

Edgar Filing: DSW Inc. - Form 10-Q

DSW Inc.  
Form 10-Q  
August 31, 2012

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549  
FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934  
For the quarterly period ended July 28, 2012

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 1-32545

DSW INC.  
(Exact name of registrant as specified in its charter)

Ohio 31-0746639  
(State or other jurisdiction of (I.R.S. Employer Identification No.)  
Incorporation or organization)  
810 DSW Drive, Columbus, Ohio 43219  
(Address of principal executive offices) (Zip Code)  
(614) 237-7100

Registrant's telephone number, including area code  
N/A

(Former name, former address and former fiscal year, if changed since last report)

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 or a smaller reporting company. See definitions of "large accelerated filer",  
"accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large  
Accelerated Filer   
Accelerated Filer

Non-accelerated   
Filer  
(Do not check if  
smaller reporting  
company)  
Smaller reporting   
company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

The number of outstanding Class A Common Shares, without par value, as of August 24, 2012 was 35,003,693 and Class B Common Shares, without par value, as of August 24, 2012 was 9,653,102.

---

DSW INC.  
TABLE OF CONTENTS

---

| Item No.   | Page      |
|--|-----------|
| Part I. Financial Information  |           |
| Item 1. Financial Statements   |           |
| <u>Condensed Consolidated Balance Sheets at July 28, 2012 and January 28, 2012</u>   | <u>2</u>  |
| <u>Condensed Consolidated Statements of Operations and Comprehensive Income for the three and six months ended July 28, 2012 and July 30, 2011</u> | <u>3</u>  |
| <u>Condensed Consolidated Statements of Shareholders' Equity for the six months ended July 28, 2012 and July 30, 2011</u>                          | <u>4</u>  |
| <u>Condensed Consolidated Statements of Cash Flows for the six months ended July 28, 2012 and July 30, 2011</u>                                    | <u>6</u>  |
| <u>Notes to the Condensed Consolidated Financial Statements</u>  | <u>8</u>  |
| <u>Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations</u>   | <u>22</u> |
| <u>Item 3. Quantitative and Qualitative Disclosures About Market Risk</u>  | <u>30</u> |
| <u>Item 4. Controls and Procedures</u>   | <u>30</u> |
| Part II. Other Information   |           |
| <u>Item 1. Legal Proceedings</u>   | <u>31</u> |
| <u>Item 1A. Risk Factors</u>   | <u>31</u> |
| <u>Item 2. Unregistered Sales of Equity Securities and Use of Proceeds</u>   | <u>32</u> |
| <u>Item 3. Defaults Upon Senior Securities</u>   | <u>32</u> |
| <u>Item 4. Mine Safety Disclosure</u>  | <u>32</u> |
| <u>Item 5. Other Information</u>   | <u>32</u> |
| <u>Item 6. Exhibits</u>  | <u>32</u> |
| <u>Signature</u>   | <u>33</u> |
| <u>Index to Exhibits</u>   | <u>34</u> |

## Part I. FINANCIAL INFORMATION

## Item 1. Financial Statements

DSW INC.

## CONDENSED CONSOLIDATED BALANCE SHEETS

(in thousands, except share amounts)

(unaudited)

|   | July 28, 2012 | January 28, 2012 |
|---|---------------|------------------|
| <b>ASSETS</b>   |               |                  |
| Cash and equivalents  | \$61,059      | \$79,003         |
| Short-term investments  | 319,910       | 296,697          |
| Accounts receivable, net  | 24,755        | 16,900           |
| Accounts receivable from related parties  | 33            | 96               |
| Inventories   | 367,228       | 334,390          |
| Prepaid expenses and other current assets   | 23,870        | 24,448           |
| Deferred income taxes   | 119,746       | 116,473          |
| Total current assets  | 916,601       | 868,007          |
| Property and equipment, net   | 253,099       | 235,726          |
| Long-term investments   | 103,791       | 53,858           |
| Goodwill  | 25,899        | 25,899           |
| Deferred income taxes   |               | 15,653           |
| Other assets  | 8,285         | 8,757            |
| Total assets  | \$1,307,675   | \$1,207,900      |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>   |               |                  |
| Accounts payable  | \$151,448     | \$148,944        |
| Accounts payable to related parties   | 930           | 2,304            |
| Accrued expenses  | 111,127       | 126,998          |
| Warrant liability   | —             | 29,303           |
| Total current liabilities   | 263,505       | 307,549          |
| Other non-current liabilities   | 119,177       | 113,764          |
| Deferred income taxes   | 23,695        | —                |
| Commitments and contingencies   | —             | —                |
| Shareholders' equity:   |               |                  |
| Class A Common Shares, no par value; 170,000,000 authorized; 34,976,909 and 32,121,760 issued and outstanding, respectively | 676,506       | 624,948          |
| Class B Common Shares, no par value; 100,000,000 authorized; 9,660,627 and 11,169,972 issued and outstanding, respectively  | 180,260       | 171,864          |
| Preferred Shares, no par value; 100,000,000 authorized; no shares issued or outstanding                                     | —             | —                |
| Retained earnings (Accumulated deficit)   | 52,894        | (1,739 )         |
| Accumulated other comprehensive loss  | (8,362 )      | (8,486 )         |
| Total shareholders' equity  | 901,298       | 786,587          |
| Total liabilities and shareholders' equity  | \$1,307,675   | \$1,207,900      |

The accompanying Notes are an integral part of the Condensed Consolidated Financial Statements.

2

---

## DSW INC.

## CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE INCOME

(in thousands, except per share amounts)

(unaudited)

|  | Three months ended |                  | Six months ended |                  |
|--|--------------------|------------------|------------------|------------------|
|  | July 28,<br>2012   | July 30,<br>2011 | July 28,<br>2012 | July 30,<br>2011 |
| Net sales  | \$512,218          | \$476,310        | \$1,070,790      | \$979,898        |
| Cost of sales  | (351,973 )         | (320,758 )       | (717,955 )       | (652,196 )       |
| Operating expenses   | (112,118 )         | (106,628 )       | (234,041 )       | (219,247 )       |
| Change in fair value of derivative instruments   | (779 )             | (22,943 )        | (6,121 )         | (77,819 )        |
| Operating profit   | 47,348             | 25,981           | 112,673          | 30,636           |
| Interest expense   | (230 )             | (5,636 )         | (446 )           | (9,428 )         |
| Interest income  | 726                | 718              | 1,409            | 1,365            |
| Interest income (expense), net   | 496                | (4,918 )         | 963              | (8,063 )         |
| Income from continuing operations before income taxes                                  | 47,844             | 21,063           | 113,636          | 22,573           |
| Income tax (provision) benefit   | (18,526 )          | 124,640          | (45,711 )        | 99,701           |
| Income from continuing operations  | 29,318             | 145,703          | 67,925           | 122,274          |
| Income from discontinued operations, net of tax - Value City                           | —                  | 168              | —                | 168              |
| Income from discontinued operations, net of tax - Filene's Basement                    | —                  | —                | 1,253            | —                |
| Income from discontinued operations, net of tax  | —                  | 168              | 1,253            | 168              |
| Net income   | 29,318             | 145,871          | 69,178           | 122,442          |
| Less: net income attributable to the noncontrolling interests                          | —                  | (6,001 )         | —                | (20,695 )        |
| Net income, net of noncontrolling interests  | \$29,318           | \$139,870        | \$69,178         | \$101,747        |
| Basic and diluted earnings per share:  |                    |                  |                  |                  |
| Basic earnings per share from continuing operations, net of noncontrolling interests   | \$0.66             | \$4.05           | \$1.54           | \$3.60           |
| Diluted earnings per share from continuing operations, net of noncontrolling interests | \$0.65             | \$3.95           | \$1.51           | \$3.54           |
| Basic earnings per share from discontinued operations                                  | \$0.00             | \$0.01           | \$0.03           | \$0.01           |
| Diluted earnings per share from discontinued operations                                | \$0.00             | \$0.01           | \$0.03           | \$0.01           |
| Basic earnings per share, net of noncontrolling interests                              | \$0.66             | \$4.05           | \$1.57           | \$3.61           |
| Diluted earnings per share, net of noncontrolling interests                            | \$0.65             | \$3.96           | \$1.54           | \$3.54           |
| Shares used in per share calculations:   |                    |                  |                  |                  |
| Basic  | 44,454             | 34,522           | 44,067           | 28,211           |
| Diluted  | 45,256             | 35,360           | 44,957           | 28,705           |
| Other Comprehensive Income:  |                    |                  |                  |                  |
| Change in minimum pension liability, net of taxes of \$74                              | \$124              | \$—              | \$124            | \$—              |
| Comprehensive income   | \$29,442           | \$139,870        | \$69,302         | \$101,747        |

The accompanying Notes are an integral part of the Condensed Consolidated Financial Statements.

3

---

## DSW INC.

## CONDENSED CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY

(in thousands)

(unaudited)

|   | Number of Shares            |                             |                    |                             |                             | Retained<br>Earnings<br>(Accumulated<br>Deficit) | Total<br>Accumulated<br>Other<br>Comprehensive<br>Loss | Noncon-trolling<br>Interests | Total      |            |
|---|-----------------------------|-----------------------------|--------------------|-----------------------------|-----------------------------|--|--|------------------------------|------------|------------|
|   | Class A<br>Common<br>Shares | Class B<br>Common<br>Shares | Treasury<br>Shares | Class A<br>Common<br>Shares | Class B<br>Common<br>Shares |  |  |                              |            |            |
| Balance, January<br>29, 2011  | 21,873                      |                             | 3                  | \$ 330,022                  |                             | \$(59 )  | \$( 78,940 )   | \$( 5,842 )                  | \$ 243,688 | \$ 488,869 |
| Income from<br>continuing<br>operations, net of<br>tax                    |                             |                             |                    |                             |                             | 101,579  |  | 20,695                       |            | 122,274    |
| Income from<br>discontinued<br>operations, net of<br>tax                  |                             |                             |                    |                             |                             | 168  |  |                              |            | 168        |
| Pre-merger share and shareholders' equity activity:                       |                             |                             |                    |                             |                             |  |  |                              |            |            |
| Capital<br>transactions of<br>subsidiary                                  |                             |                             |                    |                             |                             | 2,778  |  | 6,467                        |            | 9,245      |
| Net settlement of<br>restricted shares                                    | (10 )                       |                             |                    | (345 )                      |                             |  |  |                              |            | (345 )     |
| RVI stock-based<br>compensation<br>expense, before<br>related tax effects |                             |                             |                    | 157                         |                             |  |  |                              |            | 157        |
| Exercise of stock<br>options, net of<br>settlement of<br>taxes            | 108                         |                             |                    | 1,051                       |                             |  |  |                              |            | 1,051      |
| Exercise of<br>warrant  | 96                          |                             |                    | 4,579                       |                             |  |  |                              |            | 4,579      |
| Merger-related share and shareholders' equity activity:                   |                             |                             |                    |                             |                             |  |  |                              |            |            |
| Purchase of<br>noncontrolling<br>interest                                 | 17,121                      |                             |                    | 270,850                     |                             |  |  | (270,850 )                   |            | —          |
| Exchange of<br>Class A Common<br>Shares for Class<br>B Common<br>Shares   | (11,507 )                   | 11,507                      |                    | (177,059 )                  | 177,059                     |  |  |                              |            | —          |
| Retirement of<br>treasury shares  |                             |                             | (3 )               | (59 )                       | 59                          |  |  |                              |            | —          |
| Fractional shares<br>settled in cash                                      | (1 )                        |                             |                    | (28 )                       |                             |  |  |                              |            | (28 )      |

|   |        |        |   |           |           |     |          |             |      |          |           |
|---|--------|--------|---|-----------|-----------|-----|----------|-------------|------|----------|-----------|
| Cash settlement of RVI options and SARs                                       |        |        |   |           |           |     |          |             |      | (7,000 ) | (7,000 )  |
| Stock-based compensation expense related to cash settled RVI options and SARs |        |        |   |           |           |     |          |             |      | 255      | 255       |
| RVI stock-based compensation expense, before related tax effects              |        |        |   |           |           |     |          |             |      | 339      | 339       |
| Post-merger share and shareholders' equity activity:                          |        |        |   |           |           |     |          |             |      |          |           |
| DSW stock-based compensation expense, before related tax effects              |        |        |   |           |           |     |          |             |      | 1,108    | 1,108     |
| Exercise of DSW stock options, net of settlement of taxes                     | 94     |        |   |           |           |     |          |             |      | 1,911    | 1,911     |
| Stock units granted   |        |        |   |           |           |     |          |             |      | 14       | 14        |
| Vesting of restricted stock units, net of settlement of taxes                 | 1      |        |   |           |           |     |          |             |      | (22 )    | (22 )     |
| Excess tax benefit related to stock option exercises                          |        |        |   |           |           |     |          |             |      | 4,019    | 4,019     |
| Exchange of Class B Common Shares for Class A Common Shares                   | 335    | (335 ) |   | 5,170     | (5,170 )  |     |          |             |      |          | —         |
| Balance, July 30, 2011  | 28,110 | 11,172 | — | \$434,962 | \$171,889 | \$— | \$25,585 | \$ (5,842 ) | \$ — |          | \$626,594 |

The accompanying Notes are an integral part of the Condensed Consolidated Financial Statements.

DSW INC.  
CONDENSED CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY  
(in thousands)  
(unaudited)

|  | Number of Shares            |                             |                    | Class A<br>Common<br>Shares | Class B<br>Common<br>Shares | Treasury<br>Shares | Retained<br>Earnings<br>(Accum-ulated<br>Deficit) | Total<br>Accum-ulated<br>Other<br>Compre-hensive<br>Loss | Noncon-trolling<br>Interests | Total     |
|--|-----------------------------|-----------------------------|--------------------|-----------------------------|-----------------------------|--------------------|---|--|------------------------------|-----------|
|  | Class A<br>Common<br>Shares | Class B<br>Common<br>Shares | Treasury<br>Shares |                             |                             |                    |   |  |                              |           |
| Balance, January 28, 2012  | 32,122                      | 11,170                      | —                  | \$624,948                   | \$171,864                   | \$—                | \$ (1,739 )                                       | \$ (8,486 )  | \$ —                         | \$786,587 |
| Income from continuing operations, net of tax                    |                             |                             |                    |                             |                             |                    | 67,925  |  |                              | 67,925    |
| Income from discontinued operations, net of tax                  |                             |                             |                    |                             |                             |                    | 1,253   |  |                              | 1,253     |
| DSW stock-based compensation expense, before related tax effects |                             |                             |                    | 3,587                       |                             |                    |   |  |                              | 3,587     |
| Stock units granted  |                             |                             |                    | 953                         |                             |                    |   |  |                              | 953       |
| Exercise of stock options, net of settlement of taxes            | 509                         |                             |                    | 6,309                       |                             |                    |   |  |                              | 6,309     |
| Vesting of restricted stock units, net of settlement of taxes    | 66                          |                             |                    | (1,858 )                    |                             |                    |   |  |                              | (1,858 )  |
| Excess tax benefit related to stock option exercises             |                             |                             |                    | 7,747                       |                             |                    |   |  |                              | 7,747     |
| Exchange of Class B Common Shares for Class A Common Shares      | 2,262                       | (2,262 )                    |                    | 34,820                      | (34,820 )                   |                    |   |  |                              | —         |
| Exercise of warrants   |                             | 753                         |                    |                             | 43,216                      |                    |   |  |                              | 43,216    |
| Payment of dividends (\$0.33 per share)                          |                             |                             |                    |                             |                             |                    | (14,545 )   |  |                              | (14,545 ) |
| Change in minimum pension liability, net of taxes of \$74        |                             |                             |                    |                             |                             |                    |   | 124  |                              | 124       |

Edgar Filing: DSW Inc. - Form 10-Q

|                           |        |       |   |           |           |     |           |             |      |           |
|---------------------------|--------|-------|---|-----------|-----------|-----|-----------|-------------|------|-----------|
| Balance, July 28,<br>2012 | 34,977 | 9,661 | — | \$676,506 | \$180,260 | \$— | \$ 52,894 | \$ (8,362 ) | \$ — | \$901,298 |
|---------------------------|--------|-------|---|-----------|-----------|-----|-----------|-------------|------|-----------|

The accompanying Notes are an integral part of the Condensed Consolidated Financial Statements.

DSW INC.  
 CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS  
 (in thousands)  
 (unaudited)

|  | Six months ended |               |
|--|------------------|---------------|
|  | July 28, 2012    | July 30, 2011 |
| Cash flows from operating activities:  |                  |               |
| Net income   | \$69,178         | \$122,442     |
| Less: income from discontinued operations, net of tax  | (1,253)          | (168)         |
| Income from continuing operations, net of tax  | \$67,925         | \$122,274     |
| Adjustments to reconcile net income to net cash provided by operating activities from continuing operations: |                  |               |
| Amortization of debt issuance costs and discount on debt   | 101              | 4,513         |
| Depreciation and amortization  | 27,491           | 25,740        |
| Capital transactions of subsidiary   | —                | 2,778         |
| DSW and RVI stock-based compensation expense   | 3,587            | 1,859         |
| Deferred income taxes  | 42,288           | (136,910)     |
| Change in fair value of derivative instruments   | 6,121            | 77,819        |
| Loss on disposal of long-lived assets  | 1,285            | 565           |
| Excess tax benefits related to stock option exercises  | (7,747)          | (4,019)       |
| Other  | 14,051           | 13,937        |
| Change in working capital, assets and liabilities:   |                  |               |
| Accounts receivable, net   | (7,792)          | 729           |
| Inventories  | (32,838)         | (9,250)       |
| Prepaid expenses and other current assets  | 578              | 4,071         |
| Accounts payable   | 3,813            | (25,365)      |
| Accrued expenses   | (17,389)         | (13,267)      |
| Net cash provided by operating activities from continuing operations   | \$101,474        | \$65,474      |
| Cash flows from investing activities:  |                  |               |
| Cash paid for property and equipment   | (47,041)         | (34,072)      |
| Purchases of available-for-sale investments  | (29,680)         | (109,580)     |
| Purchases of held-to-maturity investments  | (191,164)        | (119,080)     |
| Maturities and sales of available-for-sale investments   | 49,992           | 60,705        |
| Maturities of held-to-maturity investments   | 94,536           | 88,814        |
| Activity related to long-term investment - related party   | —                | (95)          |
| Net cash used in investing activities from continuing operations   | \$(123,357)      | \$(113,308)   |
| Cash flows from financing activities:  |                  |               |
| Loan proceeds from related party loan  | —                | 11,000        |
| Payment of related party loan  | —                | (11,000)      |
| Proceeds from exercise of stock options  | 10,199           | 2,962         |
| Shares withheld to satisfy income tax withholdings for restricted stock unit vesting and option exercises    | (5,748)          | —             |
| Cash settlement of RVI options and SARs  | —                | (7,000)       |
| Debt issuance costs  | —                | (2,625)       |
| Cash paid for fractional shares  | —                | (28)          |
| Dividends paid   | (16,051)         | —             |
| Proceeds from the exercise of warrants   | 7,792            | 995           |

Edgar Filing: DSW Inc. - Form 10-Q

|  |         |          |   |
|--|---------|----------|---|
| Excess tax benefits related to stock option exercises                          | 7,747   | 4,019    |   |
| Net cash provided by (used in) financing activities from continuing operations | \$3,939 | \$(1,677 | ) |

6

---

Edgar Filing: DSW Inc. - Form 10-Q

|  | Six months ended |               |
|--|------------------|---------------|
|  | July 28, 2012    | July 30, 2011 |
| Net decrease in cash and equivalents from continuing operations                          | (17,944          | ) (49,511     |
| Cash and equivalents, beginning of period  | 79,003           | 99,126        |
| Cash and equivalents, end of period  | \$61,059         | \$49,615      |
| Supplemental disclosures of cash flow information:                                       |                  |               |
| Cash paid during the period for interest   | \$—              | \$4,909       |
| Cash paid during the period for income taxes   | \$3,820          | \$22,623      |
| Proceeds from construction and tenant allowances   | \$5,995          | \$5,055       |
| Non-cash investing and financing activities:   |                  |               |
| Balance of accounts payable and accrued expenses due to property and equipment purchases | \$8,354          | \$8,032       |
| Amortization of investment discounts and premiums  | \$3,170          | \$2,881       |
| Additional paid in capital transferred from warrant liability due to warrant exercises   | \$35,424         | \$3,584       |

The accompanying Notes are an integral part of the Condensed Consolidated Financial Statements.

7

---

Table of Contents

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

1. BUSINESS OPERATIONS AND BASIS OF PRESENTATION

Business Operations- DSW and its wholly owned subsidiaries are herein referred to collectively as DSW or the “Company”. DSW’s Class A Common Shares are listed on the New York Stock Exchange under the ticker symbol “DSW”.

DSW has two reportable segments: the DSW segment, which includes the DSW stores and dsw.com sales channels, and the leased business division segment. DSW offers a wide assortment of brand name dress, casual and athletic footwear and accessories for women and men. As of July 28, 2012, DSW operated a total of 337 stores located in 41 states and dsw.com. During the six months ended July 28, 2012, DSW opened 12 new DSW stores and closed 1 DSW store.

DSW also operates leased departments for three retailers in its leased business division segment. As of July 28, 2012, DSW supplied merchandise to 262 Stein Mart stores, 80 Gordmans stores and one Frugal Fannie’s store. During the six months ended July 28, 2012, DSW added 9 new leased departments and ceased operations in 2 leased departments. DSW owns the merchandise and the fixtures, records sales of merchandise, net of returns through period end and excluding sales tax, and provides management oversight. The retailers provide the sales associates and retail space. DSW pays a percentage of net sales as rent, which is included in cost of sales as occupancy expense.

Basis of Presentation- The accompanying unaudited condensed consolidated interim financial statements should be read in conjunction with DSW’s Annual Report on Form 10-K filed with the Securities and Exchange Commission (“SEC”) on March 27, 2012 (the “2011 DSW Annual Report”). In the opinion of management, the unaudited condensed consolidated interim financial statements reflect all adjustments, consisting of normal recurring adjustments, which are necessary to present fairly the consolidated financial position, results of operations and cash flows for the periods presented.

2. BACKGROUND

Merger with Retail Ventures, Inc. ("the Merger")- On May 26, 2011, Retail Ventures, Inc. (“Retail Ventures” or “RVI”) merged with and into DSW MS LLC (“Merger Sub”), with Merger Sub surviving the Merger and continuing as a wholly owned subsidiary of DSW. Upon the closing of the Merger, each outstanding RVI common share was converted into 0.435 DSW Class A Common Shares, unless the holder of each outstanding RVI common share properly and timely elected to receive a like amount of DSW Class B Common Shares.

The Merger was accounted for as a reverse merger with RVI as the accounting acquirer and DSW (the surviving legal entity) as the accounting acquiree. As the Merger was an equity transaction between entities under common control, purchase accounting was not applied. Pre-merger financial information presented in the DSW consolidated financial statements represents consolidated RVI financial information. References to Retail Ventures or RVI refer to the pre-merger entity. The pre-merger financial information was retrospectively recast for the following matters:

• Share and per share information- DSW recast all RVI historical share and per share information, including earnings per share, to reflect the exchange ratio of 0.435 for all periods presented.

• Segment presentation- DSW maintained its historical segment presentation, which is consistent with how the chief operating decision maker, as defined in Accounting Standard Codification ("ASC") 280, Segment Reporting, reviews the business. DSW sells products through three channels: DSW stores, dsw.com and the leased business division. The reportable segments are the DSW segment, which includes the DSW stores and dsw.com sales channels, and the

leased business division segment. In order to reconcile to the condensed consolidated financial statements, DSW includes Other, which consists of assets, liabilities and expenses that are not attributable to the two reportable segments. The pre-merger or prior period condensed consolidated financial statements and notes were recast to reflect the two reportable segments and Other.

Cost of sales- DSW conformed RVI's accounting policies and recast RVI's pre-merger or prior period financial statements and notes for warehousing and store occupancy costs historically reported by RVI within operating expenses to be consistent with DSW's historical classification of these costs within cost of sales.

Principles of Consolidation- The condensed consolidated financial statements include the accounts of DSW and its wholly owned subsidiaries. All intercompany accounts and transactions have been eliminated in consolidation. In fiscal 2009 and fiscal 2007, RVI disposed of its Filene's Basement operations and Value City operations, respectively.

Table of Contents

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

Filene's Basement- On April 21, 2009, RVI disposed of Filene's Basement, Inc. and certain related entities to FB II Acquisition Corp., a newly formed entity owned by Buxbaum Holdings, Inc. ("Buxbaum"). RVI agreed to indemnify Buxbaum, FB II Acquisition Corp. and their owners against certain liabilities. On May 4, 2009, Filene's Basement filed for bankruptcy protection. On June 18, 2009, following bankruptcy court approval, SYL LLC, a subsidiary of Syms Corp ("Syms"), purchased certain assets of Filene's Basement. As of July 28, 2012, the Company had a liability of \$6.9 million under lease obligations related to leases assumed by Syms and a liability of less than \$0.1 million related to leases not assumed by Syms. See Note 16 for additional disclosure regarding the lease obligations.

3. SIGNIFICANT ACCOUNTING POLICIES

Allowance for Doubtful Accounts- The Company monitors its exposure for credit losses and records related allowances for doubtful accounts. Allowances are estimated based upon specific accounts receivable balances, where a risk of default has been identified. As of July 28, 2012 and January 28, 2012, the Company's allowances for doubtful accounts were \$0.3 million and \$0.6 million, respectively.

Inventories- Merchandise inventories are stated at lower of cost or market, determined using the retail inventory method. The retail method is widely used in the retail industry due to its practicality. Under the retail inventory method, the valuation of inventories at cost and the resulting gross profits are determined by applying a calculated cost to retail ratio to the retail value of inventories. The cost of the inventory reflected on the balance sheet is decreased by charges to cost of sales at the time the retail value of the inventory is lowered through the use of markdowns, which are reductions in prices due to customers' perception of value. Hence, earnings are negatively impacted as the merchandise is marked down prior to sale. Markdowns establish a new cost basis for inventory. Changes in facts or circumstances do not result in the reversal of previously recorded markdowns or an increase in the newly established cost basis. The markdown reserve requires management to make assumptions regarding customer preferences, fashion trends and consumer demand.

Inherent in the calculation of inventories are certain significant management judgments and estimates, including setting the original merchandise retail value, markdowns, and estimates of losses between physical inventory counts, or shrinkage, which combined with the averaging process within the retail method, can significantly impact the ending inventory valuation at cost and the resulting gross profit. DSW records a reduction to inventories and charge to cost of sales for shrinkage. Shrinkage is calculated as a percentage of sales from the last physical inventory date. Estimates are based on both historical experience as well as recent physical inventory results. Physical inventory counts are taken on an annual basis and have supported DSW's shrinkage estimates.

Sales and Revenue Recognition- Revenues from merchandise sales are recognized upon customer receipt of merchandise, are net of returns through period end, exclude sales tax and are not recognized until collectibility is reasonably assured. For sales through the dsw.com sales channel, DSW defers revenue representing a time lag for shipments to be received by the customer and also includes revenue from shipping and handling in net sales while the related costs are included in cost of sales. Revenue from gift cards is deferred and recognized upon redemption of the gift card. The Company's policy is to recognize income from breakage of gift cards when the likelihood of redemption of the gift card is remote.

Cost of Sales- In addition to the cost of merchandise, which includes markdowns and shrinkage, DSW includes in cost of sales expenses associated with warehousing (including depreciation), distribution and store occupancy (excluding depreciation and including store impairments). Warehousing costs are comprised of labor, benefits and other labor-related costs associated with the operations of the distribution and fulfillment centers. The non-labor costs associated with warehousing include rent, depreciation, insurance, utilities, maintenance and other operating costs that

are passed to DSW from the landlord. Distribution costs include the transportation of merchandise to the distribution and fulfillment centers, from the distribution center to DSW's stores and from the fulfillment center to the customer. Store occupancy costs include rent, utilities, repairs, maintenance, insurance, janitorial costs and occupancy-related taxes, which are primarily real estate taxes passed to DSW by its landlords.

Operating Expenses- Operating expenses include expenses related to store management and store payroll costs, advertising, leased business operations, store depreciation and amortization, new store advertising and other new store costs (which are expensed as incurred) and corporate expenses. Corporate expenses include expenses related to buying, information technology, depreciation expense for corporate cost centers, marketing, legal, finance, outside professional services, customer service center expenses, payroll and benefits for associates and payroll taxes.

Income Taxes- Income taxes are accounted for using the asset and liability method. The Company is required to determine the aggregate amount of income tax expense to accrue and the amount which will be currently payable based upon tax statutes of each jurisdiction in which the Company does business. In making these estimates, income is adjusted based on a

Table of Contents

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

determination of generally accepted accounting principles for items that are treated differently by the applicable taxing authorities. Deferred tax assets and liabilities, as a result of these differences, are reflected on DSW's balance sheet for temporary differences that will reverse in subsequent years. A valuation allowance is established against deferred tax assets when it is more likely than not that some or all of the deferred tax assets will not be realized. DSW succeeded to RVI's tax attributes as a result of the Merger.

**Noncontrolling Interests-** The noncontrolling interests represented the portion of legacy DSW's total shareholders' equity owned by unaffiliated investors in DSW prior to the Merger and net income attributable to the unaffiliated investors. The noncontrolling interest percentage was computed by the ratio of shares held by unaffiliated interests. After the Merger, noncontrolling interests were eliminated.

**Sale of Subsidiary Stock-** Prior to the Merger, sales of stock by a subsidiary were accounted for by RVI as capital transactions.

**Recent Accounting Pronouncements**

**Fair Value-** In May 2011, the Financial Accounting Standards Board ("FASB") issued an update to existing guidance related to fair value measurements on how to measure fair value and what disclosures to provide about fair value measurements. For fair value measurements categorized as level 3, a reporting entity should disclose quantitative information of the unobservable inputs and assumptions, a description of the valuation processes and narrative description of the sensitivity of the fair value to changes in unobservable inputs. This update is effective for interim and annual periods beginning after December 15, 2011. The adoption of this update in the first quarter of fiscal 2012 did not materially affect the Company's consolidated financial statements.

**Comprehensive Income-** In June 2011, the FASB issued an update to existing guidance related to the presentation of comprehensive income. The main provisions of this update provide that an entity that reports other comprehensive income has the option to present comprehensive income in either one continuous or two consecutive financial statements. The first option is a single statement that must present the components of net income and total net income, the components of other comprehensive income and total other comprehensive income and a total for comprehensive income. The second option is a two statement approach, in which an entity must present the components of net income and total net income in the first statement and that statement must be immediately followed by a financial statement that presents the components of other comprehensive income, a total for other comprehensive income, and a total for comprehensive income. The option in current generally accepted accounting principles that permits the presentation of other comprehensive income in the statement of changes in equity has been eliminated. This update is effective for interim and annual periods beginning after December 15, 2011. In November 2011, the FASB issued a proposed update to indefinitely defer the requirement to present reclassification adjustments in the statement of operations. The Company elected to present a single statement of operations and comprehensive income for quarterly reporting in the first quarter of fiscal 2012.

**Goodwill-** In September 2011, the FASB issued an update to existing guidance related to goodwill impairment testing. The amendments will allow an entity to first assess qualitative factors to determine whether it is necessary to perform the two-step quantitative goodwill impairment test. An entity no longer will be required to calculate the fair value of a reporting unit unless the entity determines, based on a qualitative assessment, that it is more likely than not that its fair value is less than its carrying amount. The guidance also includes examples of the types of factors to consider in conducting the qualitative assessment. This update is effective for interim and annual periods beginning after December 15, 2011. The adoption of this update in the first quarter of fiscal 2012 did not affect the Company's consolidated financial statements.

Intangible Assets- In July 2012, the FASB issued an update to existing guidance related to impairment testing for indefinite-lived intangible assets. The amendments will allow an entity to first assess qualitative factors to determine whether it is necessary to perform the quantitative impairment test. An entity no longer will be required to test the fair value of an intangible asset unless the entity determines, based on a qualitative assessment, that it is more likely than not that its fair value is less than its carrying amount. This update is effective for interim and annual periods beginning after September 15, 2012. The Company does not expect the adoption of this update to affect its consolidated financial statements.

#### 4. RELATED PARTY TRANSACTIONS

Schottenstein Affiliates- As of July 28, 2012, the Schottenstein Affiliates, entities owned by or controlled by Jay L. Schottenstein, the executive chairman of the DSW board of directors, and members of his family, owned approximately 23% of DSW's outstanding Common Shares representing approximately 69% of the combined voting power of DSW's outstanding Common Shares. As of July 28, 2012, the Schottenstein Affiliates owned 0.7 million Class A Common Shares and 9.6 million

Table of Contents

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

## Class B Common Shares.

DSW leases certain store, office space and distribution center locations owned by Schottenstein Affiliates as well as purchasing services and products from Schottenstein Affiliates. Accounts receivable from and payables to affiliates principally result from commercial transactions or affiliate transactions and normally settle in the form of cash in 30 to 60 days. As of July 28, 2012 and January 28, 2012, the balance of related party receivables was less than \$0.1 million and \$0.1 million, respectively. As of July 28, 2012 and January 28, 2012, the balance of related party payables was \$0.9 million and \$2.3 million, respectively.

## 5. STOCK-BASED COMPENSATION

Historically, both DSW and RVI issued stock-based compensation under their respective plans. After the Merger, DSW either cash settled or converted all outstanding units and options under the RVI 2000 Stock Incentive Plan ("the RVI Plan") to be exercisable for DSW Class A Common Shares. The RVI stock-based compensation instruments were adjusted retrospectively for the conversion ratio. Excluding the converted options, the DSW 2005 Equity Incentive Plan ("the DSW Plan") was otherwise not affected as a result of the Merger.

## DSW Stock Compensation Plan

The DSW Plan provides for the issuance of equity awards to purchase up to 7.6 million DSW Common Shares. The DSW Plan covers stock options, restricted stock units and director stock units. Eligible recipients include key employees of DSW and affiliates, as well as directors of DSW. Options generally vest 20% per year on a cumulative basis. Options granted under the DSW Plan generally remain exercisable for a period of ten years from the date of grant. Prior to fiscal 2005, DSW did not have a stock option plan or any equity units outstanding. Prior to the Merger, RVI accounted for all DSW share activity as a capital transaction of a subsidiary.

Stock Options- The following table summarizes DSW's stock option activity:

|                                  | Six months ended<br>July 28, 2012<br>(in thousands) |   |
|----------------------------------|---|---|
| Outstanding, beginning of period | 2,508   |   |
| Granted                          | 337   |   |
| Exercised                        | (635)   | ) |
| Forfeited                        | (36)  | ) |
| Outstanding, end of period       | 2,174   |   |
| Exercisable, end of period       | 952   |   |

DSW expensed \$2.7 million for both of the six months ended July 28, 2012 and July 30, 2011 related to stock options. The weighted-average grant date fair value of each option granted in the six months ended July 28, 2012 and July 30, 2011 was \$25.17 and \$20.44 per share, respectively. As of July 28, 2012, the total compensation cost related to nonvested DSW stock options not yet recognized was approximately \$14.9 million with a weighted average expense recognition period remaining of 3.8 years. The following table illustrates the weighted-average assumptions used in the Black-Scholes pricing model for DSW options granted in each of the periods presented:

| Assumptions:            | Six months ended<br>July 28, 2012 | July 30, 2011 |
|-------------------------|-----------------------------------|---------------|
| Risk-free interest rate | 1.2%                              | 2.4%          |

Edgar Filing: DSW Inc. - Form 10-Q

|   |           |           |
|---|-----------|-----------|
| Expected volatility of DSW common stock | 56.2%     | 55.1%     |
| Expected option term                    | 5.5 years | 5.9 years |
| Expected dividend yield                 | 1.2%      | 0.0%      |

Table of Contents

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

Restricted Stock Units ("RSU")- The following table summarizes DSW's restricted stock unit activity:

|                                  | Six months ended<br>July 28, 2012<br>(in thousands) |   |
|----------------------------------|---|---|
| Outstanding, beginning of period | 273   |   |
| Granted                          | 48  |   |
| Vested                           | (96)  | ) |
| Forfeited                        | (5)   | ) |
| Outstanding, end of period       | 220   |   |

DSW expensed \$0.8 million and \$0.6 million for the six months ended July 28, 2012 and July 30, 2011, respectively, related to restricted stock units. As of July 28, 2012, the total compensation cost related to nonvested restricted stock units not yet recognized was approximately \$3.3 million with a weighted average expense recognition period remaining of 3.0 years. The weighted average exercise price for all restricted stock units is zero.

Director Stock Units- DSW issues stock units to directors who are not employees of DSW. During the six months ended July 28, 2012 and July 30, 2011, DSW expensed \$1.0 million and \$0.9 million, respectively, for these grants. For new grants beginning in fiscal 2012, directors were given the option to exercise their units at a specified point in the future or upon completion of service. The following table summarizes DSW's director stock unit activity:

|                                  | Six months ended<br>July 28, 2012<br>(in thousands) |   |
|----------------------------------|---|---|
| Outstanding, beginning of period | 192   |   |
| Granted                          | 18  |   |
| Exercised                        | (32)  | ) |
| Outstanding, end of period       | 178   |   |

## Retail Ventures Stock Compensation Plan

Prior to the Merger, the RVI Plan provided for the issuance of stock options to purchase up to 13.0 million common shares (which represented 5.7 million DSW Common Shares factoring in the exchange ratio of 0.435 pursuant to the Merger) or the issuance of restricted stock to management, key employees of RVI and affiliates, consultants (as defined in the RVI Plan), and directors of RVI. Stock options generally vested 20% per year on a cumulative basis. Stock options granted under the RVI Plan were exercisable for a period of ten years from the date of grant.

Impact of Merger- At the date of the Merger, all RVI stock options and Stock Appreciation Rights ("SARs") granted to directors immediately vested resulting in compensation expense of \$0.3 million. At the election of each option holder, options and SARs were either paid in cash at a value equal to the RVI share price at close of the market on May 25, 2011 less the exercise price, or converted to be exercisable for DSW Class A Common Shares adjusted for the exchange ratio of 0.435. Immediately after the Merger, DSW paid \$7.0 million related to the settlement of these options and SARs, which was treated as a reduction of common stock value, and converted the remaining RVI options to 72,830 options exercisable for DSW Class A Common Shares. DSW recorded additional stock-based compensation expense of \$0.3 million related to the cash settled options and SARs as the fair value the recipient received was greater than the fair value of the option they held.

Stock Options and SARs- Excluding any expense related to the Merger, RVI expensed \$0.1 million for the six months ended July 30, 2011 related to stock options. RVI expensed less than \$0.1 million during the six months ended

July 30, 2011 related to SARs.

Restricted Shares- RVI expensed \$0.1 million for the six months ended July 30, 2011 related to restricted shares. All restricted shares were settled in the first quarter of fiscal 2011.

12

---

Table of Contents

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

## 6. INVESTMENTS

The majority of DSW's short-term available-for-sale investments are primarily municipal bonds with renewal dates of every 7 days, but longer stated maturities. Despite the long-term nature of the stated contractual maturities of these short-term investments, DSW has the ability to liquidate these securities at the renewal dates. For short-term held-to-maturity investments, which are primarily corporate bonds and municipal term notes, amortized cost approximates fair value. In addition to short-term investments, DSW has invested in long-term corporate bonds and municipal term notes to receive higher returns. These long-term investments have maturities greater than one year but less than three years and are classified as held-to-maturity. The following table discloses the major categories of DSW's investments as of the periods presented:

|                                      | Short-term investments |                  | Long-term investments |                  |
|--------------------------------------|------------------------|------------------|-----------------------|------------------|
|                                      | July 28, 2012          | January 28, 2012 | July 28, 2012         | January 28, 2012 |
| Available-for-sale:                  | (in thousands)         |                  |                       |                  |
| Bonds                                | \$114,010              | \$134,322        | \$—                   | \$—              |
| Commercial paper                     | 5,494                  | 5,485            | —                     | —                |
| Total available-for-sale investments | 119,504                | 139,807          | —                     | —                |
| Held-to-maturity:                    |                        |                  |                       |                  |
| Term notes and bonds                 | 200,406                | 156,890          | \$102,640             | \$52,707         |
| Investment – related party           | —                      | —                | 1,151                 | 1,151            |
| Total investments                    | \$319,910              | \$296,697        | \$103,791             | \$53,858         |

As of July 28, 2012 and January 28, 2012, short-term investments had gross holding gains of \$0.2 million and \$0.1 million, respectively, and as of both July 28, 2012 and January 28, 2012, gross holding losses of \$0.1 million. As of July 28, 2012 and January 28, 2012, long-term investments had gross holding gains of \$0.1 million and less than \$0.1 million, respectively, and as of both July 28, 2012 and January 28, 2012, gross holding losses of \$0.2 million.

## 7. DEBT OBLIGATIONS AND WARRANT LIABILITIES

**Derivative Instruments-** As of the effective time of the Merger, a subsidiary of DSW assumed RVI's obligations under the Premium Income Exchangeable Securities ("PIES") and warrants. The PIES were settled on September 15, 2011. In accordance with ASC 815, Derivatives and Hedging, DSW, and prior to the Merger, RVI, recognized all derivatives on the balance sheet at fair value based on the Black-Scholes pricing model using current market information. For derivatives that are not designated as hedges under ASC 815, changes in the fair values were recognized in earnings in the period of change. There were no derivatives designated as hedges outstanding as of July 28, 2012 or January 28, 2012. DSW does not hold or issue derivative financial instruments for trading purposes.

**Warrants-** The warrants originally issued by RVI on September 26, 2002 and updated on July 5, 2005 in connection with previously paid credit facilities qualified as derivatives under ASC 815. The fair values of the warrants were recorded on the balance sheet within current liabilities. As of January 28, 2012, DSW had outstanding warrants for 753,185 DSW Common Shares, which have all been exercised as of July 28, 2012.

On March 14, 2012, DSW issued 411,963 of its Class B Common Shares, without par value, to the Schottenstein Affiliates in connection with the exercise of its outstanding warrant. The common shares were issued at an exercise price of \$10.35 per share, for an aggregate cash purchase price of \$4.3 million, and DSW paid accrued dividends of

\$0.8 million related to the Company's special dividend issued on September 30, 2011. In connection with this exercise and in addition to the purchase price, DSW reclassified \$18.6 million from the warrant liability to paid in capital during the first quarter of fiscal 2012. In connection with this issuance, no underwriters were utilized, and no commissions were paid.

On May 31, 2012, DSW issued 341,222 of its Class B Common Shares, without par value, to the Schottenstein Affiliates in connection with the exercise of its outstanding warrants. The common shares were issued at an exercise price of \$10.35 per share, for an aggregate cash purchase price of \$3.5 million, and DSW paid accrued dividends of \$0.7 million related to the Company's special dividend issued on September 30, 2011. In connection with this exercise and in addition to the purchase price, DSW reclassified \$16.8 million from the warrant liability to paid in capital during the second quarter of fiscal 2012. In connection with this issuance, no underwriters were utilized, and no commissions were paid.

Table of Contents

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

The fair value of the warrants was estimated using the Black-Scholes pricing model with the following assumptions for the period presented:

|                                     |                  |
|-------------------------------------|------------------|
| Assumptions:                        | January 28, 2012 |
| Risk-free interest rate             | 0.1%             |
| Expected volatility of common stock | 43.5%            |
| Expected term                       | 0.4 years        |
| Expected dividend yield             | 1.3%             |

The fair value and balance sheet location of DSW's derivative liability were as follows for the period presented:

|                          |                        |                                    |
|--------------------------|------------------------|------------------------------------|
|                          | Balance Sheet Location | January 28, 2012<br>(in thousands) |
| Warrants – related party | Warrant liability      | \$29,303                           |

\$143.75 Million Premium Income Exchangeable Securities<sup>SM</sup> ("PIES")- A subsidiary of DSW assumed, as of the effective time of the Merger, by supplemental indenture and supplemental agreement, all of RVI's obligations with respect to the PIES. On September 15, 2011, DSW issued 3.8 million of its Class A Common Shares to the holders of the PIES. The embedded exchange feature of the PIES was accounted for as a derivative, which was recorded at fair value with changes in fair value in the statement of operations. Accordingly, the accounting for the embedded derivative addressed the variations in the fair value of the obligation to settle the PIES when the market value exceeded or was less than the threshold appreciation price.

The amount of interest expense recognized and the effective interest rate for the PIES were as follows for the period presented:

|                               |   |   |
|-------------------------------|---|---|
|                               | Six months ended<br>July 30, 2011<br>(in thousands) |   |
| Contractual interest expense  | \$4,762   |   |
| Amortization of debt discount | 1,266   |   |
| Total interest expense        | \$6,028   |   |
| Effective interest rate       | 8.6   | % |

The effect of derivative instruments on DSW's, and prior to the Merger, RVI's, condensed consolidated statements of operations was as follows for the periods presented:

|   |                    |               |                  |               |
|---|--------------------|---------------|------------------|---------------|
|   | Three months ended |               | Six months ended |               |
|   | July 28, 2012      | July 30, 2011 | July 28, 2012    | July 30, 2011 |
|   | (in thousands)     |               |                  |               |
| Warrants – related party  | \$779              | \$4,345       | \$6,121          | \$13,893      |
| Warrants – non-related party  | —                  | —             | —                | 1,192         |
| Conversion feature of short-term debt                                 | —                  | 18,598        | —                | 62,734        |
| Expense related to the change in fair value of derivative instruments | \$779              | \$22,943      | \$6,121          | \$77,819      |

DSW \$100 Million Secured Credit Facility ("the Credit Facility")- On June 30, 2010, DSW entered into a \$100 million secured revolving credit facility with a term of four years that will expire on June 30, 2014. The Credit

Facility allows the payment of dividends or redemption of stock provided that DSW meets the minimum cash and short-term investments requirement of \$125 million, as defined in the Credit Facility. Additional covenants limit payments for capital expenditures to \$125 million in any fiscal year, and if DSW has direct borrowings greater than \$25 million, the Credit Facility also requires that DSW maintain a fixed charge coverage ratio of not less than 1.1 to 1.0. DSW paid \$47.0 million for capital expenditures for the six months ended July 28, 2012. DSW was not required to calculate a fixed charge coverage ratio for the six months

Table of Contents

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

ended July 28, 2012.

As of July 28, 2012 and January 28, 2012, DSW had no outstanding borrowings under the Credit Facility, had availability under the facility of \$69.9 million and \$82.7 million, respectively, and had outstanding letters of credit of \$30.1 million and \$17.3 million, respectively.

## 8. FAIR VALUE MEASUREMENTS

Fair value is defined as 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. Therefore, fair value is a market-based measurement based on assumptions of the market participants. As a basis for these assumptions, DSW classifies its fair value measurements under the following fair value hierarchy:

Level 1 inputs are unadjusted quoted prices in active markets for identical assets or liabilities that are publicly accessible. Active markets have frequent transactions with enough volume to provide ongoing pricing information. Level 2 inputs are other than level 1 inputs that are directly or indirectly observable. These can include unadjusted quoted prices for similar assets or liabilities in active markets, unadjusted quoted prices for identical assets or liabilities in inactive markets or other observable inputs.

Level 3 inputs are unobservable inputs.

Financial Assets and Liabilities- The following table presents financial assets and liabilities measured at fair value on a recurring basis as of the periods presented:

|   | As of July 28, 2012 |          |           |         | As of January 28, 2012 |          |           |         |
|---|---------------------|----------|-----------|---------|------------------------|----------|-----------|---------|
|   | Total               | Level 1  | Level 2   | Level 3 | Total                  | Level 1  | Level 2   | Level 3 |
| Assets:                                 | (in thousands)      |          |           |         |                        |          |           |         |
| Cash and equivalents <sup>(a)</sup>     | \$61,059            | \$61,059 | \$—       | \$—     | \$79,003               | \$79,003 | \$—       | \$—     |
| Short-term investments <sup>(b)</sup>   | 319,947             | —        | \$319,947 | —       | 296,697                | —        | \$296,697 | —       |
| Long-term investments <sup>(b)(c)</sup> | 103,667             | —        | 102,516   | \$1,151 | 53,858                 | —        | 52,707    | \$1,151 |
|   | \$484,673           | \$61,059 | \$422,463 | \$1,151 | \$429,558              | \$79,003 | \$349,404 | \$1,151 |
| Liabilities:                            |                     |          |           |         |                        |          |           |         |
| Warrant liability <sup>(d)</sup>        | \$—                 | —        | —         | —       | \$29,303               | —        | \$29,303  | —       |
|   | \$—                 | —        | —         | —       | \$29,303               | —        | \$29,303  | —       |

(a) Cash and equivalents primarily represent cash deposits and investments in money market funds held with financial institutions, as well as credit card receivables that generally settle within three days. The carrying amount approximates fair value because of the relatively short average maturity of the instruments.

(b) Available-for-sale and held-to maturity investments are valued using a market-based approach using level 2 inputs such as prices of similar assets in active markets.

(c) The long-term investment - related party is evaluated for other-than-temporary impairment on an annual basis or when a triggering event occurs using a discounted cash flow valuation model using level 3 inputs such as the financial condition of the entity.

(d) The underlying assumptions for fair value measurement of the warrant liability is detailed in Note 7. Prior to exercise, the Company classified its warrant liability within level 2 as the valuation inputs are based on market observable data.

The following table presents the activity related to level 3 fair value measurements for long-term investments for the periods presented:

|   | Three months ended |               |
|---|--------------------|---------------|
|   | July 28, 2012      | July 30, 2011 |
|   | (in thousands)     |               |
| Carrying value at the beginning of the period | \$1,151            | \$1,047       |
| Carrying value at the end of the period       | \$1,151            | \$1,047       |

Table of Contents

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

|  | Six months ended |               |
|--|------------------|---------------|
|  | July 28, 2012    | July 30, 2011 |
|  | (in thousands)   |               |
| Carrying value at the beginning of the period            | \$1,151          | \$952         |
| Activity related to long-term investment - related party | —                | 95            |
| Carrying value at the end of the period                  | \$1,151          | \$1,047       |

Non-Financial Assets and Liabilities- DSW periodically evaluates the carrying amount of its long-lived assets, primarily property and equipment, and finite lived intangible assets when events and circumstances warrant such a review to ascertain if any assets have been impaired. The carrying amount of a long-lived asset or asset group is considered impaired when the carrying value of the asset or asset group exceeds the expected future cash flows from the asset or asset group. The reviews are conducted at the lowest identifiable level, which includes a store. The impairment loss recognized is the excess of the carrying value of the asset or asset group over its fair value, based on a discounted cash flow analysis using a discount rate determined by management. Should an impairment loss be realized, it will generally be included in cost of sales. There were no significant non-recurring fair value measurements recorded for the six months ended July 28, 2012 or July 30, 2011.

## 9. EARNINGS PER SHARE AND SHAREHOLDERS' EQUITY

Earnings per Share- Basic earnings per share is based on net income and a simple weighted average of common shares outstanding. For periods prior to the Merger, share count was determined by adjusting all historical RVI shares by the exchange ratio of 0.435. Diluted earnings per share reflects the potential dilution of common shares adjusted, related to outstanding RVI stock options and SARs (prior to the Merger), outstanding DSW stock options and RSUs (after the Merger) and warrants calculated using the treasury stock method. As PIES are exchangeable for DSW Class A Common Shares, they were included as potentially dilutive instruments based on the DSW common share price, after the Merger and before the settlement.

For all periods presented, where there was a loss in fair value of warrants (prior to and after the Merger) and PIES (after the Merger), the loss was included in the calculation of the net income and the corresponding shares were excluded from the diluted share count, if the effect was anti-dilutive. As all periods presented had a loss in the fair value of warrants and PIES, there were no adjustments to net income used in the calculation of diluted earnings per share computations for the periods presented.

The following is a reconciliation of the number of shares used in the calculation of diluted earnings per share computations for the periods presented:

|  | Three months ended |               | Six months ended |               |
|--|--------------------|---------------|------------------|---------------|
|  | July 28, 2012      | July 30, 2011 | July 28, 2012    | July 30, 2011 |
|  | (in thousands)     |               |                  |               |
| Weighted average shares outstanding                            | 44,454             | 34,522        | 44,067           | 28,211        |
| Assumed exercise of dilutive DSW stock options                 | 700                | 594           | 763              | 297           |
| Assumed exercise of dilutive DSW RSUs                          | 102                | 213           | 127              | 107           |
| Assumed exercise of dilutive RVI stock options and SARs        | —                  | 31            | —                | 90            |
| Number of shares for computation of diluted earnings per share | 45,256             | 35,360        | 44,957           | 28,705        |

Options and RSUs- For the second quarter of fiscal 2012, the amount of securities outstanding as of both July 28, 2012 and July 30, 2011 that were not included in the computation of dilutive earnings per share because the effect would be anti-dilutive was approximately 0.3 million. For the year-to-date period, the amount of securities outstanding as of July 28, 2012 and July 30, 2011 that were not included in the computation of dilutive earnings per share because the effect would be anti-dilutive was approximately 0.3 million and 0.1 million, respectively.

Warrants- Warrants were anti-dilutive for all periods presented and were not included in the calculation of diluted shares. For the three months ended July 28, 2012 and July 30, 2011, the assumed exercise of warrants excluded was 0.1 million and 0.6 million, respectively. For the six months ended July 28, 2012 and July 30, 2011, the assumed exercise of warrants excluded was 0.3 million and 0.6 million, respectively.

Table of Contents

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

PIES- For the three and six months ended July 30, 2011, the assumed exercise of 2.8 million and 1.4 million, respectively, common shares that would convert upon redemption of the PIES was not included in the calculation of shares since there was a loss in fair value of the PIES. The total amount of common shares that would convert upon redemption of the PIES based on the average of DSW's share prices was 3.8 million, but the assumed conversion is prorated as the PIES were only included in the calculation of earnings per share after the Merger.

Shareholders' Equity- On June 18, 2012, DSW announced that its Board of Directors has authorized the Company to repurchase up to \$100 million of Company common shares over the next twelve months. The share repurchase program may be suspended, modified or discontinued at any time, and the Company has no obligation to repurchase any amount of its common shares under the program. As of July 28, 2012, DSW has not made any repurchases under this program.

## 10. INCOME TAXES

The provision for income taxes is based on the current estimate of the annual effective tax rate and is adjusted as necessary for quarterly events.

For the three and six months ended July 28, 2012, the effective tax rate of 38.7% and 40.2%, respectively, primarily reflects the impact of state and local taxes and the change in fair value of warrants included in book income but not tax income.

For the three and six months ended July 30, 2011, the effective tax rate of (591.7)% and (441.7)%, respectively, was favorably impacted by the release of the valuation allowance and other merger related tax items, which has been reflected as an income tax benefit in the Company's condensed consolidated statements of operations. DSW was able to release the valuation allowance on RVI's deferred tax assets as a result of the Company's expected future taxable income. In addition, as a result of the Merger with RVI, the deferred tax liability related to RVI's historical basis in DSW and the deferred tax asset related to the PIES were eliminated.

Consistent with its historical financial reporting, the Company has elected to classify interest expense related to income tax liabilities, when applicable, as part of interest expense in its consolidated statements of operations rather than income tax expense. The Company will continue to classify income tax penalties as part of operating expenses in its consolidated statements of operations.

## 11. PROPERTY AND EQUIPMENT

The balance sheet caption "Property and equipment, net" was comprised of the following for the periods presented:

|   | July 28, 2012<br>(in thousands) | January 28, 2012 |
|---|---------------------------------|------------------|
| Property and equipment:                   |                                 |                  |
| Furniture, fixtures and equipment         | \$316,198                       | \$295,162        |
| Leasehold improvements                    | 233,530                         | 215,519          |
| Total property and equipment              | 549,728                         | 510,681          |
| Accumulated depreciation and amortization | (296,629)                       | (274,955)        |
| Property and equipment, net               | \$253,099                       | \$235,726        |



Table of Contents

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

## 12. ACCRUED EXPENSES

The balance sheet caption "Accrued expenses" was comprised of the following for the periods presented:

|                                    | July 28, 2012  | January 28, 2012 |
|------------------------------------|----------------|------------------|
|                                    | (in thousands) |                  |
| Gift cards and merchandise credits | \$25,237       | \$28,248         |
| Compensation                       | 17,966         | 33,427           |
| Taxes                              | 14,548         | 13,128           |
| Customer loyalty program           | 15,646         | 14,577           |
| Guarantees                         | 6,887          | 9,030            |
| Other                              | 30,843         | 28,588           |
| Total accrued expenses             | \$111,127      | \$126,998        |

Customer Loyalty Program- DSW maintains a customer loyalty program for the DSW stores and dsw.com sales channels in which program members earn reward certificates that result in discounts on future purchases. Upon reaching the target-earned threshold, the members receive reward certificates for these discounts which expire six months after being issued. DSW accrues the anticipated redemptions of the discount earned at the time of the initial purchase. To estimate these costs, DSW makes assumptions related to customer purchase levels and redemption rates based on historical experience.

## 13. OTHER NON-CURRENT LIABILITIES

The balance sheet caption "Other non-current liabilities" was comprised of the following for the periods presented:

|                                     | July 28, 2012  | January 28, 2012 |
|-------------------------------------|----------------|------------------|
|                                     | (in thousands) |                  |
| Construction and tenant allowances  | \$71,483       | \$62,474         |
| Deferred rent                       | 37,780         | 35,673           |
| Other                               | 9,914          | 15,617           |
| Total other non-current liabilities | \$119,177      | \$113,764        |

Construction and Tenant Allowances- DSW receives cash allowances from landlords, which are deferred and amortized on a straight-line basis over the noncancelable terms of the lease as a reduction of rent expense.

Deferred Rent- Many of the Company's operating leases contain predetermined fixed increases of the minimum rentals during the initial lease terms. For these leases, the Company recognizes the related rental expense on a straight-line basis over the noncancelable terms of the lease. The Company records the difference between the amounts charged to expense and the rent paid as deferred rent and begins amortizing such deferred rent upon the delivery of the lease location by the lessor.

## 14. PENSION PLAN

Merger Sub is responsible for the Filene's Basement defined benefit pension plan (the "plan") that RVI assumed as part of its sale of Filene's Basement in fiscal 2009. Benefits were frozen as of April 30, 2000. The Company's funding policy is to contribute annually the amount required to meet ERISA ("Employee Retirement Income Security Act") funding standards and that is tax deductible under the Internal Revenue Code of 1986, as amended. The Company made contributions of \$1.2 million to the plan during the six months ended July 28, 2012. The Company uses a January 31 measurement date for the plan.

On December 1, 2011, DSW adopted a plan amendment to terminate the plan with a proposed termination date of March 22, 2012. DSW is currently awaiting regulatory approval. Prior to the pension plan being fully funded, certain regulatory approvals and participant settlement elections need to be obtained. In the second quarter of fiscal 2012, DSW reclassified the non-current pension liability to a current liability, accrued expenses, as DSW has been communicating with the regulatory authorities and expects resolution of the pension plan within the next twelve months.

Table of Contents

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

The components of net periodic benefit cost are comprised of the following for the periods presented:

|                                | Three months ended |               | Six months ended |               |
|--------------------------------|--------------------|---------------|------------------|---------------|
|                                | July 28, 2012      | July 30, 2011 | July 28, 2012    | July 30, 2011 |
|                                | (in thousands)     |               |                  |               |
| Interest cost                  | \$230              | \$251         | \$460            | \$501         |
| Expected return on plan assets | (302)              | (237)         | (604)            | (472)         |
| Amortization of net loss       | 99                 | 74            | 198              | 148           |
| Net periodic benefit cost      | \$27               | \$88          | \$54             | \$177         |

## 15. SEGMENT REPORTING

DSW maintained its historical segment presentation, but recast its segment presentation to include Other. In order to reconcile to the condensed consolidated financial statements, DSW includes Other, which consists of assets, liabilities and expenses that are not attributable to the two segments, primarily related to assets and liabilities of the former RVI operations.

The Company sells products through three channels: DSW stores, dsw.com and the leased business division. The reportable segments are the DSW segment, which includes the DSW stores and dsw.com sales channels, and the leased business division segment. DSW has identified such segments based on internal management reporting and responsibilities and measures segment profit as gross profit, which is defined as net sales less cost of sales. All operations are located in the United States. The goodwill balance of \$25.9 million outstanding as of July 28, 2012 and January 28, 2012 is recorded in the DSW segment related to the DSW stores.

|                                  | DSW segment    | Leased Business<br>Division segment | Other | Total       |
|----------------------------------|----------------|-------------------------------------|-------|-------------|
|                                  | (in thousands) |                                     |       |             |
| Three months ended July 28, 2012 |                |                                     |       |             |
| Net sales                        | \$482,244      | \$29,974                            | —     | \$512,218   |
| Gross profit                     | 154,808        | 5,437                               | —     | 160,245     |
| Capital expenditures             | 22,023         | 56                                  | —     | 22,079      |
| Three months ended July 30, 2011 |                |                                     |       |             |
| Net sales                        | \$442,142      | \$34,168                            | —     | \$476,310   |
| Gross profit                     | 148,707        | 6,845                               | —     | 155,552     |
| Capital expenditures             | 15,061         | 116                                 | —     | 15,177      |
| Six months ended July 28, 2012   |                |                                     |       |             |
| Net sales                        | \$1,003,395    | \$67,395                            | —     | \$1,070,790 |
| Gross profit                     | 338,485        | 14,350                              | —     | 352,835     |
| Capital expenditures             | 45,512         | 204                                 | —     | 45,716      |
| Six months ended July 30, 2011   |                |                                     |       |             |
| Net sales                        | \$904,504      | \$75,394                            | —     | \$979,898   |
| Gross profit                     | 311,328        | 16,374                              | —     | 327,702     |
| Capital expenditures             | 34,356         | 237                                 | —     | 34,593      |
| As of July 28, 2012              |                |                                     |       |             |
| Total assets                     | \$1,212,720    | \$94,426                            | \$529 | \$1,307,675 |

As of January 28, 2012

|              |             |          |       |   |             |
|--------------|-------------|----------|-------|---|-------------|
| Total assets | \$1,118,217 | \$89,740 | \$(57 | ) | \$1,207,900 |
|--------------|-------------|----------|-------|---|-------------|

19

---

Table of Contents

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

## 16. COMMITMENTS AND CONTINGENCIES

Legal Proceedings- DSW is involved in various legal proceedings that are incidental to the conduct of its business. DSW estimates the range of liability related to pending litigation where the amount of the range of loss can be estimated. DSW records its best estimate of a loss when the loss is considered probable. When a liability is probable and there is a range of estimated loss, DSW records the most likely estimated liability related to the claim. Although it is not possible to predict with certainty the eventual outcome of any litigation, in the opinion of management, the amount of any potential liability with respect to current legal proceedings will not be material to DSW's results of operations or financial condition. As additional information becomes available, DSW will assess the potential liability related to its pending litigation and revise the estimates as needed.

As previously reported, on March 8, 2005, Retail Ventures announced that it had learned of the theft of credit card and other information from a portion of DSW's customers. DSW incurred a loss of approximately \$6.0 million relating to this incident. DSW filed a claim for coverage with its insurance carrier, which the insurance carrier denied. DSW brought suit in federal district court and won a ruling that coverage applied and was awarded \$6.8 million in damages. The insurance company appealed that decision, and oral arguments on the appeal occurred in July 2012. See Note 17 regarding the results of the appeal. DSW has not recorded any amounts related to the possible recovery.

Guarantees and Liabilities related to Discontinued Operations- As of the effective time of the Merger, a subsidiary of DSW assumed the obligations under RVI's guarantees related to discontinued operations. DSW may become subject to various risks related to guarantees and in certain circumstances may be responsible for certain other liabilities related to discontinued operations. Changes in the amount of guarantees and liabilities related to discontinued operations are included in the income or loss from discontinued operations on the statements of operations. DSW records its best estimate of a loss when the loss is considered probable. When a liability is probable and there is a range of estimated loss, DSW records the most likely estimated liability related to the guarantee. Additionally, if the underlying obligations are paid down or otherwise liquidated by the primary obligor, subject to certain statutory requirements, DSW will recognize a reduction of the associated liability.

Filene's Basement- Following the Merger, a subsidiary of DSW, Merger Sub, assumed RVI's obligations under lease guarantees for three Filene's Basement retail store locations for leases assumed by Syms in its purchase of Filene's Basement in 2009. On November 2, 2011, Syms and Filene's Basement filed for bankruptcy protection and liquidated all of their stores in December 2011. DSW recorded a liability of \$9.0 million related to lease guarantees for two locations in fiscal 2011 and in the first quarter of fiscal 2012, adjusted the liability to \$6.9 million based on current information available to DSW, which resulted in an update of the most likely estimate. DSW assumed the lease for the third location in fiscal 2011. These lease guarantees are described in more detail below.

Union Square, NY- RVI guaranteed Filene's Basement's obligations for the Union Square location when RVI owned Filene's Basement, and the landlord at the Union Square location has brought a lawsuit against Merger Sub in the Supreme Court of the State of New York seeking payment under the guarantee. DSW believes that the liability under the guarantee may be limited based on the ultimate disposition of the lease and/or the guarantee may not be enforceable. In April 2012, the landlord advised DSW that it had signed a lease with a tenant and asserted that DSW is responsible for shortfalls and rent while the space is unoccupied. The expected range of loss is from no loss to \$8 million.

Bergen, NJ- RVI guaranteed Filene's Basement's obligations for the Bergen location when RVI owned Filene's Basement. The lease expires in September 2017. The landlord at the Bergen location has brought a lawsuit against

Merger Sub in the Supreme Court of the State of New Jersey seeking payment under the guarantee. The lease guarantee expressly caps Merger Sub's liability at \$3 million. Filene's Basement ceased operating at the Bergen location earlier in the year prior to the bankruptcy, and a third party is operating in a portion of the space leased by Filene's Basement. Currently, the ultimate disposition of the lease is unknown. DSW could successfully assert that the guarantee is not enforceable resulting in limited or no liability to DSW. The expected range of loss is from no loss to \$3 million.

Contractual Obligations- As of July 28, 2012, DSW has entered into various construction commitments, including capital items to be purchased for projects that were under construction, or for which a lease has been signed. DSW's obligations under these commitments were approximately \$7.5 million as of July 28, 2012. In addition, DSW has signed lease agreements for 32 new store locations expected to be opened over the next eighteen months, with total annual rent of approximately \$12.3 million. In connection with the new lease agreements, DSW will receive a total of \$17.6 million of construction and tenant allowance reimbursements for expenditures at these locations.

Table of Contents

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

17. SUBSEQUENT EVENTS

Dividends- On August 17, 2012, DSW announced that the Board of Directors approved a quarterly cash dividend of \$0.18 per share. The quarterly dividend will be paid on September 28, 2012 to shareholders of record at the close of business on September 18, 2012.

Legal Proceedings- As previously reported, on March 8, 2005, Retail Ventures announced that it had learned of the theft of credit card and other information from a portion of DSW's customers. DSW incurred a loss of approximately \$6.0 million relating to this incident. DSW filed a claim for coverage with its insurance carrier, which the insurance carrier denied. DSW brought suit in federal district court and won a ruling that coverage applied and was awarded \$6.8 million in damages. The insurance company appealed that decision, and oral arguments on the appeal occurred in July 2012. On August 23, 2012, DSW received notification from the Sixth Circuit Court of Appeals that the damages award was affirmed. The insurance carrier has 21 days to appeal the verdict. As this is a gain contingency resulting from a legal settlement, DSW will recognize the award at the time of receipt of cash from the insurance carrier.

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

All references to “we,” “us,” “our,” “DSW” or the “Company” in this Quarterly Report on Form 10-Q mean DSW Inc. and its wholly owned subsidiaries, including DSW Shoe Warehouse, Inc. (“DSWSW”), except where it is made clear that the term only means DSW Inc. DSW Class A Common Shares are listed for trading under the ticker symbol “DSW” on the New York Stock Exchange (“NYSE”). Prior to the merger with Retail Ventures, Inc. (the “Merger”) completed on May 26, 2011, DSW was a controlled subsidiary of Retail Ventures, Inc. (“RVI” or “Retail Ventures”). RVI common shares, without par value, which traded under the symbol “RVI”, were delisted from the New York Stock Exchange on May 26, 2011.

Company Overview

DSW is a leading U.S. branded footwear and accessories specialty retailer operating 337 shoe stores in 41 states as of July 28, 2012, and dsw.com. We offer a wide assortment of brand name and designer dress, casual and athletic footwear for women and men, as well as accessories through our DSW stores and dsw.com. We also offer kids' shoes exclusively on dsw.com. In addition, we operate 343 leased departments for three other retailers as of July 28, 2012. Our typical DSW customers are brand, value, quality and style conscious shoppers who have a passion for fashionable footwear and accessories. Our core focus is to create a distinctive shopping experience that satisfies both the rational and emotional shopping needs of our DSW customers by offering them a vast, exciting assortment of in-season styles combined with the convenience and value they desire. Our DSW stores average approximately 22,000 square feet and carry approximately 25,000 pairs of shoes. We believe this combination of assortment, convenience and value differentiates us from our competitors and appeals to consumers from a broad range of socioeconomic and demographic backgrounds.

On May 26, 2011, RVI merged with and into DSW MS LLC (“Merger Sub”), with Merger Sub surviving the Merger and continuing as a wholly owned subsidiary of DSW. Upon the closing of the Merger, each outstanding RVI common share was converted into 0.435 DSW Class A Common Shares, unless the holder properly and timely elected to receive a like amount of DSW Class B Common Shares. The Merger was accounted for as a reverse merger with RVI as the accounting acquirer and DSW (the surviving legal entity) as the accounting acquiree. As the Merger was an equity transaction between entities under common control, purchase accounting was not applied. Pre-merger financial information presented in the DSW consolidated financial statements represents consolidated RVI financial information. References to Retail Ventures or RVI refer to the pre-merger entity. The pre-merger financial information was retrospectively recast for the following matters:

• Share and per share information- DSW recast all RVI historical share and per share information, including earnings per share, to reflect the exchange ratio of 0.435 for all periods presented.

• Segment presentation- DSW maintained its historical segment presentation. DSW sells products through three channels: DSW stores, dsw.com and the leased business division. The reportable segments are the DSW segment, which includes the DSW stores and dsw.com sales channels, and the leased business division segment. In order to reconcile to the consolidated financial statements, DSW includes Other, which consists of assets, liabilities and expenses that are not attributable to the two reportable segments. The pre-merger or prior period consolidated financial statements and notes were recast to reflect the two reportable segments and Other.

• Cost of sales- DSW conformed RVI's accounting policies and recast RVI's pre-merger or prior period financial statements and notes for warehousing and store occupancy costs historically reported by RVI within operating expenses to be consistent with DSW's historical classification of these costs within cost of sales.

Cautionary Statement Regarding Forward-Looking Information for Purposes of the “Safe Harbor” Provisions of the Private Securities Litigation Reform Act of 1995

Some of the statements in this Quarterly Report on Form 10-Q contain forward-looking statements which reflect our current views with respect to, among other things, future events and financial performance. Such forward-looking statements can be identified by the use of forward-looking words such as “outlook,” “believes,” “expects,” “potential,” “continues,” “may,” “should,” “seeks,” “approximately,” “predicts,” “intends,” “plans,” “estimates,” “anticipates” or the negative counterparts of those words or other comparable words. Any forward-looking statements contained in this Quarterly Report on Form 10-Q are based upon current plans, estimates, expectations and assumptions relating to our operations, results of operations, financial condition, growth strategy and liquidity. The inclusion of this forward-looking information should not be regarded as a representation by us or any other person that the future plans, estimates or expectations contemplated by us will be achieved. Such forward-looking statements are subject to numerous risks, uncertainties and other factors that may cause actual results, performance or achievements to be materially different from any future results, performance or achievements expressed or implied by the forward-looking statements. In addition to those factors described under “Part I, Item 1A. Risk Factors,” in the DSW Form 10-K filed on March 27, 2012 and under “Part II, Item 1A. Risk Factors,” included in this Form 10-Q, some important factors that could cause actual results, performance or achievements for DSW to differ

materially from those discussed in forward-looking statements include, but are not limited to, the following:

- our success in opening and operating new stores on a timely and profitable basis;
- continuation of supply agreements and the financial condition of our leased business partners;
- disruption of our distribution and fulfillment operations;
- failure to retain our key executives or attract qualified new personnel;
- our competitiveness with respect to style, price, brand availability and customer service;
- our reliance on our “DSW Rewards” program to drive traffic, sales and customer loyalty;
- maintaining good relationships with our
  - vendors;
- our ability to anticipate and respond to fashion trends;
- fluctuation of our comparable sales and quarterly financial performance;
- uncertain general economic conditions;
- our reliance on foreign sources for merchandise and risks inherent to international trade;
- risks related to our cash and investments; and
- the realization of risks related to the Merger, including risks related to pre-merger RVI guarantees of certain Filene’s Basement leases.

If one or more of these or other risks or uncertainties materialize, or if our underlying assumptions prove to be incorrect, actual results, performance or achievements may vary materially from what we have projected. Furthermore, new factors emerge from time to time and it is not possible for management to predict all such factors, nor can it assess the impact of any such factor on the business or the extent to which any factor, or combination of factors, may cause results to differ materially from those contained in any forward-looking statement. Any forward-looking statement speaks only as of the date on which such statement is made, and, except as required by law, DSW undertakes no obligation to update any forward-looking statement to reflect events or circumstances after the date on which such statement is made or to reflect the occurrence of unanticipated events.

## Results of Operations

### Overview

During the six months ended July 28, 2012, DSW Inc. generated a 6.0% increase in comparable sales and a 9.3% increase in total sales. This comparable sales increase is in addition to a comparable sales increase of 11.5% for the comparable period last year. The increase in comparable sales was a result of an increase in traffic and conversion. All merchandise categories reported a positive comparable sales performance, with no single category driving the overall sales increase.

In the six months ended July 28, 2012, DSW Inc.'s merchandise margin rate decreased 70 basis points as a percentage of net sales over the six months ended July 30, 2011 as a result of increased markdowns. Our markdowns increased as we normalized our clearance mix to historical levels by taking additional clearance actions in the second quarter partially offset by favorable shrink results. Overall gross profit as a percentage of net sales decreased 40 basis points. In addition to the decrease in merchandise margin, occupancy leverage was offset by incremental labor to support business growth initiatives surrounding the reconfiguration of the Columbus distribution center and the expansion of the fulfillment center to support dsw.com growth.

Excluding the impact of DSW and RVI merger-related transaction costs and other RVI-related expenses of \$11.3 million in the six months ended July 30, 2011, operating expenses in the six months ended July 28, 2012 increased 70 basis points as a percentage of net sales over the prior year. This increase was primarily due to new store expenses as well as a planned shift in marketing expenses from the fall to the spring season.

We continue to make investments in our business that are critical to long-term growth, as well as returning value to our shareholders. During the six months ended July 28, 2012, we invested \$45.7 million in capital expenditures compared to \$34.6 million during the six months ended July 30, 2011. Our capital expenditures during the six months ended July 28, 2012 were primarily related to opening new stores, the distribution center reconfiguration, expansion of the fulfillment center, store remodels and business infrastructure. As a result of our financial condition, we have declared dividends of \$0.33 per share in the first half of fiscal 2012. As of July 28, 2012, our cash and short-term investments balance was \$381.0 million and long-term investments were \$103.8 million.

As of July 28, 2012, we operated 337 DSW stores, dsw.com and leased departments in 262 Stein Mart stores, 80 Gordmans stores, and one Frugal Fannie's store. DSW has two reportable segments: the DSW segment, which includes the DSW stores and dsw.com sales channels, and the leased business division segment.

Edgar Filing: DSW Inc. - Form 10-Q

The following table sets forth, for the periods indicated, the percentage relationships to net sales of the listed items included in our condensed consolidated statements of operations:

|   | Three months ended |                  | Six months ended |                  |
|---|--------------------|------------------|------------------|------------------|
|   | July 28,<br>2012   | July 30,<br>2011 | July 28,<br>2012 | July 30,<br>2011 |
| Net sales   | 100.0%             | 100.0%           | 100.0%           | 100.0%           |
| Cost of sales   | (68.7)             | (67.3)           | (67.0)           | (66.6)           |
| Gross profit  | 31.3               | 32.7             | 33.0             | 33.4             |
| Operating expenses  | (21.9)             | (22.4)           | (21.9)           | (22.4)           |
| Change in fair value of derivative instruments                | (0.2)              | (4.8)            | (0.6)            | (7.9)            |
| Operating profit  | 9.2                | 5.5              | 10.5             | 3.1              |
| Interest income (expense), net                                | 0.1                | (1.0)            | 0.1              | (0.8)            |
| Income from continuing operations before income taxes         | 9.3                | 4.5              | 10.6             | 2.3              |
| Income tax (provision) benefit                                | (3.6)              | 26.1             | (4.3)            | 10.2             |
| Income from continuing operations                             | 5.7                | 30.6             | 6.3              | 12.5             |
| Income from discontinued operations, net of tax               | —                  | —                | 0.1              | —                |
| Net income  | 5.7                | 30.6             | 6.4              | 12.5             |
| Less: net income attributable to the noncontrolling interests | —                  | (1.2)            | —                | (2.1)            |
| Net income, net of noncontrolling interests                   | 5.7%               | 29.4%            | 6.4%             | 10.4%            |

THREE MONTHS ENDED JULY 28, 2012 COMPARED TO THREE MONTHS ENDED JULY 30, 2011

Net Sales. Net sales for the second quarter of fiscal 2012 increased 7.5% from the second quarter of fiscal 2011. The following table summarizes the increase in our net sales:

|   | Three months ended July 28, 2012<br>(in millions) |
|---|---|
| Net sales for the three months ended July 30, 2011      | \$476.3   |
| Increase in comparable sales                            | 19.3  |
| Net increase from non-comparable and closed store sales | 16.6  |
| Net sales for the three months ended July 28, 2012      | \$512.2   |

The following table summarizes our net sales by reportable segment and in total:

|                                  | Three months ended             |               |
|----------------------------------|--------------------------------|---------------|
|                                  | July 28, 2012<br>(in millions) | July 30, 2011 |
| DSW segment                      | \$482.2                        | \$442.1       |
| Leased business division segment | 30.0                           | 34.2          |
| Total DSW Inc.                   | \$512.2                        | \$476.3       |

The following table summarizes our comparable sales change by reportable segment and in total:

|                                  | Three months ended |               |
|----------------------------------|--------------------|---------------|
|                                  | July 28, 2012      | July 30, 2011 |
| DSW segment                      | 4.3%               | 13.0%         |
| Leased business division segment | 3.5%               | 3.7%          |
| DSW Inc.                         | 4.2%               | 12.3%         |



The increase in comparable sales was primarily a result of an increase in transactions driven by more customers visiting our stores and dsw.com and an increase in conversion due to more of those customers making a purchase. For the DSW segment, all merchandise categories had positive comparable sales. DSW segment comparable sales increased in women's footwear by 2%, men's by 9%, athletic by 4% and accessories by 8%.

**Gross Profit.** Gross profit is defined as net sales less cost of sales. Gross profit decreased as a percentage of net sales to 31.3% in the second quarter of fiscal 2012 from 32.7% in the second quarter of fiscal 2011. By reportable segment and in total, gross profit as a percentage of net sales was:

|                                  | Three months ended |               |
|----------------------------------|--------------------|---------------|
|                                  | July 28, 2012      | July 30, 2011 |
| DSW segment                      | 32.1%              | 33.6%         |
| Leased business division segment | 18.1%              | 20.0%         |
| DSW Inc.                         | 31.3%              | 32.7%         |

DSW segment merchandise margin, defined as gross profit excluding occupancy and warehousing expenses, a non-GAAP measure, decreased as a percentage of net sales to 44.8% for the second quarter of fiscal 2012 from 46.0% for the second quarter of fiscal 2011 as a result of increased markdowns. Our markdowns increased as we normalized our clearance mix to historical levels by taking additional clearance actions in the second quarter partially offset by favorable shrink results. Store occupancy expense for the DSW segment remained relatively flat as a percentage of net sales at 10.8% for the second quarter of fiscal 2012 compared to 10.7% for the second quarter of fiscal 2011. Warehousing expense increased to 1.9% for the second quarter of fiscal 2012 from 1.7% for the second quarter of fiscal 2011 primarily due to the expansion of dsw.com.

Gross profit for the leased business division decreased 190 basis points as a percentage of net sales for the second quarter of fiscal 2012 primarily related to an increase in markdowns.

**Operating Expenses.** Operating expenses as a percentage of net sales were 21.9% and 22.4% for the second quarter of fiscal 2012 and the second quarter of fiscal 2011, respectively. Excluding the impact of DSW and RVI merger-related transaction costs and other RVI-related expenses of \$6.1 million in the second quarter of fiscal 2011, operating expenses as a percentage of net sales were 21.1% in the second quarter of fiscal 2011. This 80 basis point increase as a percentage of net sales over the comparable period for the prior year was primarily due to new store expenses and a planned shift in marketing expenses from the fall to the spring season. For the second quarter of fiscal 2012, operating income related to RVI was \$0.1 million.

**Change in Fair Value of Derivative Instruments.** During the second quarter of fiscal 2012 and the second quarter of fiscal 2011, DSW, and prior to the Merger, RVI, recorded a non-cash charge of \$0.8 million and \$4.3 million, respectively, related to the change in the fair value of warrants. During the second quarter of fiscal 2011, the Company recorded a non-cash charge of \$18.6 million related to the change in the fair value of the conversion feature of the PIES, which settled in the third quarter of fiscal 2011. The change in the fair value of the derivatives was primarily due to the increase in stock price.

**Interest Income (Expense), Net.** As a result of the elimination of PIES interest expense due to the settlement of the PIES in the third quarter of fiscal 2011, we now have interest income, net for the second quarter of fiscal 2012 rather than interest expense, net for the second quarter of fiscal 2011.

**Income Taxes.** Our effective tax rate for the second quarter of fiscal 2012 was 38.7%, compared to (591.7)% for the second quarter of fiscal 2011. The effective tax rate of 38.7% for the second quarter of fiscal 2012 reflects the impact of state and local taxes and the change in fair value of the warrants, which are included for book income but not in tax income. The effective tax rate of (591.7)% for the second quarter of fiscal 2011 was favorably impacted by the release of the valuation allowance and other merger related tax items.

Income from Discontinued Operations, Net of Tax. During the second quarter of fiscal 2012, there was no income from discontinued operations. During the second quarter of fiscal 2011, income from discontinued operations, net of tax, was due to a revaluation of a guarantee due to changes in facts and circumstances related to the guarantee.

Noncontrolling Interests. As of the effective time of the Merger, there were no noncontrolling interests and thus no net income attributable to the noncontrolling interests in the second quarter of fiscal 2012. For the second quarter of fiscal 2011, net income attributable to the noncontrolling interests was \$6.0 million.

## SIX MONTHS ENDED JULY 28, 2012 COMPARED TO SIX MONTHS ENDED JULY 30, 2011

Net Sales. Net sales for the six months ended July 28, 2012 increased 9.3% from the six months ended July 30, 2011. The following table summarizes the increase in our net sales:

|   | Six months ended July 28, 2012<br>(in millions) |
|---|---|
| Net sales for the six months ended July 30, 2011        | \$979.9   |
| Increase in comparable sales                            | 56.8  |
| Net increase from non-comparable and closed store sales | 34.1  |
| Net sales for the six months ended July 28, 2012        | \$1,070.8                                       |

The following table summarizes our net sales by reportable segment and in total:

|                                  | Six months ended<br>July 28, 2012<br>(in millions) | July 30, 2011 |
|----------------------------------|--|---------------|
| DSW segment                      | \$1,003.4  | \$904.5       |
| Leased business division segment | 67.4   | 75.4          |
| Total DSW Inc.                   | \$1,070.8  | \$979.9       |

The following table summarizes our comparable sales change by reportable segment and in total:

|                                  | Six months ended<br>July 28, 2012 | July 30, 2011 |
|----------------------------------|-----------------------------------|---------------|
| DSW segment                      | 6.2%                              | 11.9%         |
| Leased business division segment | 2.9%                              | 6.7%          |
| DSW Inc.                         | 6.0%                              | 11.5%         |

The increase in comparable sales was primarily a result of an increase in transactions driven by more customers visiting our stores and dsw.com. For the DSW segment, all merchandise categories had positive comparable sales. DSW segment comparable sales increased in women's footwear by 5%, men's by 8%, athletic by 5% and accessories by 8%.

Gross Profit. Gross profit is defined as net sales less cost of sales. Gross profit decreased as a percentage of net sales to 33.0% in the six months ended July 28, 2012 from 33.4% in the six months ended July 30, 2011. By reportable segment and in total, gross profit as a percentage of net sales was:

|                                  | Six months ended<br>July 28, 2012 | July 30, 2011 |
|----------------------------------|-----------------------------------|---------------|
| DSW segment                      | 33.7%                             | 34.4%         |
| Leased business division segment | 21.3%                             | 21.7%         |
| DSW Inc.                         | 33.0%                             | 33.4%         |

DSW segment merchandise margin, defined as gross profit excluding occupancy and warehousing expenses, a non-GAAP measure, decreased as a percentage of net sales to 45.9% for the six months ended July 28, 2012 from 46.6% for the six months ended July 30, 2011. Our markdowns increased as we normalized our clearance mix to historical levels by taking additional clearance actions in the second quarter partially offset by favorable shrink results. Store occupancy expense for the DSW segment decreased as a percentage of net sales to 10.3% for the six months

ended July 28, 2012 from 10.5% for the six months ended July 30, 2011 primarily as a result

26

---

of the comparable sales increase. Warehousing expense increased to 1.9% for the six months ended July 28, 2012 from 1.7% for the six months ended July 30, 2011 primarily due to incremental labor to support business growth initiatives surrounding the reconfiguration of the Columbus distribution center and the expansion of the fulfillment center to support dsw.com growth.

Gross profit for the leased business division decreased 40 basis points as a percentage of net sales for the six months ended July 28, 2012 primarily due to an increase in markdowns.

Operating Expenses. Operating expenses as a percentage of net sales were 21.9% and 22.4% for the six months ended July 28, 2012 and the six months ended July 30, 2011, respectively. Excluding the impact of DSW and RVI merger-related transaction costs and other RVI-related expenses of \$11.3 million in the six months ended July 30, 2011, operating expenses as a percentage of net sales were 21.2% for the six months ended July 30, 2011. This 70 basis point increase as a percentage of net sales over the comparable period for the prior year was primarily due to new store expenses as well as a planned shift in marketing expenses from the fall to the spring season. For the six months ended July 28, 2012, expenses related to RVI were \$0.3 million.

Change in Fair Value of Derivative Instruments. During the six months ended July 28, 2012 and the six months ended July 30, 2011, DSW, and prior to the Merger, RVI, recorded a non-cash charge of \$6.1 million and \$15.1 million, respectively, related to the change in the fair value of warrants. During the six months ended July 30, 2011, the Company recorded a non-cash charge of \$62.7 million related to the change in the fair value of the conversion feature of the PIES, which settled in the third quarter of fiscal 2011. The change in the fair value of the derivatives was primarily due to the increase in stock price.

Interest Income (Expense), Net. As a result of the elimination of PIES interest expense due to the settlement of the PIES in the third quarter of fiscal 2011, we now have interest income, net for the six months ended July 28, 2012 rather than interest expense, net for the six months ended July 30, 2011.

Income Taxes. Our effective tax rate for the six months ended July 28, 2012 was 40.2%, compared to (441.7)% for the six months ended July 30, 2011. The effective tax rate of 40.2% for the six months ended July 28, 2012 reflects the impact of state and local taxes and the change in fair value of the warrants, which are included for book income but not in tax income. The effective tax rate of (441.7)% for the six months ended July 30, 2011 was favorably impacted by the release of the valuation allowance and other merger related tax items.

Income from Discontinued Operations, Net of Tax. During the six months ended July 28, 2012, income from discontinued operations, net of tax, was due to reduction in expected payments under our lease guarantees for Filene's Basement. During the six months ended July 30, 2011, income from discontinued operations, net of tax, was due to a revaluation of a guarantee due to changes in facts and circumstances related to the guarantee.

Noncontrolling Interests. As of the effective time of the Merger, there were no noncontrolling interests and thus no net income attributable to the noncontrolling interests in the six months ended July 28, 2012. For the six months ended July 30, 2011, net income attributable to the noncontrolling interests was \$20.7 million.

#### Non-GAAP Financial Measures

DSW utilizes merchandise margin, a non-GAAP financial measure, to explain its gross profit performance. Management believes this non-GAAP measure is an indication of the Company's performance as the measure provides a consistent means of comparing performance between periods and competitors as retailers differ on their definition of cost of sales. Management uses this non-GAAP measure to assist in the evaluation of the performance of our segments and to make operating decisions. Within Management's Discussion and Analysis, DSW discloses merchandise margin, store occupancy expenses and warehousing expense, which reconcile to gross profit.

### Seasonality

Our business is subject to seasonal merchandise trends when our customers' interest in new seasonal styles increases. New spring styles are introduced in the first quarter, and new fall styles are introduced in the third quarter. Unlike many other retailers, we do not experience a significant increase in net sales during our fourth quarter associated with the winter holiday season.

### Liquidity and Capital Resources

Our primary ongoing cash flow requirements are for inventory purchases, capital expenditures made in connection with our store expansion, improving our information systems, the remodeling of existing stores and infrastructure growth. Our working capital and

inventory levels typically build seasonally. We believe that we have sufficient financial resources and access to financial resources at this time. We are committed to a cash management strategy that maintains liquidity to adequately support the operation of the business, our growth strategy and to withstand unanticipated business volatility. We believe that cash generated from DSW operations, together with our current levels of cash and investments as well as availability under our revolving credit facility, should be sufficient to maintain our ongoing operations, support seasonal working capital requirements, fund capital expenditures related to projected business growth for the foreseeable future and continue payments of dividends to our shareholders.

**Net Working Capital.** Net working capital is defined as current assets less current liabilities. Net working capital increased to \$653.1 million as of July 28, 2012 from \$560.5 million as of January 28, 2012, primarily due to an increase in inventory to support new stores and planned sales increases, a decrease in warrant liability due to exercises and the payment of fiscal 2011 incentive compensation. As of July 28, 2012 and January 28, 2012, the current ratio was 3.5 and 2.8, respectively.

**Operating Cash Flows.** For the six months ended July 28, 2012, our net cash provided by operations was \$101.5 million compared to \$65.5 million for the six months ended July 30, 2011 driven primarily by DSW's utilization of RVI's federal net operating losses and tax credits to offset its taxable income, which generated significant cash tax savings, and we believe should continue to generate cash tax savings in the remainder of fiscal 2012 and fiscal 2013.

Although our plan for continued expansion could place increased demands on our financial, managerial, operational and administrative resources and result in increased demands on management, we do not believe that our anticipated growth plan will have an unfavorable impact on our operations or liquidity. Uncertainty in the United States economy could result in reductions in customer traffic and comparable sales in our existing stores with the resultant increase in inventory levels and markdowns. Reduced sales may result in reduced operating cash flows if we are not able to appropriately manage inventory levels or leverage expenses. These potential negative economic conditions may also affect future profitability and may cause us to reduce the number of future store openings, impair goodwill or impair long-lived assets.

**Investing Cash Flows.** For the six months ended July 28, 2012, our net cash used in investing activities was \$123.4 million compared to \$113.3 million for the six months ended July 30, 2011. During the six months ended July 28, 2012, we incurred \$45.7 million in capital expenditures, of which \$30.0 million related to stores and \$15.7 million related to information technology, the reconfiguration of the Columbus distribution center, the expansion of the dsw.com fulfillment center and business infrastructure. During the six months ended July 28, 2012, we had net purchases of short-term and long-term investments of \$76.3 million compared to net purchases of short-term and long-term investments of \$79.1 million during the six months ended July 30, 2011.

We expect to spend approximately \$115 million for capital expenditures in fiscal 2012. Our future investments will depend primarily on the number of stores we open and remodel, infrastructure and information technology programs that we undertake and the timing of these expenditures. We plan to open approximately 35 to 40 stores in fiscal 2012. In addition to our investments in new stores and remodeling stores, we will invest in the reconfiguration of the Columbus distribution center and the expansion of the dsw.com fulfillment center to support business growth. During fiscal 2011, the average investment required to open a typical new DSW store was approximately \$2.1 million, excluding any construction and tenant allowances. Of this amount, gross inventory typically accounted for \$0.7 million, fixtures and leasehold improvements typically accounted for \$1.1 million and new store advertising and other new store expenses typically accounted for \$0.3 million.

**Financing Cash Flows.** For the six months ended July 28, 2012, our net cash provided by financing activities was \$3.9 million compared to net cash used by financing activities of \$1.7 million for the six months ended July 30, 2011. The change in cash provided by financing activities was primarily related to increased proceeds from the exercise of stock options and the increase in the cash provided by the exercise of warrants partially offset by the payment of dividends

for the six months ended July 28, 2012. Net cash used by financing activities for the six months ended July 30, 2011 were primarily related to the Merger with RVI, and those activities did not recur in fiscal 2012.

On June 18, 2012, DSW announced that its Board of Directors has authorized the Company to repurchase up to \$100 million of Company common shares over the next twelve months. The repurchase program will be funded using the Company's available cash. The share repurchase program may be suspended, modified or discontinued at any time, and the Company has no obligation to repurchase any amount of its common shares under the program. As of July 28, 2012, DSW has not made any repurchases under this program.

Our Credit Facility and other liquidity considerations are described more fully below:

\$100 Million Credit Facility ("Credit Facility"). On June 30, 2010, we entered into a \$100 million secured revolving credit facility

with a term of four years that will expire on June 30, 2014. Our Credit Facility allows the payment of dividends and redemption of our stock by us or our subsidiaries provided that we meet the minimum cash and short-term investments requirement of \$125 million as defined in the Credit Facility. Additional covenants limit our payments for capital expenditures to \$125 million in any fiscal year, and if we have direct borrowings greater than \$25 million, our Credit Facility also requires that we maintain a fixed charge coverage ratio of not less than 1.1 to 1.0. We paid \$47.0 million for capital expenditures for the six months ended July 28, 2012. As of July 28, 2012, we were not required to calculate the fixed charge coverage ratio as we did not have direct borrowings greater than \$25 million. We had availability under the Credit Facility of \$69.9 million and outstanding letters of credit of \$30.1 million as of July 28, 2012.

#### Other Liquidity Considerations

**Warrants.** On May 31, 2012, DSW issued 341,222 of its Class B Common Shares, without par value, to the Schottenstein Affiliates in connection with the exercise of its outstanding warrants. The common shares were issued at an exercise price of \$10.35 per share, for an aggregate cash purchase price of \$3.5 million, and DSW paid accrued dividends of \$0.7 million related to the Company's special dividend issued on September 30, 2011. In connection with this issuance, no underwriters were utilized and no commissions were paid.

On March 14, 2012, DSW issued 411,963 of its Class B Common Shares, without par value, to the Schottenstein Affiliates in connection with the exercise of its outstanding warrant. The common shares were issued at an exercise price of \$10.35 per share, for an aggregate cash purchase price of \$4.3 million, and DSW paid accrued dividends of \$0.8 million related to the Company's special dividend issued on September 30, 2011. In connection with this issuance, no underwriters were utilized and no commissions were paid.

On April 28, 2011, RVI issued 221,037 common shares (which represent 96,151 DSW Common Shares factoring in the exchange ratio of 0.435 subsequent to the Merger), without par value, to Millennium Partners, L.P. ("Millennium") in connection with Millennium's exercise of its outstanding warrant that was originally issued by RVI. The common shares were issued at an exercise price of \$4.50 per share, for an aggregate cash purchase price of \$1.0 million. In connection with this exercise, the Company reclassified \$3.6 million from the warrant liability to paid in capital during the first quarter of fiscal 2011, for a total of \$4.6 million increase to paid in capital. In connection with this issuance, no underwriters were utilized, and no commissions were paid.

**RVI credit facility.** In connection with the completion of the Merger, DSW repaid RVI's obligations during the second quarter of fiscal 2011 under the RVI credit facility with SEI, a Schottenstein Affiliate, of \$11.0 million in principal and \$0.1 million in interest.

#### Contractual Obligations

We had outstanding letters of credit that totaled approximately \$30.1 million and \$17.3 million, respectively, as of July 28, 2012 and January 28, 2012 under our Credit Facility. If certain conditions are met under these arrangements, we would be required to satisfy the obligations in cash. Due to the nature of these arrangements and based on historical experience and future expectations, we do not expect to make any significant payment outside of terms set forth in these arrangements.

As of July 28, 2012, we have entered into various construction commitments, including capital items to be purchased for projects that were under construction, or for which a lease has been signed. Our obligations under these commitments were approximately \$7.5 million as of July 28, 2012. In addition, we have signed lease agreements for 32 new store locations expected to be opened over the next eighteen months, with total annual rent of approximately \$12.3 million. In connection with the new lease agreements, we will receive a total of \$17.6 million of construction and tenant allowance reimbursements for expenditures at these locations.

We operate all of our stores, warehouses and corporate office space from leased facilities. Lease obligations are accounted for either as operating leases or as capital leases based on lease by lease review at lease inception. The Company had no capital leases outstanding as of July 28, 2012 or January 28, 2012.

#### Off-Balance Sheet Arrangements

As of July 28, 2012, DSW has not entered into any "off-balance sheet" arrangements, as that term is described by the Securities and Exchange Commission.

#### Proposed Accounting Standards

The Financial Accounting Standards Board ("FASB") periodically issues Accounting Standard Updates, some of which require implementation by a date falling within or after the close of the fiscal year. See Note 3 to the Condensed Consolidated Financial Statements for a discussion of the new accounting standards implemented.

## Critical Accounting Policies

As discussed in Note 3 to our condensed consolidated financial statements included elsewhere in this Quarterly Report on Form 10-Q, the preparation of our condensed consolidated financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of commitments and contingencies at the date of the condensed consolidated financial statements and reported amounts of revenues and expenses during the reporting period. We base these estimates and judgments on our historical experience and other factors we believe to be relevant, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. The process of determining significant estimates is fact-specific and takes into account factors such as historical experience, current and expected economic conditions, product mix, and in some cases, actuarial and appraisal techniques. We constantly re-evaluate these significant factors and make adjustments where facts and circumstances dictate.

### Item 3. Quantitative and Qualitative Disclosures About Market Risk.

**Cash and Investments-** Our cash and equivalents have maturities of 90 days or fewer. At times, cash and equivalents may be in excess of Federal Deposit Insurance Corporation (“FDIC”) insurance limits. We also have investments in various short-term and long-term investments. Our available-for-sale investments generally renew every 7 days, and we also have held-to-maturity investments that have terms greater than 365 days. These financial instruments may be subject to interest rate risk through lost income should interest rates increase during their term to maturity and thus may limit our ability to invest in higher income investments.

**\$100 Million Credit Facility-** As of July 28, 2012, there was no long-term debt outstanding. Future borrowings, if any, would bear interest at rates in accordance with our credit facility and would be subject to interest rate risk. Because we have no outstanding debt, we do not believe that a hypothetical adverse change of 1% in interest rates would have a material effect on our financial position.

### Item 4. Controls and Procedures.

#### Evaluation of Disclosure Controls and Procedures

We, under the supervision and with the participation of our management, including the Chief Executive Officer and Chief Financial Officer, performed an evaluation of our disclosure controls and procedures, as such term is defined in Securities Exchange Act Rules 13a-15(e) and 15d-15(e). Based on that evaluation, our Chief Executive Officer and Chief Financial Officer concluded, as of the end of the period covered by this report, that such disclosure controls and procedures were effective.

#### Changes in Internal Control over Financial Reporting

No change was made in our internal control over financial reporting, as such term is defined in Exchange Act Rules 13a-15(f) or 15d-15(e), during our most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

## PART II. OTHER INFORMATION

### Item 1. Legal Proceedings.

Guarantee of Union Square lease- RVI guaranteed Filene's Basement's obligations for the Union Square location when RVI owned Filene's Basement, and in February 2012, the landlord at the Union Square location brought a lawsuit against Merger Sub in the Supreme Court of the State of New York seeking payment under the guarantee. A third party has entered into a lease for this location, but the landlord has asserted that DSW is responsible for rent and certain costs while the space is unoccupied. We believe that the guarantee may not be enforceable and/or that the amount of liability under the guarantee may be limited. We will continue to monitor our potential liability regarding this lease obligation.

Guarantee of Bergen, NJ lease- RVI guaranteed Filene's Basement's obligations for the Bergen location when RVI owned Filene's Basement. In July 2012, the landlord at the Bergen, NJ location brought a lawsuit against Merger Sub in the Supreme Court of the State of New Jersey seeking payment under the guarantee. A third party is operating in a portion of the space leased by Filene's Basement, but the landlord has asserted that DSW is responsible for rent and certain costs. We believe that the guarantee may not be enforceable and/or that the amount of liability under the guarantee may be limited. We will continue to monitor our potential liability regarding this lease obligation.

Other legal proceedings- Other than the proceedings noted above, we are involved in various legal proceedings that are incidental to the conduct of our business. We estimate the range of liability related to pending litigation where the amount of the range of loss can be estimated. We record our best estimate of a loss when the loss is considered probable. When a liability is probable and there is a range of estimated loss, we record the most likely estimated liability related to the claim. Although it is not possible to predict with certainty the eventual outcome of any litigation, in the opinion of management, the amount of any potential liability with respect to these proceedings will not be material to our results of operations or financial condition.

### Item 1A. Risk Factors.

The following risk factor supplements DSW's risk factors set forth in Part I, Item 1A of our last Annual Report on Form 10-K for the fiscal year ended January 28, 2012.

Prior to the Merger, RVI had actual liabilities and significant contingent liabilities. As of the effective time of the Merger, Merger Sub, a subsidiary of DSW, assumed RVI's obligations with respect to these actual liabilities and contingent liabilities, if they become actual liabilities, which could adversely affect DSW's financial condition.

Merger Sub assumed the obligations of RVI under these guarantees. On November 2, 2011, Syms and Filene's Basement filed for bankruptcy protection. RVI guaranteed the obligations of Filene's Basement in connection with three leases for retail store locations. Merger Sub may be responsible for any obligations of RVI under these guarantees. These leases expire in January 2017, September 2017 and October 2024. DSW assumed one of these leases. We have recorded a liability of \$6.9 million associated with the remaining lease guarantees.

The landlord at the Union Square location has brought a lawsuit against Merger Sub seeking to recoup payments under the guarantee. A third party has entered into a lease for this location, but the landlord has asserted that DSW is responsible for rent while the space was unoccupied. We believe that the guarantee may not be enforceable and/or that the amount of liability under the guarantee may be limited. If the guarantee is deemed to be enforceable, the new lease may not release Merger Sub from liability under the original guarantee.

In July 2012, the landlord at the Bergen, NJ location brought a lawsuit against Merger Sub in the Supreme Court of the State of New Jersey seeking payment under the guarantee. A third party is operating in a portion of the space leased by Filene's Basement, but the landlord has asserted that DSW is responsible for rent and certain costs. We

believe that the guarantee may not be enforceable and/or that the amount of liability under the guarantee may be limited. We will continue to monitor our potential liability regarding these lease obligations.

In addition, if the assumptions or estimates regarding the amount of any actual or contingent liabilities made by the Company were incorrect or become incorrect due to changes in economic conditions, among other reasons, this could cause the amount of any actual liability to exceed the amounts estimated, which could have a material adverse effect on DSW's financial condition.

## Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.

(a) Recent sales of unregistered securities. See Note 7 regarding the exercise of warrants by the Schottenstein Affiliates.

(b) Use of Proceeds. Not applicable.

(c) Purchases of equity securities by the issuer and affiliated purchasers.

DSW made no purchases of its Common Shares during the three months ended July 28, 2012, excluding shares withheld to satisfy tax withholdings for stock option exercises, net settlement of stock options and the vesting of restricted stock units. These shares withheld are summarized in the table below (shares in thousands):

| Period                         | Total number of shares purchased<br>(in thousands) | Average price paid per share | Total number of shares purchased as part of publicly announced programs<br>(in millions) | Approximate dollar value of shares that may yet be purchased under the programs |
|--------------------------------|--|------------------------------|--|---|
| April 29, 2012 to May 26, 2012 | 140  | \$60.14                      | —  | —   |
| May 27, 2012 to June 30, 2012  | 6  | \$57.65                      | —  | \$100.0   |
| July 1, 2012 to July 28, 2012  | —  | —                            | —  | 100.0   |
|                                | 146  |                              | —  | \$100.0   |

**\$100 Million Share Repurchase Program-** On June 18, 2012, DSW announced that its Board of Directors has authorized the Company to repurchase up to \$100 million of Company common shares over the next twelve months. The repurchase program will be funded using the Company's available cash. The share repurchase program may be suspended, modified or discontinued at any time, and the Company has no obligation to repurchase any amount of its common shares under the program. As of July 28, 2012, DSW has not made any repurchases under this program.

**Dividends-** The payment of any future dividends is at the discretion of our Board of Directors and is based on our future earnings, cash flow, financial condition, capital requirements, changes in U.S. taxation, general economic condition and any other relevant factors. It is anticipated that dividends will be declared on a quarterly basis. Our Credit Facility allows the payment of dividends by us or our subsidiaries provided that we meet the minimum cash and short-term investments requirement of \$125 million, as defined in our Credit Facility.

Item 3. Defaults Upon Senior Securities. None.

Item 4. Mine Safety Disclosure. Not Applicable.

Item 5. Other Information. None.

Item 6. Exhibits. See Index to Exhibits on page 34.

SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

DSW INC.

(Registrant)

Date: August 31, 2012

By: /s/ Douglas J. Probst

Douglas J. Probst

Executive Vice President and Chief Financial Officer

(principal financial and accounting officer and duly authorized officer)

INDEX TO EXHIBITS

| Exhibit Number | Description  |
|----------------|--|
| 31.1           | Rule 13a-14(a)/15d-14(a)<br>Certification of Chief Executive Officer |
| 31.2           | Rule 13a-14(a)/15d-14(a)<br>Certification of Chief Financial Officer |
| 32.1           | Section 1350 Certification of<br>Chief Executive Officer             |
| 32.2           | Section 1350 Certification of<br>Chief Financial Officer             |
| 101            | XBRL Instance Document   |

34