916	$24,524
Allowance for sales returns	11,790	10,077
Product recall reserves	6,590	4,324
Other current liabilities	5,306	4,346
Total other current liabilities	$47,602	$43,271

During the three and six months ended July 29, 2017, the Company recorded a $5.0 million charge related to the recall of certain products, resulting in a reduction of net revenues by $4.0 million, increased cost of goods sold by $0.8 million and increased selling, general and administrative expenses by $0.2 million. In addition, during the three and six months ended July 29, 2017, the Company revised its estimate related to a product recall that was initiated during the fourth quarter of fiscal 2016, which resulted in an increase of net revenues of $0.2 million and a decrease of selling, general and administrative expenses by $0.1 million.

NOTE 8—OTHER NON-CURRENT OBLIGATIONS

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

	July 29, 2017	January 28, 2017
Notes payable for share repurchases	$19,390	$19,390
Promissory note [1]	12,323	—
Capital lease obligations—non-current	7,675	7,242
Deferred contract incentive [2]	6,548	7,739
Unrecognized tax benefits	2,570	2,508
Rollover units and profit interests [3]	1,998	1,784
Other non-current obligations	6,148	6,021
Total other non-current obligations	$56,652	$44,684

(1) Represents the non-current portion of a promissory note secured by the Company's aircraft.
(2) Represents the non-current portion of an incentive payment received in relation to a 5-year service agreement. The amount will be amortized over the term of the agreement.
(3) Represents rollover units and profit interests associated with the acquisition of Waterworks. Refer to Note 15—Stock-Based Compensation.

NOTE 9—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 July 29, 2017, none of these conditions have occurred and, as a result, the 2020 Notes are not convertible as of July 29, 2017. On and after March 15, 2020, until the close of business on the second scheduled trading day immediately preceding the maturity date, holders may convert all or a portion of their 2020 Notes at any time, regardless of the foregoing circumstances. Upon conversion, the 2020 Notes will be settled, at the Company’s election, in cash, shares of the Company’s common stock, or a combination of cash and shares of the Company’s common stock. If the Company has not delivered a notice of its election of settlement method prior to the final conversion period it will be deemed to have elected combination settlement with a dollar amount per note to be received upon conversion of $1,000.

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

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

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

Debt issuance costs related to the 2020 Notes were comprised of discounts upon original issuance of $3.8 million and third party offering costs of $2.3 million. Discounts and third party offering costs attributable to the liability component are recorded as a contra-liability and are presented net against the convertible senior notes due 2020 balance on the condensed consolidated balance sheets. During both the three months ended July 29, 2017 and July 30, 2016, the Company recorded $0.3 million related to the amortization of debt issuance costs. During both the six months ended July 29, 2017 and July 30, 2016, the Company recorded $0.5 million related to the amortization of debt issuance costs.

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

	July 29, 2017	January 28, 2017
Liability component		
Principal	$300,000	$300,000
Less: Debt discount	(52,258)	(60,124)
Net carrying amount	$247,742	$239,876
Equity component (1)	$84,003	$84,003

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

The Company recorded interest expense of $4.0 million and $3.7 million for the amortization of the debt discount related to the 2020 Notes during the three months ended July 29, 2017 and July 30, 2016, respectively. The Company recorded interest expense of $7.9 million and $7.4 million for the amortization of the debt discount related to the 2020 Notes during the six months ended July 29, 2017 and July 30, 2016, respectively.

2020 Notes—Convertible Bond Hedge and Warrant Transactions

In connection with the offering of the 2020 Notes in June 2015 and the exercise in full of the overallotment option in July 2015, the Company entered into convertible note hedge transactions whereby the Company has the option to purchase a total of approximately 2.5 million shares of its common stock at a price of approximately $118.13 per share. The total cost of the convertible note hedge transactions was $68.3 million. In addition, the Company sold warrants whereby the holders of the warrants have the option to purchase a total of approximately 2.5 million shares of the Company's common stock at a price of $189.00 per share. The warrants contain certain adjustment mechanisms whereby the total number of shares to be purchased under such warrants may be increased up to a cap of 5.1 million shares of common stock (which cap may also be subject to adjustment). The Company received $30.4 million in cash proceeds from the sale of these warrants. Taken together, the purchase of the convertible note hedges and sale of the warrants are intended to offset any actual earnings dilution from the conversion of the 2020 Notes until the Company's common stock is above approximately $189.00 per share. As these transactions meet certain accounting criteria, the convertible note hedges and warrants are recorded in stockholders' equity, 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 deferred tax liability and deferred tax asset are recorded in deferred tax assets on the condensed consolidated balance sheets.

0.00% Convertible Senior Notes due 2019

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

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

Prior to March 15, 2019, the 2019 Notes will be convertible only under the following circumstances: (1) during any calendar quarter commencing after September 30, 2014, if, for at least 20 trading days (whether or not consecutive) during the 30 consecutive trading day period ending on the last trading day of the immediately preceding fiscal quarter, the last reported sale price of the Company's common stock on such trading day is greater than or equal to 130% of the applicable conversion price on such trading day; (2) during the five consecutive business day period after any ten consecutive trading day period in which, for each day of that period, the trading price per $1,000 principal amount of 2019 Notes for such trading day was less than 98% of the product of the last reported sale price of the Company's common stock and the applicable conversion rate on such trading day; or (3) upon the occurrence of specified corporate transactions. As of July 29, 2017, none of these conditions have occurred and, as a result, the 2019 Notes are not convertible as of July 29, 2017. 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 of $1,000.

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

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

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

Debt issuance costs related to the 2019 Notes were comprised of discounts and commissions payable to the initial purchasers of $4.4 million and third party offering costs of $1.0 million. Discounts, commissions payable to the initial purchasers and third party offering costs attributable to the liability component are recorded as a contra-liability and are presented net against the convertible senior notes due 2019 balance on the condensed consolidated balance sheets. During both the three months ended July 29, 2017 and July 30, 2016, the Company recorded $0.2 million related to the amortization of debt issuance costs. During both the six months ended July 29, 2017 and July 30, 2016, the Company recorded $0.4 million related to the amortization of debt issuance costs.

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

	July 29, 2017	January 28, 2017
Liability component		
Principal	$350,000	$350,000
Less: Debt discount	(28,304)	(35,457)
Net carrying amount	$321,696	$314,543
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 $3.6 million and $3.4 million for the amortization of the debt discount related to the 2019 Notes during the three months ended July 29, 2017 and July 30, 2016, respectively. The Company recorded interest expense of $7.2 million and $6.8 million for the amortization of the debt discount related to the 2019 Notes during the six months ended July 29, 2017 and July 30, 2016, respectively.

2019 Notes—Convertible Bond Hedge and Warrant Transactions

In connection with the offering of the 2019 Notes, the Company entered into convertible note hedge transactions whereby the Company has the option to purchase a total of approximately 3.0 million shares of its common stock at a price of approximately $116.09 per share. The total cost of the convertible note hedge transactions was $73.3 million. In addition, the Company sold warrants whereby the holders of the warrants have the option to purchase a total of approximately 3.0 million shares of the Company’s common stock at a price of $171.98 per share. The warrants contain certain adjustment mechanisms whereby the total number of shares to be purchased under such warrants may be increased up to a cap of 6.0 million shares of common stock (which cap may also be subject to adjustment). The Company received $40.4 million in cash proceeds from the sale of these warrants. Taken together, the purchase of the convertible note hedges and sale of the warrants are intended to offset any actual dilution from the conversion of the 2019 Notes and to effectively increase the overall conversion price from $116.09 per share to $171.98 per share. As these transactions meet certain accounting criteria, the convertible note hedges and warrants are recorded in stockholders’ equity, 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 $27.5 million in connection with the debt discount associated with the 2019 Notes and recorded a deferred tax asset of $28.6 million in connection with the convertible note hedge transactions. The deferred tax liability and deferred tax assets are included in deferred tax assets on the condensed consolidated balance sheets.

NOTE 10—CREDIT FACILITIES

The following credit facilities were outstanding as of July 29, 2017 (in thousands):

	Outstanding Amount	Unamortized Debt Issuance Costs	Net Carrying Amount
Asset based credit facility	$ 283,000	$ —	$283,000
LILO term loan	80,000	(547)	79,453
Second lien term loan	100,000	(3,090)	96,910
Total credit facilities	$ 463,000	$ (3,637)	$459,363

There were no amounts outstanding under any credit facilities as of January 28, 2017.

Asset Based Credit Facility & LILO Term Loan

In August 2011, Restoration Hardware, Inc., along with its Canadian subsidiary, Restoration Hardware Canada, Inc., entered into a credit agreement with Bank of America, N.A., as administrative agent, and certain other lenders.

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

The Company incurred $3.6 million of deferred financing fees related to the credit agreement, which are included in other non-current assets on the condensed consolidated balance sheets, and will be amortized over the life of the revolving line of credit, which has a maturity date of June 28, 2022. As a result of the credit agreement, unamortized deferred financing fees of $0.1 million related to the previous facility were expensed during the three and six months ended July 29, 2017 and $1.1 million related to the previous facility will be amortized over the life of the new revolving line of credit.

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

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

The credit agreement contains various restrictive covenants, including, among others, limitations on the ability to incur liens, make loans or other investments, incur additional debt, issue additional equity, merge or consolidate with or into another person, sell assets, pay dividends or make other distributions, or enter into transactions with affiliates, along with other restrictions and limitations typical to credit agreements of this type and size. As of July 29, 2017, Restoration Hardware, Inc. was in compliance with all applicable covenants of the credit agreement.

As of July 29, 2017, the Company had $283.0 million in outstanding borrowings and $181.1 million of availability under the revolving line of credit, net of $13.1 million in outstanding letters of credit. As of July 29, 2017, the Company had $80.0 million outstanding borrowings under the LILO term loan facility. As a result of the consolidated fixed-charge coverage ratio (“FCCR”) restriction that limits the last 10% of borrowing availability, actual incremental borrowing available to the Company and the other affiliated parties under the revolving line of credit is approximately $129.4 million as of July 29, 2017.

Second Lien Credit Agreement

On July 7, 2017, Restoration Hardware, Inc., a wholly-owned subsidiary of RH, entered into a credit agreement (the “second lien credit agreement”), dated as of July 7, 2017, among Restoration Hardware, Inc., as lead borrower, the guarantors party thereto, the lenders party thereto, each of whom are funds and accounts managed or advised by Apollo Capital Management, L.P., and its affiliated investment managers, and Wilmington Trust, National Association as administrative agent and collateral agent with respect to an initial term loan in an aggregate principal amount equal to $100.0 million with a maturity date of January 7, 2023 (the “second lien term loan”).

The Company incurred $3.6 million of debt issuance costs related to the second lien credit agreement, which are presented net against the term loans balance on the condensed consolidated balance sheets.

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

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

The borrowings under the second lien credit agreement may be prepaid in whole or in part at any time, subject to certain minimum payment requirements and a prepayment premium.

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

The second lien credit agreement also contains a financial ratio covenant not found in the credit agreement based upon a senior secured leverage ratio of consolidated secured debt to consolidated EBITDA.

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

As of July 29, 2017, Restoration Hardware, Inc. had $100.0 million in outstanding borrowings. As of July 29, 2017, Restoration Hardware, Inc. was in compliance with all applicable covenants of the second lien credit agreement.

Intercreditor Agreement

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

NOTE 11—FAIR VALUE OF FINANCIAL INSTRUMENTS

Financial Assets and Liabilities

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

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

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

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

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

Fair Value Measurements

All of the Company's investments are classified as available-for-sale and are carried at fair value. The Company did not hold any short-term or long-term investments as of July 29, 2017. Assets measured at fair value were as follows as of January 28, 2017 (in thousands):

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

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

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

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

There were no purchases, sales, issuances, or settlements related to recurring level 3 measurements during the three and six months ended July 29, 2017 or July 30, 2016. There were no transfers into or out of level 1 and level 2 during the three and six months ended July 29, 2017 or July 30, 2016.

Fair Value of Financial Instruments

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

	July 29, 2017		January 28, 2017	
	Fair Value	Carrying Value	Fair Value	Carrying Value
Convertible senior notes due 2019	$308,012	$321,696	$295,381	$314,543
Convertible senior notes due 2020	$244,178	$247,742	$232,463	$239,876

The fair value of each of the 2019 Notes and 202