

ACE HARDWARE CORPORATION
Quarterly report for the period ended September 28, 2019



ACE HARDWARE CORPORATION
INDEX TO CONSOLIDATED FINANCIAL STATEMENTS AND
SUPPLEMENTARY DATA

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Review Report of Independent Auditors

The Board of Directors
Ace Hardware Corporation

We have reviewed the consolidated financial information of Ace Hardware Corporation, which comprise the consolidated balance sheets as of September 28, 2019 and September 29, 2018, and the related consolidated statements of income and comprehensive income for the three and nine-month periods ended September 28, 2019 and September 29, 2018, and the consolidated statements of equity and cash flows for the nine-month periods ended September 28, 2019 and September 29, 2018.

Management's Responsibility for the Financial Statements

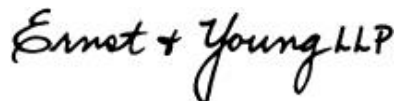
Management is responsible for the preparation and fair presentation of the interim financial information in conformity with U.S. generally accepted accounting principles; this includes the design, implementation, and maintenance of internal control sufficient to provide a reasonable basis for the preparation and fair presentation of interim financial information in conformity with U.S. generally accepted accounting principles.

Auditor's Responsibility

Our responsibility is to conduct our review in accordance with auditing standards generally accepted in the United States applicable to reviews of interim financial information. A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with auditing standards generally accepted in the United States, the objective of which is the expression of an opinion regarding the financial information. Accordingly, we do not express such an opinion.

Conclusion

Based on our review, we are not aware of any material modifications that should be made to the consolidated financial information referred to above for it to be in conformity with U.S. generally accepted accounting principles.

The logo for Ernst & Young LLP, featuring the company name in a stylized, handwritten-style font.

Chicago, Illinois
November 19, 2019

ACE HARDWARE CORPORATION
CONSOLIDATED STATEMENTS OF INCOME
(Unaudited, in millions)

| | <u>Three Months Ended</u> | | <u>Nine Months Ended</u> | |
|---|--|--|--|--|
| | <u>September 28, 2019 (13 Weeks)</u> | <u>September 29, 2018 (13 Weeks)</u> | <u>September 28, 2019 (39 Weeks)</u> | <u>September 29, 2018 (39 Weeks)</u> |
| Revenues: | | | | |
| Wholesale revenues | \$ 1,403.8 | \$ 1,341.3 | \$ 4,231.6 | \$ 4,060.3 |
| Retail revenues | 126.3 | 85.9 | 364.5 | 266.7 |
| Total revenues | <u>1,530.1</u> | <u>1,427.2</u> | <u>4,596.1</u> | <u>4,327.0</u> |
| Cost of revenues: | | | | |
| Wholesale cost of revenues | 1,220.5 | 1,174.1 | 3,716.4 | 3,573.8 |
| Retail cost of revenues | 69.3 | 48.2 | 201.4 | 150.5 |
| Total cost of revenues | <u>1,289.8</u> | <u>1,222.3</u> | <u>3,917.8</u> | <u>3,724.3</u> |
| Gross profit: | | | | |
| Wholesale gross profit | 183.3 | 167.2 | 515.2 | 486.5 |
| Retail gross profit | 57.0 | 37.7 | 163.1 | 116.2 |
| Total gross profit | <u>240.3</u> | <u>204.9</u> | <u>678.3</u> | <u>602.7</u> |
| Wholesale operating expenses: | | | | |
| Distribution operations expenses | 45.4 | 44.2 | 135.2 | 125.0 |
| Selling, general and administrative expenses | 50.3 | 46.0 | 146.0 | 142.4 |
| Retailer success and development expenses | 36.4 | 38.6 | 118.3 | 114.2 |
| Retail operating expenses | 50.9 | 40.1 | 140.0 | 112.1 |
| Retail pre-opening expenses | 2.2 | 0.3 | 6.2 | 1.0 |
| Total operating expenses | <u>185.2</u> | <u>169.2</u> | <u>545.7</u> | <u>494.7</u> |
| Operating income | 55.1 | 35.7 | 132.6 | 108.0 |
| Interest expense | (5.4) | (5.5) | (17.7) | (15.0) |
| Interest income | 1.1 | 3.0 | 5.7 | 5.0 |
| Other income, net | 6.4 | 1.8 | 9.4 | 4.7 |
| Income tax benefit | 3.3 | 1.3 | 6.9 | 0.3 |
| Net income | <u>60.5</u> | <u>36.3</u> | <u>136.9</u> | <u>103.0</u> |
| Less: net income attributable to noncontrolling interests | <u>0.2</u> | <u>-</u> | <u>0.4</u> | <u>0.4</u> |
| Net income attributable to Ace Hardware Corporation | <u>\$ 60.3</u> | <u>\$ 36.3</u> | <u>\$ 136.5</u> | <u>\$ 102.6</u> |
| Patronage distributions accrued | <u>\$ 68.6</u> | <u>\$ 45.7</u> | <u>\$ 158.1</u> | <u>\$ 121.6</u> |
| Patronage distributions accrued for third party retailers | <u>\$ 66.4</u> | <u>\$ 43.9</u> | <u>\$ 152.1</u> | <u>\$ 116.4</u> |

See accompanying notes to the consolidated financial statements.

ACE HARDWARE CORPORATION
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(Unaudited, in millions)

| | <u>Three Months Ended</u> | | <u>Nine Months Ended</u> | |
|---|--|--|--|--|
| | <u>September 28, 2019 (13 Weeks)</u> | <u>September 29, 2018 (13 Weeks)</u> | <u>September 28, 2019 (39 Weeks)</u> | <u>September 29, 2018 (39 Weeks)</u> |
| Net income | \$ 60.5 | \$ 36.3 | \$ 136.9 | \$ 103.0 |
| Other comprehensive income (loss) net of tax: | | | | |
| Unrealized gain (loss) on investments | 0.4 | (1.2) | 1.6 | (2.1) |
| Unrealized (loss) gain on derivative financial instrument | (0.1) | 0.3 | (0.9) | 1.6 |
| Total other comprehensive income (loss), net | <u>0.3</u> | <u>(0.9)</u> | <u>0.7</u> | <u>(0.5)</u> |
| Comprehensive income | 60.8 | 35.4 | 137.6 | 102.5 |
| Less: Comprehensive income attributable to noncontrolling interests | <u>0.1</u> | <u>-</u> | <u>0.3</u> | <u>0.4</u> |
| Comprehensive income attributable to Ace Hardware Corporation | <u>\$ 60.7</u> | <u>\$ 35.4</u> | <u>\$ 137.3</u> | <u>\$ 102.1</u> |

See accompanying notes to the consolidated financial statements.

ACE HARDWARE CORPORATION
CONSOLIDATED BALANCE SHEETS
(In millions, except share data)

| | <u>September 28, 2019</u> | <u>December 29, 2018</u> | <u>September 29, 2018</u> |
|--|-------------------------------|------------------------------|-------------------------------|
| | (Unaudited) | (Audited) | (Unaudited) |
| Assets | | | |
| Cash and cash equivalents | \$ 24.7 | \$ 25.6 | \$ 22.6 |
| Marketable securities | 58.4 | 50.4 | 46.7 |
| Receivables, net of allowance for doubtful accounts of \$5.5, \$6.7 and \$6.3, respectively | 500.9 | 434.4 | 479.3 |
| Inventories | 975.5 | 931.8 | 984.1 |
| Prepaid expenses and other current assets | 56.5 | 50.4 | 47.3 |
| Total current assets | <u>1,616.0</u> | <u>1,492.6</u> | <u>1,580.0</u> |
| Property and equipment, net | 373.7 | 368.6 | 368.6 |
| Notes receivable, net of allowance for doubtful accounts of \$1.5, \$2.8 and \$2.8, respectively | 18.6 | 11.8 | 13.2 |
| Goodwill and other intangible assets | 99.7 | 94.2 | 95.3 |
| Other assets | 106.9 | 91.3 | 89.8 |
| Total assets | <u>\$ 2,214.9</u> | <u>\$ 2,058.5</u> | <u>\$ 2,146.9</u> |
| Liabilities and Equity | | | |
| Current maturities of long-term debt | \$ 59.6 | \$ 60.6 | \$ 55.3 |
| Accounts payable | 843.4 | 748.9 | 820.4 |
| Patronage distributions payable in cash | 62.6 | 55.0 | 47.9 |
| Patronage refund certificates payable | 10.1 | 10.2 | 5.7 |
| Accrued expenses | 179.3 | 173.6 | 167.3 |
| Total current liabilities | <u>1,155.0</u> | <u>1,048.3</u> | <u>1,096.6</u> |
| Long-term debt | 268.1 | 267.1 | 302.5 |
| Patronage refund certificates payable | 126.8 | 95.6 | 106.3 |
| Other long-term liabilities | 87.5 | 79.7 | 80.1 |
| Total liabilities | <u>1,637.4</u> | <u>1,490.7</u> | <u>1,585.5</u> |
| Member Retailers' Equity: | | | |
| Class A voting common stock, \$1,000 par value, 10,000 shares authorized, 2,695, 2,719 and 2,718 issued and outstanding, respectively | 2.7 | 2.7 | 2.7 |
| Class C nonvoting common stock, \$100 par value, 6,000,000 shares authorized, 4,883,025, 4,648,554 and 4,690,749 issued and outstanding, respectively | 488.3 | 464.8 | 469.1 |
| Class C nonvoting common stock, \$100 par value, issuable to retailers for patronage distributions, 440,759, 439,591 and 349,192 shares issuable, respectively | 44.1 | 44.0 | 34.9 |
| Contributed capital | 18.7 | 18.5 | 18.5 |
| Retained earnings | 7.8 | 24.8 | 18.6 |
| Accumulated other comprehensive income (loss) | 0.9 | (1.2) | 3.7 |
| Equity attributable to Ace member retailers | <u>562.5</u> | <u>553.6</u> | <u>547.5</u> |
| Equity attributable to noncontrolling interests | 15.0 | 14.2 | 13.9 |
| Total equity | <u>577.5</u> | <u>567.8</u> | <u>561.4</u> |
| Total liabilities and equity | <u>\$ 2,214.9</u> | <u>\$ 2,058.5</u> | <u>\$ 2,146.9</u> |

See accompanying notes to the consolidated financial statements.

ACE HARDWARE CORPORATION
CONSOLIDATED STATEMENTS OF EQUITY
(Unaudited, in millions)

Shareholders of Ace Hardware Corporation

| | Capital Stock | | Class C Stock Issuable to Retailers for Patronage Dividends | Additional Stock Subscribed | Contributed Capital | Retained Earnings | Accumulated Other Comprehensive Income (Loss) | Noncontrolling Interests | Total Equity |
|------------------------------------|---------------|----------|---|-----------------------------------|------------------------|----------------------|--|-----------------------------|--------------|
| | Class A | Class C | | | | | | | |
| Balances at December 30, 2017 | \$ 2.7 | \$ 441.3 | \$ 48.9 | \$ - | \$ 18.3 | \$ 33.2 | \$ 3.5 | \$ 13.0 | \$ 560.9 |
| Net income | - | - | - | - | - | 102.6 | - | 0.4 | 103.0 |
| Other comprehensive loss | - | - | - | - | - | - | (0.5) | - | (0.5) |
| Net payments on subscriptions | - | - | - | 0.9 | - | - | - | - | 0.9 |
| Stock issued | 0.1 | 48.9 | (48.9) | (0.9) | - | - | - | - | (0.8) |
| Change in noncontrolling interests | - | - | - | - | (0.1) | (0.1) | - | 0.6 | 0.4 |
| Stock repurchased | (0.1) | (21.1) | - | - | - | - | - | - | (21.2) |
| Patronage distributions issuable | - | - | 34.9 | - | - | - | - | - | 34.9 |
| Patronage distributions payable | - | - | - | - | - | (116.4) | - | - | (116.4) |
| Adoption of accounting standard | - | - | - | - | - | (0.7) | 0.7 | - | - |
| Other | - | - | - | - | 0.3 | - | - | (0.1) | 0.2 |
| Balances at September 29, 2018 | \$ 2.7 | \$ 469.1 | \$ 34.9 | \$ - | \$ 18.5 | \$ 18.6 | \$ 3.7 | \$ 13.9 | \$ 561.4 |
| Balances at December 29, 2018 | \$ 2.7 | \$ 464.8 | \$ 44.0 | \$ - | \$ 18.5 | \$ 24.8 | \$ (1.2) | \$ 14.2 | \$ 567.8 |
| Net income | - | - | - | - | - | 136.5 | - | 0.4 | 136.9 |
| Other comprehensive income | - | - | - | - | - | - | 0.7 | - | 0.7 |
| Net payments on subscriptions | - | - | - | 0.7 | - | - | - | - | 0.7 |
| Stock issued | 0.1 | 43.6 | (44.0) | (0.7) | - | (0.1) | - | - | (1.1) |
| Change in noncontrolling interests | - | - | - | - | (0.1) | - | - | 0.5 | 0.4 |
| Stock repurchased | (0.1) | (20.1) | - | - | - | - | - | - | (20.2) |
| Patronage distributions issuable | - | - | 44.1 | - | - | - | - | - | 44.1 |
| Patronage distributions payable | - | - | - | - | - | (152.1) | - | - | (152.1) |
| Adoption of accounting standard | - | - | - | - | - | (1.4) | 1.4 | - | - |
| Other | - | - | - | - | 0.3 | 0.1 | - | (0.1) | 0.3 |
| Balances at September 28, 2019 | \$ 2.7 | \$ 488.3 | \$ 44.1 | \$ - | \$ 18.7 | \$ 7.8 | \$ 0.9 | \$ 15.0 | \$ 577.5 |

See accompanying notes to the consolidated financial statements.

ACE HARDWARE CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited, in millions)

| | Nine Months Ended | |
|--|-------------------------------------|-------------------------------------|
| | September 28, 2019 (39 Weeks) | September 29, 2018 (39 Weeks) |
| Operating Activities | | |
| Net income | \$ 136.9 | \$ 103.0 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 44.2 | 38.1 |
| Amortization of deferred financing costs | 0.3 | 0.4 |
| Gain on the disposal of assets, net | (5.7) | (2.0) |
| Credit for doubtful accounts | (1.0) | (1.6) |
| Other, net | 0.6 | 0.8 |
| Changes in operating assets and liabilities, exclusive of effects of acquisitions: | | |
| Receivables | (80.2) | (86.5) |
| Inventories | (16.6) | (197.0) |
| Other current assets | (3.6) | (5.7) |
| Other long-term assets | (29.2) | 9.5 |
| Accounts payable and accrued expenses | 91.4 | 137.6 |
| Other long-term liabilities | 8.3 | 11.3 |
| Deferred taxes | (4.1) | (0.1) |
| Net cash provided by operating activities | <u>141.3</u> | <u>7.8</u> |
| Investing Activities | | |
| Purchases of marketable securities | (41.0) | (6.4) |
| Proceeds from sale of marketable securities | 37.3 | 10.0 |
| Purchases of property and equipment | (54.5) | (48.8) |
| Cash paid for acquired businesses, net of cash received | (22.5) | (18.5) |
| Increase in notes receivable, net | (7.0) | (3.6) |
| Proceeds from sale of assets | 22.0 | - |
| Other, net | (0.7) | (1.2) |
| Net cash used in investing activities | <u>(66.4)</u> | <u>(68.5)</u> |
| Financing Activities | | |
| Net (repayments) borrowings under revolving lines of credit | (8.7) | 133.3 |
| Principal payments on long-term debt | (7.4) | (7.3) |
| Payments of debt issuance costs | (1.3) | - |
| Payments of cash portion of patronage distribution | (51.3) | (58.0) |
| Payments of patronage refund certificates | (5.3) | (6.4) |
| Repurchase of stock | (2.5) | (2.1) |
| Purchase of noncontrolling interests | (0.2) | (0.1) |
| Other, net | 0.9 | 0.9 |
| Net cash (used in) provided by financing activities | <u>(75.8)</u> | <u>60.3</u> |
| Decrease in cash and cash equivalents | (0.9) | (0.4) |
| Cash and cash equivalents at beginning of period | 25.6 | 23.0 |
| Cash and cash equivalents at end of period | <u>\$ 24.7</u> | <u>\$ 22.6</u> |
| Supplemental disclosure of cash flow information: | | |
| Interest paid | <u>\$ 16.4</u> | <u>\$ 13.4</u> |
| Income taxes paid | <u>\$ 1.0</u> | <u>\$ 1.7</u> |

See accompanying notes to the consolidated financial statements.

ACE HARDWARE CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited, in millions)

(1) Summary of Significant Accounting Policies

The Company and Its Business

Ace Hardware Corporation (“the Company”) is a wholesaler of hardware, paint and other related products. The Company also provides to its retail members value-added services such as advertising, marketing, merchandising and store location and design services. The Company’s goods and services are sold predominately within the United States, primarily to retailers that operate hardware stores and with whom the Company has a retail membership agreement. As a retailer-owned cooperative, the Company distributes substantially all of its patronage sourced income in the form of patronage distributions to member retailers based on their volume of merchandise purchases.

Ace Ecommerce Holdings LLC (“AEH”), a majority-owned and controlled subsidiary of the Company, operates The Grommet, an e-commerce company that operates a website that markets and sells new and innovative products created by independent entrepreneurs.

Ace Wholesale Holdings LLC (“AWH”) owns and operates Emery Jensen Distribution and its related wholesale companies. AWH was formed in 2014 so that the Company could begin making wholesale hardware sales to non-member retailers.

Ace Retail Holdings LLC (“ARH”) is the owner of the 132 store Westlake Ace Hardware (“Westlake”) retail chain. As a result, the Company is also a retailer of hardware, paint and other related products.

In March 2019, ARH acquired the remaining 58 percent of the outstanding stock of ACO Inc. (“ACO”) that it did not already own. ACO, which operates under the name Great Lakes Ace Hardware, is based in Farmington Hills, Michigan and is the owner of 51 neighborhood hardware stores located in Michigan and Ohio. See Note 2 for additional details of this acquisition.

Ace Hardware International Holdings, Ltd. (“AIH”), is a majority-owned and controlled subsidiary of the Company with a 20.8 percent noncontrolling interest owned by its international retailers. International retailers do not own shares of stock in the Company nor receive patronage dividends.

In September 2019, the Company formed the Ace Services Holdings LLC (“ASH”) legal entity. On September 5, 2019, ASH acquired Handyman Matters Inc., a franchisor of home improvement, maintenance and repair services. See Note 2 for additional details of this acquisition.

Basis of Presentation

The accompanying consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles (“GAAP”). Certain information and note disclosures normally included in financial statements prepared in accordance with GAAP have been condensed or omitted. The unaudited consolidated financial statements and notes should be read in conjunction with the financial statements and notes thereto included in the Company’s 2018 Annual Report. The unaudited consolidated financial statements for the three and nine months ended September 28, 2019 and September 29, 2018 both cover a 13-week period and a 39-week period, respectively.

Subsequent events have been evaluated through November 19, 2019, the date these statements were available to be issued.

The financial information included herein reflects all adjustments (consisting only of normal recurring adjustments), which, in the opinion of management, are necessary for a fair presentation of the results for the interim periods presented. The results of operations for the three and nine months ended September 28, 2019 are not necessarily indicative of the results to be expected for the full fiscal year 2019.

Principles of Consolidation

The accompanying consolidated financial statements include the accounts of the Company and its majority-owned subsidiaries. All intercompany transactions have been eliminated.

Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Reclassifications

Certain prior period amounts have been reclassified to conform to the current financial statement presentation, with no net effect on the consolidated financial statements.

ACE HARDWARE CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)
(Unaudited, in millions)

Revenue Recognition

In May 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2014-09, “Revenue from Contracts with Customers (Topic 606)” along with amendments issued in 2015 and 2016. The purpose of the new guidance is to develop a common revenue recognition standard for GAAP and International Financial Reporting Standards. The guidance affects any entity that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets unless those contracts are within the scope of other standards. The core principle of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. ASU 2014-09 allows either full retrospective adoption, meaning the standard is applied to all periods presented, or modified retrospective adoption, meaning the standard is applied only to the most current period presented in the financial statements. This guidance is effective for the Company for fiscal 2019 year-end financial statements and quarterly financial statements in fiscal 2020. The Company adopted ASU 2014-09 in the first quarter of 2019 using the modified retrospective method. The impact of adopting the new standard had no impact on the consolidated financial statements. However, the Company has expanded revenue recognition disclosures based on the new qualitative and quantitative disclosure requirements as follows:

Revenue is recognized when performance obligations under the terms of contracts with our customers are satisfied; generally, this occurs with the transfer of control of merchandise or services. Revenue is measured as the amount of consideration we expect to receive in exchange for transferring goods or providing services. The Company excludes sales and usage-based taxes collected and recognizes revenues net of expected returns. Provisions for sales returns are provided at the time the related sales are recorded based on historic returns activity.

The Company’s warehouse merchandise revenue originates with a single performance obligation to ship the products, and therefore the Company’s performance obligations are satisfied when control of the products are transferred to the customer per the arranged shipping terms. The customer takes ownership and assumes risk of loss for warehouse merchandise upon delivery. Although products are generally shipped FOB shipping point, the Company effectively retains the responsibilities of ownership until the goods reach the customer. Generally, customer billings for warehouse merchandise occur in bi-weekly intervals subsequent to revenue recognition. The Company considers shipping and handling as activities to fulfill its performance obligation for warehouse merchandise revenues. Billings for freight are accounted for as Revenues and shipping and handling costs are accounted for in Cost of revenues.

The Company has direct shipment arrangements with various vendors to deliver products to its retailers without having to physically hold the inventory at the Company’s warehouses, thereby increasing efficiency and reducing costs. The Company recognizes revenue for direct shipment arrangements upon delivery to the customer with contract terms that typically specify FOB destination. The Company recognizes the revenue and cost of goods sold from these arrangements on a gross basis as the principal in the transaction. The Company is primarily responsible for fulfilling the promise to retailers to provide merchandise at negotiated prices with the vendors, assumes inventory risk if the product is returned by the retailers, and assumes all the credit risk for the vendors with the retailers. Therefore, the Company concluded it is the principal for these transactions.

Retail revenues from retail locations owned and operated by the Company and e-commerce revenues are recognized when the customer takes ownership of the products sold and assumes the risk of loss. The customer takes ownership and assumes risk of loss generally at the point of sale in our owned retail locations. The Company’s e-commerce revenues come from Ace Hardware’s website and sales from AEH. For e-commerce transactions, customers choose whether to have merchandise delivered to them (using third-party parcel delivery companies) or to collect their merchandise from one of our stores (“in-store pick up”). For items delivered directly to the customer, control passes and revenue is recognized when delivery has been completed to the customer, as title has passed and we have transferred possession to the customer. For in-store pick up, control passes and revenue is recognized once the customer has taken possession of the merchandise. Any fees charged to customers for delivery are a component of the transaction price and are recognized when delivery has been completed. Payment terms for retail and e-commerce sales are at the point of sale.

Service revenues (advertising activities, brand building initiatives and fees for other services provided primarily to domestic retailers) are recognized when the service is complete as this is when the retailer has the ability to direct the use of and obtain the benefits from the service.

ACE HARDWARE CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)
(Unaudited, in millions)

The following table provides a summary of revenues by sales category:

| | Three Months Ended | | Nine Months Ended | |
|---|-----------------------|-----------------------|-----------------------|-----------------------|
| | September 28, 2019 | September 29, 2018 | September 28, 2019 | September 29, 2018 |
| Warehouse merchandise | \$ 1,056.5 | \$ 1,017.7 | \$ 3,133.3 | \$ 3,028.9 |
| Direct shipment merchandise | 271.6 | 254.8 | 875.7 | 835.1 |
| Retail revenues | 121.0 | 79.0 | 345.1 | 245.8 |
| E-commerce | 21.2 | 15.8 | 65.6 | 49.2 |
| Service revenues | 66.3 | 66.7 | 195.6 | 188.1 |
| Amortization of sales allowances under retailer incentive programs | (6.5) | (6.8) | (19.2) | (20.1) |
| Total revenues | \$ 1,530.1 | \$ 1,427.2 | \$ 4,596.1 | \$ 4,327.0 |

The Company offers its retailers various incentive programs which provide the retailers with certain sales allowances. The Company offers these incentive programs in anticipation of future sales to the retailers that participate in these programs. Since the sales allowances provide future economic benefit to the Company, they are capitalized in Other assets and amortized as a reduction of revenue on a straight-line basis over the period of expected future sales to these retailers, which is generally five years.

Impact of New Accounting Standards

New Accounting Pronouncements – Adopted

In January 2016, the FASB issued ASU No. 2016-01, “Financial Instruments – Overall (Subtopic 825-10), Recognition and Measurement of Financial Assets and Financial Liabilities.” ASU 2016-01 requires the change in fair value measurement for certain equity investments to be recognized in net income, simplifies the impairment assessment for equity investments without readily determinable fair values, eliminates disclosure requirements related to fair value of financial instruments measured at amortized cost for non-public entities, eliminates the requirement to disclose methods and assumptions used to estimate fair value of financial instruments measured at amortized cost for public entities and requires public entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes. Additionally, ASU 2016-01 provides disclosure presentation guidance and clarification related to valuation allowances on deferred tax assets related to available-for-sale securities. ASU 2016-01 is effective for the Company for fiscal 2019 year-end financial statements and quarterly financial statements in fiscal 2020, with early adoption permitted in fiscal 2018. The Company adopted ASU 2016-01 in the first quarter of 2019. This resulted in a reclassification adjustment of a \$1.4 million net loss from accumulated other comprehensive income (“AOCI”) to retained earnings related to the unrealized loss on the Company’s equity investments.

New Accounting Pronouncements - Issued

In February 2016, the FASB issued ASU No. 2016-02, “Leases (Topic 842)” along with amendments issued through 2019. The guidance requires that lessees recognize assets and liabilities for leases with lease terms greater than twelve months in the statement of financial position. The guidance also requires improved disclosures to help users of financial statements better understand the amount, timing and uncertainty of cash flows arising from leases. ASU 2016-02 is effective for the Company for fiscal 2021 year-end financial statements and quarterly financial statements in fiscal 2022, with early adoption permitted. The Company expects to adopt ASU No. 2016-02 in the first quarter of 2020. The Company is evaluating its contracts under this guidance to determine the impact ASU 2016-02 will have on its consolidated financial statements and believes the standard will have a material impact on the Company’s balance sheet.

In June 2016, the FASB issued ASU No. 2016-13, “Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments” along with amendments issued in 2018. The guidance requires financial assets measured at amortized cost basis to be presented at the net amount expected to be collected. The amortized cost basis of financial assets should be reduced by expected credit losses to present the net carrying value in the financial statements at the amount expected to be collected. The measurement of expected credit losses is based on past events, historical experience, current conditions and forecasts that affect the collectability of the financial assets. Additionally, credit losses relating to available-for-sale debt securities should be recorded through an allowance for credit losses. ASU 2016-13 is effective for the Company for year-end financial statements and quarterly financial statements in fiscal 2023. The Company is evaluating the impact that ASU 2016-13 will have on the Company’s consolidated financial statements.

ACE HARDWARE CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)
(Unaudited, in millions)

(2) Acquisition

In March 2019, ARH acquired the remaining 58 percent of the outstanding stock of ACO, an owner of a 51 hardware store chain that operates retail stores under the name Great Lakes Ace Hardware in Michigan and Ohio, in a series of transactions for \$11.3 million. The Company previously held a 42 percent interest in ACO which it acquired in 2017 for \$3.7 million.

The Company has estimated the fair value of ACO to be \$18.3 million as of the acquisition date based upon the consideration per share paid to acquire the remaining 58 percent and has accounted for this transaction as a business combination. As of September 28, 2019, the Company recorded a preliminary allocation of the purchase price to acquired tangible assets and liabilities assumed based on their estimated fair value at the acquisition date. The Company is in the process of determining the value, if any, for identifiable intangible assets. The Company expects to complete the purchase price allocation by the end of the fourth quarter of 2019. Based on the preliminary purchase price allocation, the Company recorded no goodwill or other intangibles.

The following table summarizes the fair value of ACO based on the \$21.50 price per share Ace paid for the 58 percent in March 2019 and the preliminary purchase price allocation at the acquisition date:

| Fair value of assets acquired and liabilities assumed: | |
|--|----------------|
| Cash | \$ 1.1 |
| Receivables | 2.4 |
| Inventories | 24.2 |
| Other current assets | 4.2 |
| Property and equipment | 5.6 |
| Other assets | 2.3 |
| Short-term debt (ACO Facility – See Note 4) | (9.8) |
| Other current liabilities | (11.7) |
| Fair value on acquisition date at \$21.50 per share | <u>\$ 18.3</u> |

In addition, during the first nine months of 2019, ARH acquired additional retail stores for consideration of \$8.9 million, prior to working capital adjustments. These acquisitions resulted in ARH recording \$5.3 million of goodwill. In September 2019, the Company acquired Handyman Matters Inc., a franchisor of home improvement, maintenance and repair services and recorded a preliminary allocation of the purchase price of \$3.4 million to goodwill and other intangibles. Goodwill has an indefinite life and, therefore, is not amortized. The goodwill is expected to be deductible for tax purposes.

(3) Inventories

Inventories consist of wholesale merchandise inventories held for sale to customers and retail merchandise inventory held for resale at Company-operated retail locations and at AEH’s warehouse locations. Substantially all of the Company’s wholesale inventories are valued on the LIFO method. The excess of replacement cost over the LIFO value of inventory was \$96.4 million, \$85.7 million and \$81.9 million at September 28, 2019, December 29, 2018 and September 29, 2018, respectively. An actual valuation of inventory under the LIFO method can be made only at the end of each year based on the inventory levels and costs at that time. When interim LIFO calculations occur, they are based on management’s estimates of expected year-end inventory levels and costs, and are subject to the final year-end LIFO inventory valuation. Inventories at retail locations operated by the Company and at AEH’s warehouses are valued at the lower of cost or net realizable value. Inventory cost is determined using the moving average method, which approximates the first-in, first-out (“FIFO”) method. The Company regularly reviews its inventory and establishes a reserve for excess and obsolete inventory based on a number of factors, including historical sales, sales forecasts, obsolescence due to technology changes and defective goods.

Inventories consisted of:

| | September 28, 2019 | December 29, 2018 | September 29, 2018 |
|--|-----------------------|----------------------|-----------------------|
| Wholesale merchandise inventory (LIFO) | \$ 820.4 | \$ 824.5 | \$ 873.4 |
| Retail merchandise inventory at Company-operated stores and AEH warehouses (FIFO) | 155.1 | 107.3 | 110.7 |
| Inventories | <u>\$ 975.5</u> | <u>\$ 931.8</u> | <u>\$ 984.1</u> |

ACE HARDWARE CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)
(Unaudited, in millions)

(4) Debt

Prior to February 2019, the Company had a \$600.0 million line of credit that was expandable to \$750.0 million through a \$150.0 million accordion feature. At the Company's discretion, borrowings under the prior credit facility incurred interest at a rate of either 25 to 100 basis points over the prime rate or 125 to 200 basis points over the London Interbank Offered Rate ("LIBOR") depending on the Company's leverage ratio. The credit facility was due to expire on May 29, 2020.

On February 1, 2019, the Company amended its line of credit facility, increasing its borrowing capacity to \$700.0 million. The new facility is expandable to \$1.0 billion through a \$300.0 million accordion that is exercisable without the consent of existing lenders provided that the Company is not in default of the credit agreement and further provided that none of the existing lenders are required to provide any portion of the increased facility. At the Company's discretion, borrowings under the credit facility bear interest at a rate of either 0 to 75 basis points over the prime rate or 100 to 175 basis points over the LIBOR rate depending on the Company's leverage ratio as defined under the agreement. The credit facility was priced at LIBOR plus 125 basis points at September 28, 2019. The credit facility expires on February 1, 2024 and requires maintenance of certain financial covenants including a maximum allowable average leverage ratio and a minimum fixed charge coverage ratio. As of September 28, 2019, the Company was in compliance with its covenants and \$253.9 million was outstanding under the credit facility.

The credit facility includes a \$175.0 million sublimit for the issuance of standby and commercial letters of credit. As of September 28, 2019, a total of \$14.7 million in letters of credit were outstanding. The credit facility requires the Company to pay fees based on the unused portion of the line of credit at a rate of 12.5 to 25 basis points per annum depending on the Company's leverage ratio.

The credit facility allows the Company to make revolving loans and other extensions of credit to AIH in an aggregate principal amount not to exceed \$75.0 million at any time. As of September 28, 2019, there were no loans or other extensions of credit provided to AIH.

The Company entered into an interest rate swap derivative agreement to reduce the risk of interest rate volatility for the credit facility. The interest rate swap started on March 13, 2017 and expires on May 13, 2020. The swap agreement fixes the LIBOR rate on \$150.0 million of the revolving credit facility at 2.18 percent, resulting in an effective rate of 3.43 percent after adding the 1.25 percent margin based on the current pricing tier per the credit agreement. The swap arrangement has been designated as a cash flow hedge and has been evaluated to be highly effective. As a result, the after-tax change in the fair value of the swap is recorded in AOCI as a gain or loss on derivative financial instruments.

Prior to March 5, 2019, the Company's Westlake subsidiary had a \$75.0 million asset-based revolving credit facility ("Westlake Facility"). The Westlake Facility was due to mature on October 24, 2022 and was expandable to \$100.0 million under certain conditions. Under this facility, Westlake had the right to issue letters of credit up to a maximum of \$7.5 million. At Westlake's discretion, borrowings under this facility incurred interest at a rate of either the prime rate plus an applicable spread of 25 basis points to 50 basis points or LIBOR plus an applicable spread of 125 basis points to 150 basis points, depending on Westlake's average availability under the Westlake Facility as measured on a trailing 12-month basis.

On March 5, 2019, Westlake amended its credit facility, increasing the Westlake Facility size by \$25.0 million to \$100.0 million and reduced the unused fees to 15 basis points. All other terms remained the same. The Westlake Facility was priced at LIBOR plus 125 basis points at September 28, 2019.

The Westlake Facility is collateralized by substantially all of Westlake's personal property and intangible assets. Borrowings under the facility are subject to a borrowing base calculation consisting of certain advance rates applied to eligible collateral balances (primarily consisting of certain receivables and inventories). This agreement requires maintenance of certain financial covenants including a minimum fixed charge coverage ratio. As of September 28, 2019, ARH was in compliance with its covenants and had \$43.8 million outstanding under the Westlake Facility.

The Company's ACO subsidiary (see Note 2 for additional details of this acquisition) has a \$20.0 million asset-based revolving credit facility ("ACO Facility"). The ACO Facility matures on November 6, 2022. Borrowings under the ACO Facility are subject to a borrowing base calculation consisting of certain advance rates applied to eligible receivables and inventory. The interest rate is based on either the lender's prime rate plus 100 basis points or LIBOR plus 200 basis points. As of September 28, 2019, ACO was in compliance with its covenants and had \$4.6 million outstanding under the ACO Facility. As of September 28, 2019, \$2.0 million of the outstanding debt was priced at LIBOR plus 200 basis points and \$2.6 million was priced at prime plus 100 basis points.

Both the ACO Facility and the Westlake Facility include a lender-controlled cash concentration system that results in all of ACO and Westlake's daily available cash being applied to the outstanding borrowings under their facilities. Pursuant to FASB Accounting Standards Codification Section 470-10-45, "Classification of Revolving Credit Agreements Subject to Lock-Box Arrangements and Subjective Acceleration Clauses," the borrowings under the ACO Facility and Westlake Facility have been classified as a Current maturity of long-term debt as of September 28, 2019.

ACE HARDWARE CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)
(Unaudited, in millions)

Total debt outstanding is comprised of the following:

| | September 28, 2019 | December 29, 2018 | September 29, 2018 |
|---|-----------------------|----------------------|-----------------------|
| Revolving Credit Facility | \$ 253.9 | \$ 251.7 | \$ 285.6 |
| Westlake Facility | 43.8 | 49.5 | 44.1 |
| ACO Facility | 4.6 | - | - |
| Installment notes with maturities through 2023 at a fixed rate of 6.00% | 25.4 | 26.5 | 28.1 |
| Total debt | 327.7 | 327.7 | 357.8 |
| Less: maturities within one year | (59.6) | (60.6) | (55.3) |
| Long-term debt | \$ 268.1 | \$ 267.1 | \$ 302.5 |

(5) Fair Value Measurements

The tables below set forth, by level, the Company's financial assets, liabilities and derivative instruments that were accounted for at fair value as of September 28, 2019, December 29, 2018 and September 29, 2018. The tables do not include cash on hand and also do not include assets and liabilities that are measured at historical cost or any basis other than fair value. The carrying values for other current financial assets and liabilities, such as accounts receivable and accounts payable, approximate fair value due to the short maturity of such instruments. Long-term notes receivable approximate fair value because the Company charges its retailers an interest rate and a significant portion of the notes have the Company's stock as collateral.

| Items measured at fair value on a recurring basis | Carrying Value Measured at Fair Value | | | |
|--|---|----------------|----------------|-------------|
| | September 28, 2019 | Level 1 | Level 2 | Level 3 |
| Assets: | | | | |
| Cash equivalents: | | | | |
| Money market funds | \$ 5.1 | \$ 5.1 | \$ - | \$ - |
| Marketable securities: | | | | |
| Corporate fixed income securities | 31.4 | - | 31.4 | - |
| Mortgage-backed securities | 9.4 | - | 9.4 | - |
| U.S. government notes | 16.9 | 13.5 | 3.4 | - |
| Other | 0.7 | - | 0.7 | - |
| Total marketable securities | \$ 58.4 | \$ 13.5 | \$ 44.9 | \$ - |
| Accrued expenses: | | | | |
| Interest rate swap derivative | \$ 0.4 | \$ - | \$ 0.4 | \$ - |

ACE HARDWARE CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)
(Unaudited, in millions)

| Items measured at fair value on a recurring basis | Carrying Value Measured at Fair Value | | | |
|---|---|---------|---------|---------|
| | December 29, 2018 | Level 1 | Level 2 | Level 3 |
| Assets: | | | | |
| Cash equivalents: | | | | |
| Money market funds | \$ 7.7 | \$ 7.7 | \$ - | \$ - |
| Marketable securities: | | | | |
| Corporate fixed income securities | 14.1 | - | 14.1 | - |
| Equity mutual fund securities | 14.5 | 14.5 | - | - |
| Mortgage-backed securities | 6.5 | - | 6.5 | - |
| U.S. government notes | 12.4 | 11.8 | 0.6 | - |
| Other | 2.9 | - | 2.9 | - |
| Total marketable securities | \$ 50.4 | \$ 26.3 | \$ 24.1 | \$ - |
| Other assets: | | | | |
| Interest rate swap derivative | \$ 0.8 | \$ - | \$ 0.8 | \$ - |

| Items measured at fair value on a recurring basis | Carrying Value Measured at Fair Value | | | |
|---|---|---------|---------|---------|
| | September 29, 2018 | Level 1 | Level 2 | Level 3 |
| Assets: | | | | |
| Cash equivalents: | | | | |
| Money market funds | \$ 11.0 | \$ 11.0 | \$ - | \$ - |
| Marketable securities: | | | | |
| Corporate fixed income securities | 14.0 | - | 14.0 | - |
| Equity mutual fund securities | 11.8 | 11.8 | - | - |
| Mortgage-backed securities | 5.7 | - | 5.7 | - |
| U.S. government notes | 12.5 | 12.0 | 0.5 | - |
| Other | 2.7 | - | 2.7 | - |
| Total marketable securities | \$ 46.7 | \$ 23.8 | \$ 22.9 | \$ - |
| Other assets: | | | | |
| Interest rate swap derivative | \$ 1.4 | \$ - | \$ 1.4 | \$ - |

Money market funds, Equity mutual fund securities and U.S. government notes – The Company’s valuation techniques used to measure the fair values of money market funds, equity mutual fund securities and U.S. government notes, that were classified as Level 1 in the tables above, are derived from quoted market prices for identical instruments, as active markets for these instruments exist.

Corporate fixed income securities, Mortgage-backed securities and Other – Other securities primarily consist of taxable municipal bonds, corporate asset-backed securities, and U.S. Agency fixed rate notes and bonds. The Company’s valuation techniques used to measure the fair values of corporate fixed income securities, mortgage-backed securities and other securities, that were classified as Level 2 in the tables above, are derived from the following: non-binding market consensus prices that are corroborated by observable market data, quoted market prices for similar instruments, or pricing models, such as discounted cash flow techniques, with all significant inputs derived from or corroborated by observable market data.

The fair value of the Company’s marketable securities exceeded their cost by \$1.5 million and \$3.3 million at September 28, 2019 and September 29, 2018, respectively.

ACE HARDWARE CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)
(Unaudited, in millions)

Gross proceeds from the sale of marketable securities and the related realized gains and losses for the three months and nine months ended September 28, 2019 and September 29, 2018 were as follows:

| | Three Months Ended | | Nine Months Ended | |
|-----------------------|-----------------------|-----------------------|-----------------------|-----------------------|
| | September 28, 2019 | September 29, 2018 | September 28, 2019 | September 29, 2018 |
| Gross proceeds | \$ 5.2 | \$ 5.2 | \$ 37.3 | \$ 10.0 |
| Gross realized gains | 0.2 | 2.1 | 0.8 | 2.1 |
| Gross realized losses | - | - | (0.1) | (0.1) |

Gross realized gains and losses were determined using the specific identification method. For the nine months ended September 28, 2019, the Company reclassified \$0.6 million of unrealized gains and \$0.1 million of unrealized losses on marketable securities that were recorded in AOCI as of December 29, 2018 into realized income. These amounts were recorded to Interest income in the Consolidated Statement of Income.

The following table summarizes the contractual maturity distributions of the Company's debt securities at September 28, 2019. Actual maturities may differ from the contractual or expected maturities since borrowers may have the right to prepay obligations with or without prepayment penalties.

| Fair value of available-for-sale debt securities | Due in One Year or Less | Due After One Year through Five Years | Due After Five Years through Ten Years | Due After Ten Years | Total |
|--|-------------------------------|---|---|------------------------|---------|
| Corporate fixed income securities | \$ 1.1 | \$ 14.9 | \$ 10.6 | \$ 4.8 | \$ 31.4 |
| Mortgage-backed securities | - | 0.2 | 1.1 | 8.1 | 9.4 |
| U.S. government notes | 2.5 | 8.2 | 2.0 | 4.2 | 16.9 |
| Other | - | - | 0.2 | 0.5 | 0.7 |
| Total | \$ 3.6 | \$ 23.3 | \$ 13.9 | \$ 17.6 | \$ 58.4 |

The Company uses variable-rate LIBOR debt to finance its operations. These debt obligations expose the Company to interest rate volatility risk. The Company attempts to minimize this risk and fix a portion of its overall borrowing costs through the utilization of interest rate swap derivatives. Variable cash flows from outstanding debt are converted to fixed-rate cash flows by entering into receive-variable, pay-fixed interest rate swaps. The Company does not use derivative instruments for trading or speculative purposes, and all derivative instruments are recognized in the Consolidated Balance Sheet at fair value. Hedge ineffectiveness is eliminated by matching all terms of the hedged item and the hedging derivative at inception and on an ongoing basis. The Company does not exclude any terms from consideration when applying the matched terms method.

The Company entered into an interest rate swap derivative agreement, which started on March 13, 2017 and expires on May 13, 2020. The swap agreement fixes the LIBOR rate on \$150.0 million of the revolving credit facility at 2.18 percent, resulting in an effective rate of 3.43 percent after adding the 1.25 percent margin based on the current pricing tier per the credit agreement.

The fair value of the Company's interest rate swap is estimated using Level 2 inputs, which are based on model-derived valuations in which all significant inputs and significant value drivers are observable in active markets. The Company also considers counterparty credit risk and bilateral or "own" credit risk adjustments in estimating fair value, in accordance with the requirements of GAAP. As of September 28, 2019, the fair value of the interest rate swap was a liability balance of \$0.4 million. As of December 29, 2018, and September 29, 2018, the fair value of the interest rate swap was an asset balance of \$0.8 million and \$1.4 million, respectively. The Company classifies short-term derivative liabilities as Accrued expenses and long-term derivative assets as Other assets on the Consolidated Balance Sheets.

Because the interest rate swap has been designated as a cash flow hedge and has been evaluated to be highly effective, the change in the fair value is recorded in AOCI as a gain or loss on derivative financial instruments. The amount in AOCI is reclassified to earnings if the derivative instrument is sold, extinguished or terminated, or at the time it becomes expected to be sold, extinguished or terminated. The net of tax amount recorded in AOCI for the fair value adjustment of the interest rate swap was an unrealized loss of \$0.3 million and unrealized gains of \$0.6 million and \$1.0 million as of September 28, 2019, December 29, 2018 and September 29, 2018, respectively. This unrealized loss is not expected to be reclassified into interest expense before the expiration of the hedge on May 13, 2020. The impact of any ineffectiveness is recognized in earnings. However, there was no hedge ineffectiveness related to the interest rate swap for the nine months ended September 28, 2019 and September 29, 2018.

ACE HARDWARE CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)
(Unaudited, in millions)

The Company's debt instruments are recorded at cost on the Consolidated Balance Sheets. The fair value of the Company's debt was approximately \$328.5 million at September 28, 2019, compared to the carrying value, including accrued interest, of \$328.8 million. The estimated fair value of long-term debt is based on estimated rates for similar instruments and discounted cash flow analysis using the Company's weighted-average interest rate and is, therefore, classified as Level 3 within the fair value hierarchy.

(6) Income Taxes

Income tax differs from the amount computed by applying the statutory U.S. Federal income tax rate of 21 percent to pre-tax income because of the effect of the following items:

| | Three Months Ended | | Nine Months Ended | |
|--|-----------------------|-----------------------|-----------------------|-----------------------|
| | September 28, 2019 | September 29, 2018 | September 28, 2019 | September 29, 2018 |
| Expected tax at U.S. Federal income tax rate | \$ (12.0) | \$ (7.4) | \$ (27.3) | \$ (21.6) |
| Patronage distribution deductions | 13.9 | 9.3 | 31.9 | 24.5 |
| Other, net | 1.4 | (0.6) | 2.3 | (2.6) |
| Income tax benefit (expense) | \$ 3.3 | \$ 1.3 | \$ 6.9 | \$ 0.3 |

(7) Supplemental Disclosures of Cash Flow Information

During the nine months ended September 28, 2019 and September 29, 2018, accrued patronage distributions of \$14.3 million and \$9.8 million, respectively, were offset against trade receivables and notes receivable owed to the Company by its member retailers with no net impact in the Consolidated Statements of Cash Flows.

During the nine months ended September 28, 2019 and September 29, 2018, non-cash repurchases of stock from retailers of \$16.2 million and \$19.1 million, respectively, were offset against trade receivables of \$4.5 million and \$4.3 million, respectively, and notes receivable of \$5.4 million and \$5.1 million, respectively. The remaining \$6.3 million and \$9.7 million, respectively, were primarily issued as notes payable with no net impact in the Consolidated Statements of Cash Flows. In connection with the acquisition of ACO, the Company recorded a non-cash elimination of ACO's investment in the Class A and Class C shares of the Company of \$1.4 million with no net impact in the Consolidated Statement of Cash Flows.

In June 2015, the Company entered into a forward interest rate swap derivative agreement, which started on March 13, 2017 and expires on May 13, 2020. The fair value of the interest rate swap derivative was recorded as Accrued expenses of \$0.4 million as of September 28, 2019 and Other assets of \$1.4 million as of September 28, 2018. The Company offset these adjustments in fair value, net of tax, against AOCI with no net impact in the Consolidated Statements of Cash Flows.

During the nine months ended September 28, 2019, the Company received \$4.3 million of property and equipment prior to quarter end and accrued for these items as no cash payments were made. These capital expenditures were not included in the Purchases of property and equipment in the Consolidated Statement of Cash Flows for the nine months ended September 28, 2019. During the nine months ended September 28, 2019, the Company paid \$2.5 million for property and equipment that was purchased and accrued during the year ended December 29, 2018. These capital expenditures were included in the Purchases of property and equipment in the Consolidated Statement of Cash Flows for the nine months ended September 28, 2019.

ACE HARDWARE CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)
(Unaudited, in millions)

(8) Warehouse Facility Closure Costs

During 2018 and 2019, the Company closed three leased distribution facilities and returned possession to the landlords. The Company also closed its owned Retail Support Center (“RSC”) in Prince George, Virginia. As of December 29, 2018, the Company had a remaining liability of \$1.5 million for post-employment benefits and \$1.0 million for inventory markdown reserves related to these former facilities. During the nine months ended September 28, 2019, the Company recorded a \$1.0 million benefit in Wholesale cost of revenues to offset the inventory markdowns upon final disposition of the inventory related to these facilities and made \$1.5 million in payments for post-employment benefits. The Company also has \$1.9 million and \$2.1 million of remaining net lease liability as of September 28, 2019 and December 29, 2018, respectively, relating to an ARH distribution facility that is no longer used.

Accrued warehouse facility closure costs activity for the nine months ended September 28, 2019 is as follows:

| | Remaining Net Lease Liability | Post- employment Benefits | Inventory Markdown Reserves | Total |
|---------------------------------------|-------------------------------------|---------------------------------|-----------------------------------|---------------|
| Balance at December 29, 2018 | \$ 2.1 | \$ 1.5 | \$ 1.0 | \$ 4.6 |
| Reclass to wholesale cost of revenues | - | - | (1.0) | (1.0) |
| Payments | (0.2) | (1.5) | - | (1.7) |
| Balance at September 28, 2019 | <u>\$ 1.9</u> | <u>\$ -</u> | <u>\$ -</u> | <u>\$ 1.9</u> |

As a result of the closure of the Prince George RSC, as of December 29, 2018, the Company had concluded that the long-lived assets at its Prince George RSC (land and building) met the criteria to be classified as assets held for sale. The carrying value of these assets totaled \$15.8 million. In the third quarter, the Company sold the Prince George RSC for net proceeds of approximately \$20.7 million and recorded a gain of \$4.9 million on the transaction.

(9) Lease Commitments

The Company has acquired 13 store leases from a former home improvement retailer. The Company acquired these store leases at various dates during the second, third and fourth quarters of 2019. The estimated future minimum lease payments of the 13 leases are approximately \$93.1 million as of September 28, 2019. ARH operates 11 of the locations and 2 of the locations have been assigned to Ace retailers. The Company remains contingently liable for payment of these assigned leases.

**MANAGEMENT'S DISCUSSION AND ANALYSIS OF
FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

The following discussion and analysis summarizes the significant factors affecting the Company's consolidated operating results and financial condition during the three- and nine- month periods ended September 28, 2019 and September 29, 2018. This discussion and analysis should be read in conjunction with the Company's 2018 Annual Report, as well as the consolidated financial statements (unaudited) and notes thereto contained in this report that have been prepared in accordance with U.S. generally accepted accounting principles ("GAAP"). Results of the interim periods presented are not necessarily indicative of the results to be expected for the full fiscal year due to seasonal and other factors.

Results of Operations

Comparison of the Three Months Ended September 28, 2019 to the Three Months Ended September 29, 2018

The following data summarizes the Company's performance in 2019 as compared to 2018 (in millions):

| | 2019 | | 2018 | | Favorable/ (Unfavorable) | |
|---|----------------|-------------------|----------------|-------------------|-----------------------------|---------------|
| | \$ | % of Revenues* | \$ | % of Revenues* | \$ | % |
| Revenues: | | | | | | |
| Wholesale revenues | 1,403.8 | 91.7% | 1,341.3 | 94.0% | 62.5 | 4.7% |
| Retail revenues | 126.3 | 8.3% | 85.9 | 6.0% | 40.4 | 47.0% |
| Total revenues | 1,530.1 | 100.0% | 1,427.2 | 100.0% | 102.9 | 7.2% |
| Gross profit: | | | | | | |
| Wholesale gross profit | 183.3 | 13.1% | 167.2 | 12.5% | 16.1 | 9.6% |
| Retail gross profit | 57.0 | 45.1% | 37.7 | 43.9% | 19.3 | 51.2% |
| Total gross profit | 240.3 | 15.7% | 204.9 | 14.4% | 35.4 | 17.3% |
| Operating expenses: | | | | | | |
| Wholesale operating expenses | 132.1 | 9.4% | 128.8 | 9.6% | (3.3) | (2.6%) |
| Retail operating expenses | 50.9 | 40.3% | 40.1 | 46.7% | (10.8) | (26.9%) |
| Retail pre-opening expenses | 2.2 | 1.7% | 0.3 | 0.3% | (1.9) | (633.3%) |
| Total operating expenses | 185.2 | 12.1% | 169.2 | 11.9% | (16.0) | (9.5%) |
| Operating income | 55.1 | 3.6% | 35.7 | 2.5% | 19.4 | 54.3% |
| Interest expense | (5.4) | (0.4%) | (5.5) | (0.4%) | 0.1 | 1.8% |
| Other income, net | 10.6 | 0.7% | 6.1 | 0.4% | 4.5 | 73.8% |
| Net income attributable to Ace Hardware Corporation | <u>60.3</u> | <u>3.9%</u> | <u>36.3</u> | <u>2.5%</u> | <u>24.0</u> | <u>66.1%</u> |

*Wholesale gross profit and expenses are shown as a percentage of wholesale revenues. Retail gross profit and expenses are shown as a percentage of retail revenues. Non-operating items are shown as a percentage of total revenues.

A reconciliation of consolidated revenues follows (in millions):

| | Amount | % Change vs. 2018 |
|--|-------------------|----------------------|
| 2018 Revenues | <u>\$ 1,427.2</u> | |
| <i>Wholesale Merchandise Revenues change based on new and cancelled domestic stores:</i> | | |
| Revenues increase from new stores added since January 2018 | 35.3 | 2.5% |
| Revenues decrease from stores cancelled since January 2018 | (7.9) | (0.6%) |
| Increase in wholesale merchandise revenues to comparable domestic stores | 54.2 | 3.8% |
| Decrease in AWH wholesale revenues | (3.4) | (0.2%) |
| Increase in AIH wholesale revenues | 4.7 | 0.3% |
| Increase in ARH retail revenues | 42.0 | 2.9% |
| Other revenue changes, net (including elimination of \$15.6 million in sales to ACO) | (22.0) | (1.5%) |
| 2019 Revenues | <u>\$ 1,530.1</u> | <u>7.2%</u> |

Consolidated revenues for the three months ended September 28, 2019 totaled \$1.5 billion, an increase of \$102.9 million, or 7.2 percent, as compared to the prior year third quarter. Total wholesale revenues were \$1.4 billion for the third quarter 2019, an increase of \$62.5 million, or 4.7 percent, as compared to the prior year third quarter. The categories with the largest revenue gains were hand and power tools, grilling and outdoor power equipment. New stores are defined as stores that were activated from January 2018 through

September 2019. In 2019, the Company had an increase in wholesale merchandise revenues from new domestic stores of \$35.3 million. This increase was partially offset by a decrease in wholesale merchandise revenues due to domestic store cancellations of \$7.9 million. As a result, the Company realized a net increase in wholesale merchandise revenues of \$27.4 million related to the impact of both new stores affiliated with the Company and from stores that cancelled their membership in 2018 and 2019. Wholesale merchandise revenues to comparable domestic stores increased \$54.2 million. This net increase was partially offset by the elimination of \$15.6 million of sales to ACO Inc. (“ACO”) which became a wholly-owned subsidiary and was fully consolidated beginning in the first quarter of 2019. This elimination was not required in 2018.

The number of the Company’s worldwide Ace retail outlets is summarized as follows:

| | Three Months Ended | |
|---|---------------------------|-----------------------|
| | September 28, 2019 | September 29, 2018 |
| Retailer outlets at beginning of period | 5,298 | 5,161 |
| New retailer outlets added | 48 | 75 |
| Retailer outlet cancellations | (19) | (26) |
| Retailer outlets at end of period | <u>5,327</u> | <u>5,210</u> |

Revenues from the Ace Wholesale Holdings LLC (“AWH”) subsidiary were \$99.3 million during the three months ended September 28, 2019. This is a decrease of \$3.4 million, or 3.3 percent, from the third quarter of 2018 which was the result of a decision to reduce the number of products available for sale to certain customers due to low profitability.

Revenues from the Ace Hardware International Holdings, Ltd. (“AIH”) subsidiary were \$69.0 million during the three months ended September 28, 2019. This is an increase of \$4.7 million, or 7.3 percent, from the third quarter of 2018. This increase was primarily driven by higher sales to key retailers in Saudi Arabia and Kuwait.

Total retail revenues for the quarter were \$126.3 million, an increase of \$40.4 million, or 47.0 percent, as compared to the prior year third quarter. Retail revenues from Ace Retail Holdings LLC (“ARH”) were \$121.0 million in the third quarter of 2019, an increase of \$42.0 million, or 53.2 percent, from the third quarter of 2018. A significant portion of this increase was due to the inclusion of ACO which was fully consolidated beginning in the first quarter of 2019 and contributed \$27.8 million of this increase. The remaining increase was the result of new retail stores added by the Westlake Ace Hardware (“Westlake”) retail chain since the third quarter of 2018 coupled with a 4.9 percent increase in Westlake same-store-sales. Westlake operated 132 stores at the end of the third quarter of 2019 compared to 122 stores at the end of the third quarter of 2018. Retail revenues from Ace Ecommerce Holdings LLC (“AEH”) were \$5.3 million in the third quarter of 2019. This was a decrease of \$1.6 million from the third quarter of 2018.

Wholesale gross profit for the three months ended September 28, 2019 was \$183.3 million, an increase of \$16.1 million from the third quarter of 2018. The wholesale gross margin percentage was 13.1 percent of wholesale revenues in the third quarter of 2019, up from 12.5 percent in the third quarter of 2018. The increase in the wholesale gross margin percentage was due to additional vendor funds earned and higher initial product gross profit rates as a result of passing through vendor price increases. These price increases were partially offset by the unfavorable LIFO expense that vendor price increases create.

Retail gross profit for the third quarter of 2019 was \$57.0 million, an increase of \$19.3 million from the third quarter of 2018. This increase was largely the result of the inclusion of ACO results in the current quarter of \$11.6 million. The retail gross margin percentage was 45.1 percent of retail revenues in the third quarter of 2019, an increase from 43.9 percent in the third quarter of 2018. The increase in the retail gross margin percentage was a result of the inclusion of ACO results in the current quarter which carried a higher margin. For ARH, retail gross profit as reported in the Ace financial statements is based on the Ace wholesale acquisition cost of product, not ARH’s acquisition cost which includes a markup from the Company.

Wholesale operating expenses increased \$3.3 million, or 2.6 percent, from the third quarter of 2018. The increase is due to higher distribution costs resulting from the increased volume of higher wholesale revenues and increased compensation costs. As a percentage of wholesale revenues, wholesale operating expenses decreased to 9.4 percent of wholesale revenues in the third quarter of 2019 from 9.6 percent of wholesale revenues in the third quarter of 2018.

Retail operating expenses increased \$10.8 million, or 26.9 percent, from the third quarter of 2018. This increase was primarily due to the inclusion of ACO operating expenses of \$10.1 million as a result of consolidating ACO results beginning in the first quarter of 2019. The remaining increase was primarily due to new stores added by ARH since the third quarter of 2018. Retail operating expenses as a percentage of retail revenue decreased to 40.3 percent of retail revenues in the third quarter of 2019 from 46.7 percent in the third quarter of 2018. The third quarter of 2018 included a full year of amortization on the intangible assets identified from the purchase of The Grommet by AEH in September 2017 versus only one quarter of intangible amortization in 2019. Excluding the extra nine months of intangible amortization in the third quarter of 2018, retail operating expenses were 43.5 percent of retail revenue.

Retail pre-opening expenses of \$2.2 million were incurred in the third quarter of 2019 related to one-time, start-up costs from eleven new stores in California opened by Westlake in the third quarter of 2019 or to be opened in the fourth quarter of 2019.

Other income, net increased \$4.5 million from the third quarter of 2018. This increase was primarily due to a \$4.9 million gain on the sale of the Company's Prince George Retail Support Center ("RSC").

Comparison of the Nine Months Ended September 28, 2019 to the Nine Months Ended September 29, 2018

The following data summarizes the Company's performance in 2019 as compared to 2018 (in millions):

| | 2019 | | 2018 | | Favorable/ (Unfavorable) | |
|--|----------------|-------------------|----------------|-------------------|-----------------------------|----------------|
| | \$ | % of Revenues* | \$ | % of Revenues* | \$ | % |
| Revenues: | | | | | | |
| Wholesale revenues | 4,231.6 | 92.1% | 4,060.3 | 93.8% | 171.3 | 4.2% |
| Retail revenues | 364.5 | 7.9% | 266.7 | 6.2% | 97.8 | 36.7% |
| Total revenues | 4,596.1 | 100.0% | 4,327.0 | 100.0% | 269.1 | 6.2% |
| Gross profit: | | | | | | |
| Wholesale gross profit | 515.2 | 12.2% | 486.5 | 12.0% | 28.7 | 5.9% |
| Retail gross profit | 163.1 | 44.7% | 116.2 | 43.6% | 46.9 | 40.4% |
| Total gross profit | 678.3 | 14.8% | 602.7 | 13.9% | 75.6 | 12.5% |
| Operating expenses: | | | | | | |
| Wholesale operating expenses | 399.5 | 9.4% | 381.6 | 9.4% | (17.9) | (4.7%) |
| Retail operating expenses | 140.0 | 38.4% | 112.1 | 42.0% | (27.9) | (24.9%) |
| Retail pre-opening expenses | 6.2 | 1.7% | 1.0 | 0.4% | (5.2) | (520.0%) |
| Total operating expenses | 545.7 | 11.9% | 494.7 | 11.4% | (51.0) | (10.3%) |
| Operating income | 132.6 | 2.9% | 108.0 | 2.5% | 24.6 | 22.8% |
| Interest expense | (17.7) | (0.4%) | (15.0) | (0.3%) | (2.7) | (18.0%) |
| Other income, net | 21.6 | 0.5% | 9.6 | 0.2% | 12.0 | 125.0% |
| Net income attributable to Ace Hardware Corporation | 136.5 | 3.0% | 102.6 | 2.4% | 33.9 | 33.0% |

*Wholesale gross profit and expenses are shown as a percentage of wholesale revenues. Retail gross profit and expenses are shown as a percentage of retail revenues. Non-operating items are shown as a percentage of total revenues.

A reconciliation of consolidated revenues follows (in millions):

| | Amount | % Change vs. 2018 |
|--|-------------------|----------------------|
| 2018 Revenues | \$ 4,327.0 | |
| <i>Wholesale Merchandise Revenues change based on new and cancelled domestic stores:</i> | | |
| Revenues increase from new stores added since January 2018 | 134.6 | 3.1% |
| Revenues decrease from stores cancelled since January 2018 | (32.1) | (0.7%) |
| Increase in wholesale merchandise revenues to comparable domestic stores | 118.5 | 2.7% |
| Increase in AWH wholesale revenues | 2.0 | - |
| Decrease in AIH wholesale revenues | (3.7) | (0.1%) |
| Increase in ARH retail revenues | 99.3 | 2.3% |
| Other revenue changes, net (including elimination of \$41.8 million in sales to ACO) | (49.5) | (1.1%) |
| 2019 Revenues | \$ 4,596.1 | 6.2% |

Consolidated revenues for the nine months ended September 28, 2019 totaled \$4.6 billion, an increase of \$269.1 million, or 6.2 percent, as compared to the prior year. Total wholesale revenues were \$4.2 billion, an increase of \$171.3 million, or 4.2 percent, as compared to the prior year. Increases were noted across all departments with grilling, hand and power tools and outdoor power equipment showing the largest gains. New stores are defined as stores that were activated from January 2018 through September 2019. During the nine months ended September 28, 2019, the Company had an increase in wholesale merchandise revenues from new domestic stores of \$134.6 million. This increase was partially offset by a decrease in wholesale merchandise revenues due to domestic store cancellations of \$32.1 million. As a result, the Company realized a net increase in wholesale merchandise revenues of \$102.5 million related to the impact of both new stores affiliated with the Company and from stores that cancelled their membership in 2018 and 2019. Wholesale merchandise revenues to comparable domestic stores increased \$118.5 million compared to the prior year. This increase was partially offset by the elimination of \$41.8 million of sales to ACO which was fully consolidated beginning in the first quarter of 2019. This elimination was not required in 2018.

The number of the Company's worldwide Ace retail outlets is summarized as follows:

| | Nine Months Ended | |
|---|-------------------------------|-------------------------------|
| | September 28, 2019 | September 29, 2018 |
| Retailer outlets at beginning of period | 5,253 | 5,121 |
| New retailer outlets added | 139 | 178 |
| Retailer outlet cancellations | (65) | (89) |
| Retailer outlets at end of period | <u>5,327</u> | <u>5,210</u> |

Revenues from AWH were \$307.0 million during the nine months ended September 28, 2019. This is an increase of \$2.0 million, or 0.7 percent, from the prior year. This increase was primarily due to higher sales from AWH's retailer convention, partially offset by lower sales due to a decision to reduce the number of products available for sale to certain customers due to low profitability.

Revenues for AIH were \$194.3 million during the nine months ended September 28, 2019. This is a decrease of \$3.7 million, or 1.9 percent, from the prior year. This decrease was primarily due to having had significant sales in 2018 related to hurricane rebuilding efforts in the Caribbean as well as lower sales to customers in the UAE and Ecuador.

Retail revenues from ARH were \$345.1 million during the nine months ended September 28, 2019. This is an increase of \$99.3 million or 40.4 percent from the prior year. The increase was primarily due to the inclusion of ACO which was fully consolidated beginning in the first quarter of 2019 and contributed \$69.1 million of this increase. The remaining increase was the result of new retail stores added by Westlake since September of 2018 coupled with a 3.6 percent increase in same-store-sales. Retail revenues from AEH were \$19.4 million during the nine months ended September 28, 2019 compared to \$20.9 million during the first nine months of 2018.

Wholesale gross profit for the first nine months of 2019 was \$515.2 million, an increase of \$28.7 million from the first nine months of 2018. The wholesale gross margin percentage was 12.2 percent of wholesale revenues, up from 12.0 percent in 2018.

Retail gross profit for the nine months ended September 28, 2019 was \$163.1 million, an increase of \$46.9 million from the nine months ended September 29, 2018. This increase was the result of the inclusion of ACO results in the current year of \$28.4 million. Retail gross margin percentage was 44.7 percent of retail revenues in 2019, up from 43.6 percent in 2018. The increase in the retail gross margin percentage was a result of the inclusion of ACO results in the nine months ended September 28, 2019 which carried a higher margin. For ARH, retail gross profit as reported in the Ace financial statements is based on the Ace wholesale acquisition cost of product, not ARH's acquisition cost which includes a markup from the Company.

Wholesale operating expenses increased \$17.9 million, or 4.7 percent, in the nine months ended September 28, 2019 as compared to the nine months ended September 29, 2018. The increase is primarily due to higher distribution costs resulting from the increased volume from higher wholesale revenues and increased compensation expense. As a percentage of wholesale revenues, wholesale operating expenses remained flat at 9.4 percent for both nine month periods ending September 28, 2019 and September 29, 2018.

Retail operating expenses of \$140.0 million increased \$27.9 million, or 24.9 percent, in the nine months ended September 28, 2019 as compared to the nine months ended September 29, 2018. This increase was primarily due to the inclusion of ACO operating expenses of \$23.5 million as a result of consolidating ACO results beginning in the first quarter of 2019. The remaining increase was primarily due to new stores added by ARH since the second quarter of 2018. Retail operating expenses as a percentage of retail revenue decreased to 38.4 percent of retail revenues in the first nine months of 2019 from 42.0 percent in the first nine months of 2018 primarily due to the inclusion of ACO which has a lower operating expense ratio than Westlake.

Retail pre-opening expenses of \$6.2 million increased \$5.2 million from the third quarter of 2018. This increase was related to one-time, start-up costs from eleven new stores in California opened by Westlake during the first nine months of 2019 or to be opened in the fourth quarter of 2019.

Other income, net increased \$12.0 million from the third quarter of 2018. This increase was primarily due to a gain on the sale of the Company's Prince George RSC, a change in estimated annual effective income tax rate and gains on equity investments.

Liquidity and Capital Resources

The Company believes that existing cash balances, along with the existing lines of credit and long-term financing, will be sufficient to finance the Company's working capital requirements, debt service, patronage distributions, capital expenditures, share redemptions from retailer cancellations and growth initiatives for at least the next 12 months.

The Company's borrowing requirements have historically arisen from, and are expected to continue to arise from, seasonal working capital needs, debt service, capital improvements and acquisitions, patronage distributions and other general corporate purposes. In the past, the Company has met its operational cash needs using cash flows from operating activities and funds from its revolving credit facilities. The Company currently estimates that its cash flows from operating activities and working capital, together with its lines of credit, will be sufficient to fund its short-term liquidity needs. Actual liquidity and capital funding requirements depend on numerous factors, including operating results, general economic conditions and the cost of capital.

The Company has a \$700.0 million line of credit that is expandable to \$1.0 billion through a \$300.0 million accordion that is exercisable without the consent of existing lenders provided that the Company is not in default of the credit agreement and further provided that none of the existing lenders are required to provide any portion of the increased facility. At the Company's discretion, borrowings under the credit facility bear interest at a rate of either 0 to 75 basis points over the prime rate or 100 to 175 basis points over the London Interbank Offered Rate ("LIBOR") depending on the Company's leverage ratio as defined under the agreement. The credit facility was priced at LIBOR plus 125 basis points at September 28, 2019. The credit facility expires on February 1, 2024 and requires maintenance of certain financial covenants including a maximum allowable average leverage ratio and a minimum fixed charge coverage ratio. As of September 28, 2019, the Company was in compliance with its covenants and \$253.9 million was outstanding under the credit facility.

The credit facility includes a \$175.0 million sublimit for the issuance of standby and commercial letters of credit. As of September 28, 2019, a total of \$14.7 million in letters of credit were outstanding. The credit facility requires the Company to pay fees based on the unused portion of the line of credit at a rate of 12.5 to 25 basis points per annum depending on the Company's leverage ratio.

The credit facility allows the Company to make revolving loans and other extensions of credit to AIH in an aggregate principal amount not to exceed \$75.0 million at any time. As of September 28, 2019, there were no loans or other extensions of credit provided to AIH.

The Company entered into an interest rate swap derivative agreement to reduce the risk of interest rate volatility for the credit facility. The interest rate swap started on March 13, 2017 and expires on May 13, 2020. The swap agreement fixes the LIBOR rate on \$150.0 million of the revolving credit facility at 2.18 percent, resulting in an effective rate of 3.43 percent after adding the 1.25 percent margin based on the current pricing tier per the credit agreement. The swap arrangement has been designated as a cash flow hedge and has been evaluated to be highly effective. As a result, the after-tax change in the fair value of the swap is recorded in accumulated other comprehensive income as a gain or loss on derivative financial instruments.

The Company's Westlake subsidiary has a \$100.0 million asset-based revolving credit facility ("Westlake Facility"). The Westlake Facility matures on October 24, 2022. Under this facility, Westlake has the right to issue letters of credit up to a maximum of \$7.5 million. At the Company's discretion, borrowings under this facility bear interest at a rate of either the prime rate plus an applicable spread of 25 basis points to 50 basis points or LIBOR plus an applicable spread of 125 basis points to 150 basis points, depending on the Company's average availability under the Westlake Facility as measured on a trailing 12-month basis. The Westlake Facility was priced at LIBOR plus 125 basis points at September 28, 2019.

The Westlake Facility is collateralized by substantially all of Westlake's personal property and intangible assets. Borrowings under the facility are subject to a borrowing base calculation consisting of certain advance rates applied to eligible collateral balances (primarily consisting of certain receivables and inventories). This agreement requires maintenance of certain financial covenants including a minimum fixed charge coverage ratio. As of September 28, 2019, ARH was in compliance with its covenants and had \$43.8 million in loans outstanding under the Westlake Facility.

The Company's ACO subsidiary (see Note 2 for additional details of this acquisition) has a \$20.0 million asset-based revolving credit facility ("ACO Facility"). The ACO Facility matures on November 6, 2022. Borrowings under the ACO Facility are subject to a borrowing base calculation consisting of certain advance rates applied to eligible receivables and inventory. The interest rate is based on either the lender's prime rate plus 100 basis points or LIBOR plus 200 basis points. As of September 28, 2019, ACO was in compliance with its covenants and had \$4.6 million outstanding under the ACO Facility. As of September 28, 2019, \$2.0 million of the outstanding debt was priced at LIBOR plus 200 basis points and \$2.6 million was priced at prime plus 100 basis points.

Both the ACO Facility and the Westlake Facility include a lender-controlled cash concentration system that results in all of ACO and Westlake's daily available cash being applied to the outstanding borrowings under their facilities. Pursuant to Financial Accounting Standards Board Accounting Standards Codification Section 470-10-45, "Classification of Revolving Credit Agreements Subject to Lock-Box Arrangements and Subjective Acceleration Clauses," the borrowings under the ACO Facility and Westlake Facility have been classified as a Current maturity of long-term debt as of September 28, 2019.

Total debt, the majority of which is comprised of the \$302.3 million borrowed on lines of credit, was \$327.7 million as of September 28, 2019, compared to \$327.7 million and \$357.8 million as of December 29, 2018 and September 29, 2018, respectively.

Cash Flows

The Company had \$24.7 million and \$22.6 million of cash and cash equivalents at September 28, 2019 and September 29, 2018, respectively. Following is a summary of the Company's cash flows from operating, investing and financing activities for the first nine months of 2019 and 2018, respectively (in millions):

| | 2019 | 2018 |
|--|----------|----------|
| Cash provided by operating activities before changes in assets and liabilities | \$ 175.3 | \$ 138.7 |
| Net changes in assets and liabilities | (34.0) | (130.9) |
| Net cash provided by operating activities | 141.3 | 7.8 |
| Net cash used in investing activities | (66.4) | (68.5) |
| Net cash (used in) provided by financing activities | (75.8) | 60.3 |
| Net change in cash and cash equivalents | \$ (0.9) | \$ (0.4) |

The Company's operating activities provided \$141.3 million of cash during the first nine months of 2019 compared to \$7.8 million provided in 2018. Excluding the impact of net changes in assets and liabilities, cash provided by operating activities increased from \$138.7 million in the first nine months of 2018 to \$175.3 million in the first nine months of 2019. This \$36.6 million increase was primarily the result of a \$33.9 million increase in net income for the first nine months of 2019.

The net change in assets and liabilities used \$34.0 million of cash in the first nine months of 2019 compared to \$130.9 million in the first nine months of 2018. This \$96.9 million decrease in net working capital was driven by a \$180.4 million lower inventory build in 2019 compared to 2018. In 2018, the Company invested in additional inventory to maintain service levels due to poor fill rates and to stock the new Fredericksburg RSC and has continued to maintain that level of inventory in 2019. The year over year decrease in inventory growth is partially offset by a \$46.3 million decrease in the growth of accounts payable and accrued expenses.

Net cash used in investing activities was \$66.4 million in the first nine months of 2019 compared to \$68.5 million in the first nine months of 2018. Investing activities in 2019 primarily consisted of \$54.5 million in capital expenditures which were partially offset by \$22.0 million in proceeds from sale of assets. There was also \$22.5 million paid for the acquisition of ACO Inc., Handyman Matters Inc., and additional retail stores by ARH. Investing activities in the first nine months of 2018 primarily consisted of \$48.8 million in capital expenditures, including \$13.2 million for the new Fredericksburg RSC, and \$18.5 million paid for the acquisition of retail stores by ARH.

Net cash used in financing activities was \$75.8 million in the first nine months of 2019 compared to \$60.3 million provided by financing activities in the first nine months of 2018. During 2019, the Company had \$8.7 million of net repayments under the revolving lines of credit, paid \$51.3 million for the cash portion of the 2018 patronage distribution, paid \$5.3 million on patronage refund certificates and made payments on long-term debt of \$7.4 million. During 2018, the Company had \$133.3 million of net borrowings under the revolving lines of credit, paid \$58.0 million for the cash portion of the 2017 patronage distribution, paid \$6.4 million on patronage refund certificates and made payments on long-term debt of \$7.3 million.

Contractual Obligations and Commitments

For the nine months ended September 28, 2019, there have been no significant changes to the Company's contractual obligations and commitments as disclosed in its 2018 Annual Report other than what was described in Note 9 to the Financial Statements.

Critical Accounting Policies and Estimates

For a description of the Company's critical accounting policies and estimates, please see the Application of Critical Accounting Policies and Estimates section in the Management's Discussion and Analysis of Financial Condition and Results of Operations section of the Company's 2018 Annual Report.

Qualitative and Quantitative Disclosure About Market Risk

The Company is exposed to market risk in the normal course of its business operations, including the risk of loss from inflation and changes in price, foreign currency, interest rates and customer credit risk.

There has been no material change in the Company's exposure to market risk from what was disclosed in the 2018 Annual Report.

Disclosure Regarding Forward-Looking Statements

This document includes certain forward-looking statements about the expectations of the Company. Although the Company believes these statements are based on reasonable assumptions, actual results may vary materially from stated expectations. Such forward-looking statements may be identified by the use of forward-looking words or phrases such as “anticipate,” “believe,” “expect,” “intend,” “may,” “planned,” “potential,” “should,” “will,” “would,” “project,” “estimate,” “ultimate,” or similar phrases. Actual results may differ materially from those indicated in the Company’s forward-looking statements and undue reliance should not be placed on such statements.

Factors that could cause materially different results include, but are not limited to, weather conditions; natural disasters; fair value accounting adjustments; inventory valuation; health care costs; insurance costs or recoveries; legal costs; borrowing needs; interest rates; credit conditions; economic and market conditions; accidents, leaks, equipment failures, service interruptions, and other operating risks; legislative actions; tax rulings or audit results; asset sales; significant unplanned capital needs; changes in accounting principles, interpretations, methods, judgments or estimates; performance of major customers, transporters, suppliers and contractors; labor relations; civil unrest; and acts of terrorism.

Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date of this report. The Company undertakes no obligation to publicly release any revision to these forward-looking statements to reflect events or circumstances after the date of this report.

MANAGEMENT'S RESPONSIBILITY FOR FINANCIAL STATEMENTS

The consolidated financial statements presented in this Quarterly Report have been prepared with integrity and objectivity and are the responsibility of the management of Ace Hardware Corporation. These consolidated financial statements have been prepared in conformity with U.S. generally accepted accounting principles and properly reflect certain estimates and judgments based upon the best available information.

The Company maintains a system of internal accounting controls, which is supported by an internal audit program and is designed to provide reasonable assurance, at an appropriate cost, that the Company's assets are safeguarded and transactions are properly recorded. This system is continually reviewed and modified in response to changing business conditions and operations and as a result of recommendations by the internal and external auditors. In addition, the Company has distributed to employees its policies for conducting business affairs in a lawful and ethical manner.

The Audit Committee of the Board of Directors meets periodically with the independent auditors and with the Company's internal auditors, both privately and with management present, to review accounting, auditing, internal control and financial reporting matters. The Audit Committee recommends to the full Board of Directors the selection of the independent auditors and regularly reviews the internal accounting controls, the activities of the outside auditors and internal auditors and the financial condition of the Company. Both the Company's independent auditors and the internal auditors have free access to the Audit Committee.

November 19, 2019

/s/ John Venhuizen

John Venhuizen

President and Chief Executive Officer

/s/ William M. Guzik

William M. Guzik

Executive Vice President,

Chief Financial Officer and Chief Risk Officer

/s/ Steven G. Locanto

Steven G. Locanto

Corporate Controller



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