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This Annual Report contains information about our company. Unless otherwise indicated or required by the context, the terms “Ace,” “we,” “our,” “us” and the “Company” refer to Ace Hardware Corporation and all of its subsidiaries that are consolidated under U.S. generally accepted accounting principles (“GAAP”). The terms “member,” “retailer,” “member retailer,” “dealer,” “you,” “your” and similar words refer to someone who becomes a member of Ace and purchases our stock. In this Annual Report, we reference some of our own trademarked products (e.g., Clark + Kensington® paints) and services, as well as those of unrelated third parties with whom we do business (e.g., Valspar® paints); all trademarks appearing in this Annual Report are the property of their respective owners. Our fiscal years for the years 2018, 2017 and 2016 ended on December 29, 2018, December 30, 2017, and December 31, 2016, respectively. When we refer to a year, we are referring to the fiscal year ended on those respective dates. Data in this summary is as of December 29, 2018 unless indicated otherwise.

SUMMARY

Our Company

Ace Hardware is the largest retailer-owned hardware cooperative in the world with more than 5,200 locally owned and operated hardware stores. Domestically, Ace retail hardware stores operate in all 50 states and the District of Columbia. Ace Hardware Corporation markets and distributes hardware products, paint and other merchandise to our network of independent retailers around the world. Ace also provides value-added services such as advertising, market research, merchandising assistance, promotional support, assistance with site location, store format design, retail training services, insurance and store technology services. Ace Hardware International Holdings, LTD. (“AIH”), a majority owned subsidiary of Ace, serves international retailers in approximately 68 countries. Ace and its subsidiaries operate an expansive network of distribution centers in the U.S. and have distribution capabilities in Ningbo, China; Colon, Panama; and Dubai, United Arab Emirates. Since 1924, Ace has been an important part of local communities around the world and known as the place with the helpful hardware folks.

In September 2017, the Company formed the Ace Ecommerce Holdings LLC (“AEH”) legal entity. On September 30, 2017, AEH acquired 94.3 percent of the issued and outstanding capital stock of The Daily Grommet Inc. (“The Grommet”), an e-commerce startup company that operates a website that markets and sells new and innovative products created by independent entrepreneurs.

In 2014, the Company formed the Ace Wholesale Holdings LLC (“AWH”) legal entity for sales of products to non-member retailers. AWH does business as Emery Jensen Distribution (“EJD”). The Company believes that the formation of EJD will serve as a catalyst to further leverage wholesale purchasing power and advance the Company’s strategic plans as a leader in the wholesale distribution industry.

Ace Retail Holdings LLC (“ARH”) is the owner of the 123 store Westlake Ace Hardware retail chain. As a result, the Company is also a retailer of hardware, paint and other merchandise. In addition, in March 2019, ARH increased its non-controlling shareholder interest in ACO Inc. (“ACO”) to a controlling shareholder interest. ACO has been engaged in the business of owning and operating Ace stores under the name Great Lakes Ace Hardware in the United States since 2014 and operates 52 stores in Michigan.

Ace positions itself as “The Helpful Place” – a conveniently located hardware store that provides not only quality goods but also knowledgeable store staff. We believe that “The Helpful Place” is one of the most recognized slogans in the hardware and home improvement industry.

As the principal supplier to our U.S. retailer network, Ace purchases hardware, paint and other merchandise in quantity lots and resells this merchandise in smaller lots to our retailers. Ace’s aggregate purchasing volume and supplier relationships enable us to realize substantial purchasing savings and to pass such savings on to our retailers. This enables Ace’s retailers to have consistent access to a broad range of hardware and related products and to better compete in their local markets.

We operate 14 retail support centers (“RSCs”), eight freight consolidation/redistribution facilities and three other warehouse facilities across the United States that total over 12.6 million square feet of distribution space. Ten of these RSCs, with a total of approximately 7.8 million square feet of distribution space, are Company-owned. In 2018, the Company replaced its distribution facility in Prince George, Virginia with its newly leased 1.1 million square foot RSC in Fredericksburg, Pennsylvania. In addition, the Company is close to completing its planned closure of two distribution facilities in the Mid-Atlantic region. In 2019, the West Jefferson RSC will be expanded by 309,000 square feet. This expansion will enable West Jefferson to fill break orders on site. In addition, Ace and its subsidiaries also have distribution capabilities in Laredo, Texas; Dubai, United Arab Emirates; Colon, Panama; and Ningbo, China.

To help foster our retailers’ continued success, fuel their entrepreneurial spirit and enhance their viability in an increasingly competitive home improvement marketplace, Ace provides two basic programs for its member retailers – Ace Branded stores and Individually Branded stores.

Approximately 410 stores, or 9 percent, of our network of domestic stores are individually branded. Sales to these retailers represented approximately 5 percent of our 2018 fiscal year domestic merchandise sales to member retailers. Our Individually Branded Retailer program is ideal for retailers who have strong individual name recognition in their local communities and do not rely as much on the Ace brand for their success. While they do not participate in Ace’s marketing programs, as members of Ace they still rely on

Ace's broad product assortment (including Ace private label products), low product pricing, extensive distribution network, and eligibility for patronage distributions. They go to market under their own business name and identity.

The remaining approximately 4,090 domestic stores, or 91 percent, of our network of domestic stores operate under the Ace brand. Sales to these retailers represented approximately 95 percent of our 2018 fiscal year domestic merchandise sales to member retailers.

Ace also supports 20/20 Vision, its long-term retail growth strategy. The strategy builds on Ace's commitments to enhance retailer performance and ensure retailer growth, not only today, but long term. 20/20 Vision provides Ace and our retailers with a clear path to the future. The strategy is consumer-focused, aligned with our corporate strategy and contains two paths for growth that can be implemented separately or concurrently. The two paths for growth are Pinnacle Performance Retailing and Accelerated Store Growth. Pinnacle Performance Retailing is designed to help Ace retailers improve their store performance by increasing sales and net profits. Accelerated Store Growth is designed to encourage Ace retailers with the desire and ability to open new stores. It is also intended to increase store count through new investors, conversions of competitors' stores and by reducing the number of stores that leave Ace or close.

Ace's Capital Stock Structure

Our capital stock is divided into two classes, Class A and Class C. Only Class A Stock has voting rights. Class C Stock is issued in connection with all store memberships and annually as part of our patronage distribution. Our Board of Directors has the right to redeem portions or all of the outstanding shares of Class C Stock that have been issued as patronage distributions. If Ace is ever liquidated, the outstanding shares of Class C Stock have priority over the outstanding shares of Class A Stock in the distribution of our net assets. If our net assets were to exceed that priority amount, they would be distributed proportionately among the stockholders of both classes of our stock. (See "Description of Capital Stock – Voting Rights," "– Liquidation Rights" and "– Redemption Provisions.")

Ace operates as a cooperative. Accordingly, the declaration of dividends on any shares of any class of our stock is prohibited. (See "Description of Capital Stock – Dividend Rights.")

Membership Applications – Subscriptions for Class A and Class C Stock

The purchase of our stock enables retailers to obtain membership in Ace. Membership entitles our retailers to purchase merchandise and services from us. Members are also eligible to receive patronage distributions based on the volume of merchandise they purchase from us, but these distributions are dependent on Ace's patronage-based business being profitable. (See "Membership Information – Patronage Distributions – Patronage Distribution Determinations.") We cannot guarantee that patronage distributions will be made for any year.

Our stock is sold only to approved retailers of hardware and related products who apply for membership in Ace Hardware Corporation. The purchase price (par value) for each share of Class A Stock is \$1,000 and the purchase price (par value) for each share of Class C Stock is \$100.

For an initial membership, you must subscribe and pay for one share of Class A Stock plus 40 shares of Class C Stock, with an aggregate subscription price of \$5,000. You must also pay a \$5,000 fee for processing your membership application. If you apply for membership for an additional store location that you own or control, you must subscribe and pay for 50 shares of Class C Stock (\$5,000) for that location and pay another \$5,000 processing fee.

Your membership may generally be terminated upon various notice periods and for various reasons, including voluntary termination, as provided in the Membership Agreement.

Ace also sells merchandise to retailers that are not members of Ace through its AWH, AEH and AIH subsidiaries, but such non-member retailers do not own any Ace stock and are not eligible to receive any patronage distributions.

Repurchase of Shares by Ace

If your membership for a store location terminates, your Class A share and all of your Class C shares for that location must be sold back to us, generally at par value, unless the shares are transferred to another party whom we agree to accept as a retailer for that location. We generally pay the repurchase price in a combination of cash and an interest-bearing four-year installment note. (See "Description of Capital Stock – Other Restrictions and Rights.")

Under Delaware corporate law, we are not allowed to repurchase any of our shares if our net assets are less than the par value of our aggregate outstanding shares of capital stock or if our net assets would be reduced below that amount by virtue of the repurchase.

Patronage Distributions and Income Tax Treatment

As a cooperative, we distribute patronage annually to member retailers based on their qualified merchandise purchases from us. Under our current plan, which can be modified by our Board of Directors, 40 percent of the total annual patronage distribution to each retailer is paid in cash. The remainder is paid in shares of Class C Stock and in Patronage Refund Certificates. The cash portion of any patronage distribution payable to a past due or terminated retailer is generally applied against that retailer's indebtedness or other obligations to us, if any, unless the retailer makes a written request to receive 20 percent of the patronage distribution in cash. (See "Membership Information – Patronage Distributions.")

The cash payments and stated dollar amounts of Class C Stock and Patronage Refund Certificates, along with the fair market value of any other property that we distribute as patronage, are considered income for federal income tax purposes of the recipient. (See "Federal Income Taxes – Tax Treatment of Patronage Distributions.")

Risks of Membership

Owning and operating a retail hardware store as an Ace retailer, especially a group of such stores, can be rewarding, both financially and otherwise. There are, however, a number of risks that one should consider carefully before making a decision to become an Ace retailer. See "Risks of Membership" for some of the more important risks. There may be other issues, risks and benefits particularly relevant to you that are not summarized in the "Risks of Membership" section.

ACE'S BUSINESS

Company History

Our company traces its history to the early 1920s, when the traditional way of buying hardware merchandise was to purchase products from a middleman or "jobber." This distribution method drove up the price on every hardware item, thereby cutting into the retailer's profit. In response, a group of Chicago-area hardware retailers - Richard Hesse, William Stauber, Frank Burke, Gern Lindquist and Oscar Fisher - decided they would pool their hardware buying needs, which allowed them to buy directly from manufacturers and to eliminate the jobber. This strategy enabled those retailers to realize considerable savings, decrease inventory costs and compete more effectively with the larger stores in their markets - a concept still valid today.

In 1928, this group of retailers incorporated their business in Illinois as Ace Stores (later re-named Ace Hardware Corporation). The Company was named in honor of the superior World War I fliers dubbed "aces." We opened our first warehouse in 1929, and by 1934, our membership had grown to 41 retailers and our annual sales exceeded \$650,000. During the 1960s, we expanded into the south and west regions of the country, and by 1969, we had opened distribution centers in Georgia and California - our first distribution facilities outside of Chicago. We opened our first international store, in Guam, in 1968.

By the early 1970s, large home center chains began to take market share from small independent retailers. In response, Ace and our retailers began operating as a cooperative. In 1976, our retailers took full control when shareholders elected the first Board of Directors comprised solely of retailers. By this time, our wholesale sales had reached \$382 million. Ace had retailers in all 50 states and the District of Columbia by 1979. By 1985, Ace had reached \$1 billion in sales. Ace reached \$2 billion in sales in 1993, \$3 billion in sales in 1998, \$4 billion in sales in 2013 and \$5 billion in sales in 2015. The 2013 fiscal year also marked Ace's first year with more than \$100 million in net income.

Although Ace has had a retail presence outside the United States since the late 1960s, Ace implemented a more focused international growth strategy during the 1990s. In 2011, the Company restructured its international operations so that they are no longer a division within Ace's cooperative, but rather a stand-alone entity, with its own board of directors and management team. AIH is a majority-owned and controlled subsidiary of the Company with a noncontrolling interest owned by its international retailers. AIH currently has a retail presence in approximately 68 countries, with third-party distribution facilities in Dubai, United Arab Emirates; Colon, Panama; and Ningbo, China.

In December 2012, ARH acquired all of the outstanding shares of capital stock of WHI Holding Corp. ("WHI"). WHI owns all outstanding shares of Westlake Hardware, Inc. ("Westlake"). Westlake is based in Kansas City, Missouri and is the owner of 123 stores located primarily throughout the Midwest under the name Westlake Ace Hardware. In addition, in March 2019, ARH increased its non-controlling shareholder interest in ACO Inc. ("ACO") to a controlling shareholder interest. ACO has been engaged in the business of owning and operating Ace stores under the name Great Lakes Ace Hardware in the United States since 2014 and operates 52 stores in Michigan.

In 2014, the Company formed the AWH legal entity for sales to non-member retailers. AWH owns and operates EJD and its related wholesale companies.

In September 2017, AEH acquired 94.3 percent of the issued and outstanding capital stock of The Grommet. The Grommet is an e-commerce startup that operates a website that markets and sells new and innovative products created by independent entrepreneurs. Many of these products are also sold to Ace retailers for resale to consumers.

Ace's customer loyalty program, Ace Rewards®, boasts approximately 46 million members. Acehardware.com is the online face of our brand and trusted destination for online products and project solutions, and averages more than 220,000 daily visitors. Ace has invested in other digital media such as Facebook, Twitter, Instagram and YouTube. Currently, Ace has more than 600,000 Facebook fans, more than 136,000 Twitter followers, more than 43,000 Instagram followers, and more than 47 million video views on YouTube. Ace also has a mobile website that allows consumers to shop from their smart phone, as well as mobile apps for both iOS and Android devices. Ace continues to rank highly on national scales of service and customer satisfaction, and has earned numerous awards and accolades, including:

- In 2018, Ace tied for the top position in the retail category in the 2018 Temkin Experience Ratings. In addition, Ace was ranked No. 7 overall across all industries.
- In 2018, Ace ranked No. 1 in its category on *Entrepreneur* magazine's prestigious Franchise 500® list.
- In 2018, Ace ranked No. 6 on the *Franchise Times* Top 200, the annual list of largest U.S. franchises by worldwide sales.
- In 2018, Ace was recognized as America's favorite home improvement chain in a study by Market Force. Ace also ranked No. 1 in all seven customer experience categories.
- Ace Hardware ranked No. 8 on the *Chicago Tribune*'s Top Workplaces of 2018.
- Ace ranked No. 27 in STORES Magazine's Top Retailers 2018 list

Our Retailer Base

Ace has been able to attract and retain a strong base of experienced retailers by offering a broad range of products at very competitive prices, providing exceptional product availability, service levels and assisting retailers with numerous retail operational activities. As of December 29, 2018, Ace had approximately 2,700 domestic retailers operating approximately 4,500 domestic retail locations.

Ace's network of retailers covers all 50 states and the District of Columbia in the U.S. and, through our affiliated companies, customers in approximately 68 foreign countries. As of December 29, 2018, the largest concentrations of Ace retailer stores were in California (approximately 9 percent), Florida and Texas (approximately 6 percent each), Illinois and Michigan (approximately 5 percent each), and New York (approximately 4 percent). Ace shipped the largest percentages of merchandise in fiscal year 2018 to California (approximately 11 percent), Florida (approximately 7 percent), Texas (approximately 6 percent), and Illinois, New York and Michigan (approximately 4 percent each).

New Store Growth

The Company has a focused effort on attracting new retailers and on identifying growth opportunities for the Company and its retailers. The total number of Ace domestic locations during each of our past three fiscal years is summarized in the following table (excludes retail outlets served by AWH):

	2018	2017	2016
Retail outlets at beginning of period	4,418	4,363	4,311
New retail outlets added	174	152	152
Retail outlets terminated	(116)	(97)	(100)
Retail outlets at end of period	4,476	4,418	4,363
Retailers having a single outlet at end of period	2,089	2,108	2,114
Retailers having multiple outlets at end of period	643	632	624
Retailer branch locations at end of period	1,621	1,570	1,527
Company operated retail outlets	123	108	98
Retail outlets at end of period	4,476	4,418	4,363

Ace's strong competitive posture translates into success for many retailers who open new stores. The following charts show domestic new store continuations by year for, respectively, "new investor" and existing retailer "branch" stores that Ace approved for membership in each of the last five years.

New Investor Stores <u>No. of Stores Continuing with Ace at the End of Each Year</u>						
Year	No. of Stores Approved for Ace Membership	2018	2017	2016	2015	2014
2014	34	29	31	32	33	33
2015	35	32	32	33	35	
2016	33	32	32	33		
2017	32	32	32			
2018	30	30				

New Branch Stores <u>No. of Stores Continuing with Ace at the End of Each Year</u>						
Year	No. of Stores Approved for Ace Membership	2018	2017	2016	2015	2014
2014	61	53	57	60	61	61
2015	78	76	78	78	78	
2016	70	66	69	70		
2017	59	59	59			
2018	70	70				

Our Industry and Our Retailers' Core Customers

The overall U.S. home improvement industry consists of a broad range of products and services, including lawn and garden products, paint and sundries, certain building supplies and general merchandise typically used in connection with home and property improvement, remodeling, repair and maintenance. Sales within this U.S. market were estimated to be in excess of \$394 billion in 2018 by the North American Retail Hardware Association. This industry is highly fragmented and encompasses "big box" home improvement centers (such as The Home Depot, Lowe's and Menards); retail hardware stores (such as stores affiliated with our Company as well as stores affiliated with True Value and Do It Best); traditional department stores and chains offering hardware merchandise (such as Walmart, Target and Sears); and regional lumber yards and builder-contractor shops (such as 84 Lumber and United Building Centers).

Our domestic retailers generally compete in what we call the "convenience hardware" segment of the overall home improvement industry. As differentiated from the overall home improvement industry, we consider the "convenience hardware" segment of the industry to be characterized by purchases primarily of products related to home improvement and repair. These products include paint and related products and lawn and garden equipment, as well as those products less focused on large-scale building, renovation and remodeling projects. According to a report by the North American Retail Hardware Association, U.S. convenience hardware store sales were estimated at approximately \$50.8 billion in 2018. Ace estimates that its approximately 4,500 domestic outlets generated approximately \$13.0 billion in retail sales in 2018, capturing 26 percent of the domestic convenience hardware market.

We believe the core customer of the convenience hardware market is a mission shopper who values helpful service, convenience and the feel and experience of a neighborhood hardware store. These customers' purchases are typically lower ticket-price items driven by do-it-yourself improvement, repair and maintenance projects and the need for everyday household and lawn and garden items. We believe our retailers' core customer differs from the core customers of the large-format stores in that those stores typically value customers who are driven by larger scale home building and home improvement projects. Our internal analysis of customer purchases shows that the everyday improvement, maintenance and repair objectives of our retailers' customers are a significant driver of our retailers' sales.

Competitive Strengths

We believe the following competitive strengths distinguish Ace from our peers and contribute to our continued success in the convenience hardware market:

Well-Regarded for Exceptional Customer Service and Convenience. Ace positions itself as "The Helpful Place" and our local retailers differentiate themselves not only by providing high quality goods but also through their accessible, helpful and knowledgeable store staff. We believe that "The Helpful Place" is one of the most recognized slogans in the home improvement industry. In addition

to helpfulness, we believe our retailers benefit from their efficient store size and numerous, convenient locations. We believe that in comparison to larger home improvement centers and “big-box” competitors, Ace customers value our retailers’ accessible and friendly staff and the ease and speed with which they can find and purchase their desired products.

Strength of Distribution Operations. Our extensive distribution network includes 14 domestic RSCs as well as our fleet of tractors and trailers, which allows us to effectively supply our network of approximately 4,500 domestic stores. Our RSCs are equipped with information technology systems that efficiently manage and track inventory and contribute to the exceptional product availability service levels that we are able to offer to our retailer network. Our average service levels, or fill rates, were 96.2 percent, 96.2 percent and 96.5 percent for 2018, 2017, and 2016, respectively. We measure our fill rates as the percentage of units ordered that are shipped.

Ace’s extensive distribution network is key to our members’ success. Our RSCs use an integrated information service system that enables us to monitor inventory turns and levels, and to forecast labor needs at various sales volumes. This system provides Ace with daily operational information and assists us in managing our inventory and workforce.

Ace transports products from our RSCs with our truck fleet of approximately 450 tractors and approximately 1,450 freight trailers. The size of the Company’s owned and leased tractor-trailer fleet allows the Company to operate a significant backhaul business. Backhauling allows the Company to transport product from our suppliers to our crossdock facilities and our RSCs, reducing freight costs, shortening lead times and improving inventory turnover.

AWH is positioned to rapidly expand its footprint by leveraging existing Ace RSCs to become a national force for both member and non-member retailers.

Consolidated Purchasing Enhances Competitiveness of our Retailers. Ace is able to obtain lower prices on products by pooling our retailers’ buying power. The Company further reduces retailers’ cost by importing many products from overseas vendors. Under extended dating programs, the Company is given favorable payment terms on seasonal products, such as lawn and garden products, holiday promotional items and winter care products. The Company is able to pass along these extended terms to our retailers, which helps with their working capital and cash flow.

Differentiated Product and Service Offerings. We attract and retain a strong base of experienced retailers by offering a broad range of products at very competitive prices and assisting retailers with improving their operational efficiency. Our retailers and their customers value the selection of over 10,000 private label products available under the Ace brand and other proprietary brand names, including specialty product offerings such as Clark + Kensington® Paint. We also offer our retailers an extensive selection of some of the biggest brand names in the hardware industry including, but not limited to, Scotts® lawn and garden products, Weber® grills, Traeger® grills, Big Green Egg®, Stihl® power equipment, Yeti® coolers and Toro®, many of which offer exclusive products and promotions only for Ace retailers. Additional high-quality product offerings include Valspar® Paints which, together with Ace Paints, form our two-brand paint strategy. Ace has agreements with suppliers which enable our participating retailers to sell an assortment of Craftsman® tools, lawn and garden power equipment and garage door openers that they buy from us through our RSCs. The acquisition of new product curator, The Grommet, will continue to provide a stream of high quality, unique and innovative products to Ace stores.

Our service offerings allow our retailers to benefit from best practices in all aspects of managing their business, including new store development, customer service, recommended pricing, inventory management, finance and insurance, labor scheduling and marketing. These services, in addition to ongoing educational and training programs, help enhance the overall efficiency and profitability of our member retailers’ businesses and contribute to their loyalty to the Ace brand.

Diversified Network of Independent Retailers. We serve a geographically diverse network of retailers who operate approximately 4,500 domestic stores located in all 50 states and the District of Columbia. This broad network of retailers mitigates dependence on any one region of the country and reduces the impact of regional downturns. Moreover, the Company’s performance is not reliant on any one retailer. The largest retailer owns 46 stores and represents approximately 1 percent of our merchandise sales. The Company’s ten largest retailers (by purchase volume) own 251 stores and represent approximately 6 percent of our merchandise sales. Ace-affiliated companies serve international retailers in approximately 68 foreign countries. In fiscal year 2018, approximately 5 percent of Ace’s merchandise sales were made to locations outside the United States.

Long-Term, Stable Relationships with Retailers. We believe we benefit from the significant number of retailers that are long-term members of the Ace cooperative. As of December 29, 2018, approximately 77 percent of our retailers have been members for at least five years and approximately 65 percent and 41 percent have been members for at least 10 and 20 years, respectively.

Depth of Our Experienced Management Team. Our team of senior officers has extensive experience and long-term service with the Company. This group has an average of approximately 14 years of experience at Ace. In addition, we benefit from the functional expertise of our merchandise buying group, our retail support center managers and our extensive field support staff. Our leadership team has demonstrated its ability to manage Ace through past market cycles and has a successful track record of growing our business, delivering operational improvements and serving our member retailers.

Merchandise Sales to Our Network of Retailers

Ace employs a business philosophy that focuses on purchasing high-quality products at the lowest cost available, providing high levels of customer service at retail stores and making strategic investments in our distribution network. This philosophy has enabled us to establish strong, long-term customer and retailer relationships and to be viewed as a reliable and innovative performer in our respective markets.

We offer our retailers a full line of hardware products including hand and power tools, plumbing and heating supplies, garden equipment, electrical supplies, housewares and appliances, and general merchandise such as paint, cleaning and related products. Items are regularly added to and deleted from our product lines based on market research, customer demand and sales volumes (at both wholesale and retail), recommendations of suppliers and other factors.

We offer approximately 117,000 Stock Keeping Units (SKUs), including nationally branded merchandise and private label products through our network of RSCs. Our extensive product line enables us to provide our retailers with the majority of the products they need.

Ace sells merchandise to our retailers in three ways:

- Warehouse sales involve the sale of merchandise that we regularly carry in our inventory at our RSCs.
- Bulletin sales involve special bulletin offers where we place a special order for merchandise after retailers commit to buy specific quantities of it.
- Direct shipment sales involve sales where the merchandise is shipped directly to retailers by vendors.

Warehouse sales involve the sale of merchandise that we stock at our RSCs. We purchase large quantities of merchandise (mainly from manufacturers), stock it in our RSCs and sell it in smaller lots to our retailers. Most of these products are sold at a price based primarily on our cost, to which we add freight charges and a variable handling charge of approximately 10 percent. We maintain inventory quantities sufficient to meet normal replenishment orders, which enable us to keep our inventories at productive levels. Orders are usually filled within one day of receipt.

Warehouse sales accounted for approximately 80 percent of Ace's 2018 fiscal year wholesale merchandise sales. The following is a breakdown of our total warehouse sales among various general classes of merchandise for each of the past three fiscal years:

Class of Merchandise	2018	2017	2016
Paint, cleaning and related supplies	20%	20%	20%
Plumbing and heating supplies	14	13	13
Garden, rural equipment and related supplies	17	17	17
Electrical supplies	9	10	10
Hand and power tools	11	11	11
General hardware	9	9	8
Sundry	15	15	14
Housewares and small appliances	5	5	7

Bulletin sales (which are included in warehouse sales) involve special bulletin offers where we place a special order for merchandise after retailers commit to buy specific quantities of it. Bulletin sales generally relate to retail promotional events and seasonal products, and accounted for approximately 7 percent of Ace's 2018 fiscal year wholesale merchandise sales. We purchase merchandise for bulletin sales based upon retailers' orders. When the bulletin shipment arrives, we break it up into smaller quantities and deliver it to the retailers who ordered it. We generally apply a handling charge of approximately 6 percent to bulletin sales, plus freight charges.

Direct shipment sales include sales where the merchandise is shipped directly to retailers by vendors. Direct shipment sales accounted for approximately 20 percent of Ace's 2018 fiscal year wholesale merchandise sales. Retailers place direct shipment orders with our vendors. The vendors then bill Ace for these orders and ship the merchandise directly to retailers. We, in turn, bill the ordering retailers for the cost of the merchandise (including freight where applicable) plus a fixed percentage handling charge based on each retailer's prior year direct shipment dollar volume. The handling charge begins at 2.0 percent and declines to 0.5 percent for those retailers whose annual purchase volumes exceed \$815,000.

We charge freight to retailers on all warehouse sales. The freight rate is billed as a fixed percentage of each retailer's warehouse purchases. Additionally, a fuel surcharge may be applied to the freight charge if the national average cost of diesel exceeds \$2.05 per gallon based on an established matrix. Sales made by our affiliated companies to retailers located outside of the continental United States may incur additional freight and handling charges related to ocean container transportation.

Private Label Programs

Our merchandise offering to our retailers also includes privately labeled products. Ace's private label program provides our domestic retailers with over 10,000 Ace private label and store branded SKUs. RSC sales of private label product were over \$643 million in 2018. We have seven store brands including: Celebrations, Fab Cordz, Grill Mark, Home Plus, Living Accents, Oak Brook and Steel Grip. Sales of Ace private label represented approximately 14 percent of the Company's merchandise sales in 2018.

When choosing merchandise for the private label Ace brand, we target products that are not highly brand sensitive and offer our retailers an opportunity to make more margin than the national brand equivalents. The Company purchases its private label products from over 290 suppliers on an item-specific basis. We ensure consistent quality in our private label products through various means including factory site visits, third-party laboratory testing for some products, and specific criteria for imported products. The Company changes suppliers from time to time when product quality or pricing improvements are available.

Retailer Conventions

Ace hosts two conventions each year, one in the spring (usually early March) with an emphasis on Trim-a-Tree and holiday products, and one in the fall (usually in late September or early October) with an emphasis on lawn and garden products. The timing of these conventions offers retailers ample time to prepare for the seasonal needs of the upcoming year. However, the conventions offer much more than a chance to get a jumpstart on seasonal needs. Year-round products are offered by hundreds of exhibitors, and Ace also hosts booths showcasing dozens of corporate services and programs. Speeches from Board members and corporate officers provide retailers with key information, and valuable training sessions help retailers and employees improve their business skills. A typical convention covers 820,000 square feet of display space and is visited by approximately 16,000 people.

Ace Service Offerings

In addition to hosting conventions as well as other shows and product exhibits for our retailers, we also provide them with many special services. We offer all of these services at established charges. These services include inventory control systems, fact-based, market driven retail pricing recommendations, and a "checklist" service that provides current information about all of our product offerings. We also provide a choice of ongoing educational and training programs for retailers. (See "Membership Information – Retailer Assessments and Charges.")

The Company's district managers support retailers with a detailed analysis of store operations, pricing, advertising, inventory control and merchandising plans to help retailers enhance their competitive position. Other services we offer are provided through third party service providers. Our services include:

- *Pricing-Related Services.* While each of our retailers determines the pricing strategy for his or her own stores, we offer retailers an assortment of pricing-related services designed to help improve their gross margin dollars and enhance price competitiveness. These include services such as recommended localized pricing, item changes, as well as loyalty programs and promotions via electronic communications for each store.
- *Advertising.* We support Ace's strong brand name recognition by making significant investments in national television, audio (terrestrial radio and streaming), online marketing and digital display advertising. Lou Manfredini, a nationally known home improvement expert, serves as Ace's Home Expert. We provide tools to support our retailers' regional and local advertising efforts. Ace offers a local marketing portal that our retailers can use to create customized local marketing materials such as emails, postcards, billboards, signage and social and digital media assets. Retailers are able to download for free customizable TV and radio commercials.
- *Ace Rewards®.* To further promote the Ace brand name, Ace maintains a preferred customer loyalty program, Ace Rewards. The program is aimed at delivering consumer touch points which drive profitable revenues to retailers and leverage the relationship between customers and their local Ace stores. As of December 29, 2018, Ace Rewards has approximately 46 million members. Average spending for Ace Rewards customers is higher than for non-Ace Rewards customers, as the average transaction amount for Ace Rewards customers is approximately 17 percent higher than non-Ace Rewards customers.
- *Market and Consumer Research.* We provide market and consumer research to our retailers. In an effort to delineate the strengths and weaknesses of major competitors in the marketplace, the Company conducts consumer research on a national level. On the local level, the Company helps assess the trade area of existing stores, the potential of the trade area and the performance level of individual stores.
- *New Store Analysis.* In analyzing new or expanded store opportunities, the Company assists retailers with site analysis, demographic information, store size and format recommendations, sales and other projections, décor, merchandising and advertising.

- *Bankcard Program.* We provide credit and debit card transaction processing for our retailers. The Company acts as the merchant of record and processes credit and debit card settlements. Retailers' sales transactions are transmitted daily and automatically credited to their Ace statement.
- *Insurance Services.* Our wholly owned subsidiary, Ace Insurance Agency, Inc., provides a retailer commercial insurance program. This program offers property, general liability, flood, business interruption, employment practices, rental, cyber, crime, wind and workers' compensation insurance. Ace Insurance Agency, Inc. is managed by experienced industry professionals and is licensed in all 50 states and the District of Columbia.
- *Analysis of Underperforming Stores.* The Company tracks the financial performance of all stores. When appropriate, we formulate marketing and operational recommendations targeted to improve individual store performance.
- *Retailer Credit.* Generally, the more collateral, guarantees or other evidence of financial strength, the higher the Ace credit limit for which that retailer qualifies. We periodically review and establish credit limits for retailers based on payment history and financial ratios, as well as other considerations relating to the performance of specific retailers.
- *Retailer Loans.* The Company has various lending programs which are available to qualified retailers. The notes bear interest at various rates based on market rates, the loan program or the retailer's credit quality. Payments on these notes are primarily collected by the Company through the application of future patronage distributions, retailer billings or stock repurchases.
- *Customer Insight Program.* The Company offers various optional services to retailers to gain information about their customer service performance. The services include mystery shops (either in store, at a competitor, by telephone or by video) and customer and employee engagement surveys.
- *Visual Merchandising Services.* The Company offers visual merchandising services including the installation of fixtures and merchandising for new stores, conversions and remodels.
- *Workforce Management.* The Company offers retailers the option to purchase a license and implement Workforce Management software. The software gives retailers the ability to manage labor forecasts, scheduling, time and attendance.
- *Professional Retail Services.* The Company offers retailers training programs (pre-opening and continuing) via in-store training and workshops to assist retailers in addressing common retailer processes and issues, including customer service, inventory management, store finances and operations.

Other Ace Retailer Programs and Benefits

We offer other programs designed to maximize our retailers' competitive position. These programs include:

- *New Store Incentives.* Ace's New Store Incentives help qualifying retailers, including prospective conversion stores, open new locations by providing substantial merchandise credits in exchange for remaining an Ace retailer for five years.
- *Payment Terms on Seasonal Merchandise.* Ace provides extended payment terms (datings) on seasonal and certain other merchandise purchases to assist retailers with their cash flow. These datings are intended to allow the retailer to capture the cash flow of the merchandise sale before being required to pay Ace.

Distribution

Ace's extensive distribution network is key to our members' success. Our RSCs use an integrated information system that enables us to monitor inventory turns and levels, and to forecast labor needs at various sales volumes. This system provides Ace with daily operational information requirements and assists us in managing our inventory and workforce. Through this system, Ace is able to track every pallet of merchandise in our RSCs and coordinate our warehouse picking operation.

Ace also utilizes technology to ensure low cost distribution, including voice-picking and inbound and outbound radio frequency scanning. The result is improved order accuracy that enables most retailers to avoid verifying quantities of merchandise received at the retail location. Additionally, our retailers can check inventory availability, make special purchase requests and monitor prices on commodity items through ACENET, our intranet that serves as the primary communication vehicle between us and our retailers.

Ace's RSC locations distribute merchandise to our retailers in a timely fashion. Ace transports products from our RSCs with our own truck fleet of approximately 450 tractors and approximately 1,450 freight trailers. We generally lease tractors and own trailers.

The size of the Company's owned and leased tractor-trailer fleet allows the Company to operate a significant backhaul business. Backhauling allows the Company to transport product from our suppliers to our crossdock facilities and our RSCs, reducing inbound freight costs, shortening lead times and improving inventory turnover. Our average service levels, or fill rates, were 96.2 percent, 96.2 percent and 96.5 percent for 2018, 2017, and 2016, respectively.

Suppliers

Ace purchases merchandise from approximately 4,100 suppliers ranging from local suppliers to large multinational corporations. No one supplier accounted for more than 6.0 percent of products purchased in fiscal 2018. Our top ten vendors accounted for approximately 26.7 percent of our merchandise purchases in 2018. We maintain a staff of experienced merchants in each of our product departments who work closely with our suppliers' sales staffs.

Ace works with our suppliers to ensure a timely flow of products to our retailers. Through collaborative replenishment programs, Ace communicates RSC inventory and product sales information electronically to certain suppliers who are then responsible for generating orders automatically based on this data. These programs are advantageous to Ace, our retailers, and our suppliers. We can maximize utilization of our RSC warehouse space and increase inventory turns, while our suppliers are provided with current and accurate demand data for their products, and our retailers receive over 96 percent of the items they order.

Technology

Ace uses technology to maximize efficiency both in our retailers' operations and in our RSCs. Among the computerized retail services developed or supported by Ace for our retailers are: (i) retail store systems, including point-of-sale (POS) to manage pricing and product promotion; (ii) inventory, merchandising and pricing software (including category management and shelf-management); and (iii) other management information and productivity systems, including drop-ship support. Many in-store operations are enhanced and streamlined by using Ace supported programs. These programs include:

- Eagle for Windows – This third-party system is a distributed in-store computer that provides POS, inventory management, accounts receivable, accounts payable, general ledger and reporting capabilities. The system is provided directly from the vendor to retailers, subject to the terms and fees included in an agreement between the vendor and retailer. The system allows the retailer to create computer-generated orders for stock replenishment, participate in the Ace Rewards customer loyalty program, and is integrated to a number of the enterprise systems at the Ace corporate headquarters.
- ACENET – This intranet site serves as the primary communication platform between Ace and our retailers. In addition, a wealth of information such as product catalogs and special ordering functions can be accessed through this program. ACENET is a portal for the *Ace Way of Retailing*, which documents the best practices for operating an Ace store.
- www.acehardware.com – Ace Hardware's website is its branding, shopping and research solution for consumers, and it received over 82 million visitors in 2018. The website offers online shoppers more than 60,000 SKUs that can be shipped directly to their home or to their local Ace store. Retailers are also able to create personalized web pages for their stores on this site. Ace has implemented an In-Store Pickup (ISPU) feature that allows consumers to check product availability at their local Ace and if they choose, order online and pick up at their Ace store as early as the same day. In 2018, Ace re-platformed its existing website to allow for store-specific pricing, full integration with the Ace Rewards program, and to enable the introduction of a new program called Buy Online, Deliver from Store (BODFS).

Ace has invested significantly in wholesale information technology to build and manage an enterprise architecture and high-speed telecommunications network that links manufacturers, wholesale distribution, Ace retailers and consumers in the supply chain. We anticipate continued investment in technology for the foreseeable future.

Ace International

We opened our first international store in 1968 and since then have developed a sizable international business. In early 2011, we restructured our international operations into a new stand-alone legal entity as opposed to a division within the Ace cooperative structure. AIH plans to achieve its growth strategy by expanding into new markets and enhancing existing wholesale and retail support services for its international retailers. AIH has its own management team and board of directors. AIH is a majority-owned and controlled subsidiary of the Company with a noncontrolling interest owned by its international retailers. Ace-affiliated retailers located outside the U.S. do not own shares of stock in the Company nor do they receive patronage dividends.

AIH has retailer relationships in approximately 68 countries and U.S. territories. The major regions in which it does business include the Middle East, Caribbean, Latin America, the Pacific Rim and Asia.

The total number of retail outlets operated by AIH customers during each of the past three fiscal years is summarized in the following table:

	2018	2017	2016
Retail outlets at beginning of period	703	631	579
New retail outlets added	83	84	55
Retail outlets terminated	(9)	(12)	(3)
Retail outlets at end of period	777	703	631

AIH currently has offices located in Dubai, United Arab Emirates; Panama City, Panama; and Shanghai, China, each providing in-country resources to international retailers in their respective regions. The China facility also serves as a buying office, sourcing direct-import products from Asia for both Ace domestic and international retailers. In addition, AIH manages warehouse operations through third-party providers located in Dubai, United Arab Emirates; Colon, Panama and Ningbo, China. These warehouses provide region-specific merchandise to AIH's retailers.

Currently, AIH operates two facilities in the U.S. that provide freight forwarding services to our affiliated international retailers: one is located in Medley, Florida and the other in Carson, California.

The Company's percentage of merchandise revenues by geographic region in fiscal years 2018, 2017 and 2016 are presented in the table below:

	2018	2017	2016
United States revenues	95.1%	94.9%	95.2%
Foreign revenues	4.9	5.1	4.8
Total revenues	100.0%	100.0%	100.0%

Trademark and Service Mark Registrations

The names "Ace Hardware" and "Ace" are used extensively by retailers and us in the promotion, advertising and marketing of products and services that we and our retailers sell. We have had various trademark and service mark registrations issued by the U.S. Patent and Trademark Office for these and other marks.

Employees

As of December 29, 2018, we had approximately 8,700 employees, of whom approximately 2,000 were salaried employees. In general, our employees are covered by non-negotiated benefit plans that include healthcare, death benefits and, with few exceptions, 401k retirement benefits.

Legal Proceedings

From time to time the Company is involved in various legal and administrative proceedings that are incidental to its business, including claims relating to product liability, general negligence, environmental issues, employment, intellectual property and other matters. It is not expected that the ultimate resolution of any of these matters will have, either individually or in the aggregate, a material adverse effect on the Company's consolidated financial position or results of operations.

Regulation

The Company is subject to federal, state and local laws and regulations governing businesses generally. Management believes that the Company is in substantial compliance with all federal, state and local laws and regulations governing its business.

Competition

The retail hardware business is highly fragmented and intensely competitive. Our retailers' competitors include many large companies that have substantially greater market presence, name recognition, and financial, marketing and other resources than we or our retailers do. The Company and its retailers compete directly or indirectly with "big-box" home improvement centers (e.g., The Home Depot, Lowe's, Menards and others); retail hardware stores (e.g., True Value and Do It Best); regional lumber yards and builder-contractor shops (e.g., 84 Lumber and United Building Centers); mass merchandisers, warehouse clubs and discount stores (e.g., Walmart, Sam's Club, Costco, Target, Kmart); and catalog and Internet-based retailers (e.g., Amazon.com).

The Company's competitors include many of the same companies including True Value and Do It Best, but also include national, regional and local warehouse distributors such as Orgill and United Hardware.

For over 90 years, Ace has successfully weathered competitive pressures and various economic cycles. We believe that Ace's longevity is due to our ability to adjust to changing market conditions and the diverse nature of our retailer base.

The Company believes that its business strategy provides the Company and our retailers with a significant competitive advantage. By leveraging the purchasing power of Ace's large retailer base, we can obtain products at competitive prices from our vendors. In addition, the Company's retailer-focused support services help our retailers to compete in their local markets. The Company believes that it achieves a significant competitive advantage by combining the purchasing and operating efficiencies from its centralized supply and support services with the local market flexibility and entrepreneurship of our independent retailers.

The Company believes it can continue to compete successfully on the wholesale level and support the competitive efforts of our retailers by continuing to provide them goods at competitive prices and the support services referred to above.

Properties

Ace's general offices are located at 2200 Kensington Court, Oak Brook, Illinois 60523. The following table lists our primary offices, distribution, warehousing and other facilities, and indicates whether each property is owned or leased.

Location	Square Feet of Facility	Owned or Leased
General Offices:		
Oak Brook, Illinois	206,030	Leased
Oak Brook, Illinois	35,254	Leased
Retail Support Centers:		
Wilton, New York	1,200,365	Owned
Princeton, Illinois	1,094,756	Owned
Fredericksburg, Pennsylvania	1,080,421	Leased
Rocklin, California	1,035,000	Owned
Prescott Valley, Arizona	905,445	Owned
Loxley, Alabama	798,698	Owned
Moxee, Washington	798,107	Leased
Colorado Springs, Colorado	721,668	Owned
Maumelle, Arkansas	597,253	Owned
LaCrosse, Wisconsin	591,254	Owned
West Jefferson, Ohio	534,040	Leased
Gainesville, Georgia	481,013	Owned
Wilmer, Texas	450,262	Leased
Tampa, Florida	391,755	Owned
Freight Consolidation/Redistribution Facilities:		
Suffolk, Virginia	475,020	Leased
Kent, Washington	342,484	Leased
Carson, California	39,004	Leased
Summit, Illinois	37,236	Leased
Medley, Florida	34,020	Leased
Oakwood, Georgia	24,377	Leased
Irwindale, California	22,300	Leased
St. Louis, Missouri	13,500	Leased
Other Warehouse Facilities:		
Spokane, Washington	508,394	Leased
Portland, Maine	300,000	Leased
Pittston, Pennsylvania	173,320	Leased

Customers served from the Portland, Maine and Pittston, Pennsylvania warehouses are being transitioned to other RSCs. The Portland and Pittston warehouses will be closed and returned to the landlords in the first half of 2019. The Company also owns an 800,000 square foot warehouse facility in Prince George County, Virginia that was closed after Ace opened its new Fredericksburg, Pennsylvania RSC. The Prince George facility is under contract for sale, which is expected to close in 2019.

We also lease divisional offices and storage space and own or lease a fleet of tractors, trailers and automobiles, as well as warehouse, computer and other equipment. The Company's ARH business leases 122 retail store locations ranging in size from 9,779 to 47,443 square feet.

COMPANY MANAGEMENT AND DIRECTORS

Members of the Board of Directors

The Company's business and affairs are governed by its Board of Directors. The current By-laws of the Company provide that the Board of Directors shall be comprised of no fewer than nine and no more than 12 directors, as fixed from time to time by the Board, and may consist of member directors and non-member directors. No fewer than eight of the directors shall be member directors. A maximum of 25 percent of the directors may be non-member directors.

The directors are divided into three classes, and each class of directors serves for a three-year term. The Board determines the number of directors in each class and the number of member directors and non-member directors who comprise each class. In no event may the term of any director exceed an aggregate of nine years, except that the Chairman may serve as a director for such additional time as shall be necessary to permit him or her to serve for up to five years as Chairman.

Each member director must be a stockholder or other equity owner of a retail business that owns capital stock of the Company or a manager, executive officer, general partner or general manager or other affiliate (as defined in the Company's current By-laws) of such retail business organization that owns capital stock of the Company.

As of March 1, 2019, the Board of Directors currently consists of ten directors: eight member directors and two non-member directors.

The Board of Directors held eight formal meetings in 2018. No director attended fewer than 75 percent of the meetings of the Board and those committees on which he or she served during 2018. Directors are expected to attend annual meetings of stockholders. All incumbent directors attended the 2018 annual meeting of stockholders.

The Board of Directors acts collectively through meetings, committees and management members it appoints. In addition, the Company employs a staff of executives to manage the day-to-day business of the Company.

The members of the Board of Directors are identified below. Ages are as of March 1, 2019.

Name	Age	Position	Director Since	Term Expires
<i>Directors</i>				
James W. Ackroyd	62	Chairman of the Board, Class II Member Director	2008	2019
Stewart C. Elliott, Jr.	61	Class III Member Director	2013	2019
Kristin A. Grunder	46	Class III Member Director	2016	2019
Amy E. Kaplanis	49	Class III Member Director	2013	2019
David F. Karsten	54	Class II Member Director	2011	2020
Karen J. May	61	Class II Non-Member Director	2017	2020
Mark J. Schulein	49	Class II Member Director	2014	2020
David C. Barker	58	Class I Member Director	2018	2021
Richard W. Bennet, III	66	Class I Non-Member Director	2014	2021
Brett G. Stephenson	48	Vice Chairman of the Board, Class I Member Director	2012	2021

James W. Ackroyd is Chief Executive Officer of Vision Ace Hardware LLC, a 14-store chain in southwest Florida, a position he has held since November 1999. Mr. Ackroyd holds a Bachelor of Science degree in accounting from Bentley College (Massachusetts) and is a certified public accountant. Mr. Ackroyd's term as Chairman of the Board will expire in 2019 at which time Mr. Ackroyd will have served the maximum number of years of service permitted by the By-laws.

Stewart C. Elliott, Jr. is President of Elliot Ace Hardware, a four-store chain located in the Milwaukee, Wisconsin area, a position he has held since 1988. Mr. Elliott holds a Bachelor of Science degree in economics from the University of Michigan.

Kristin A. Grunder is the co-owner of Rome Ace Hardware, a single Ace store located in Rome, New York, a position she has held since 1999. Ms. Grunder graduated from Ithaca College with a Bachelor of Arts degree.

Amy E. Kaplanis is the Vice President of Country Ace Hardware, a single store located in Granby, Colorado, a position she has held since 2006. Ms. Kaplanis holds a Bachelor of Business Administration degree in international business from George Washington University and a Master of Business Administration degree from the University of Denver.

David F. Karsten is the President and Chief Executive Officer of a four-store chain in the suburban Arizona towns of Cave Creek, Goodyear, and Care Free, a position he has held since 2001. Mr. Karsten received a Bachelor of Science Degree in business management from Western Governors University.

Karen J. May, retired in 2018 as the Executive Vice President and Chief Human Resources Officer of Mondelez International, Inc. (formerly Kraft Foods, Inc.), a position she held since 2005. Prior to joining Kraft Foods, she was Senior Vice President and Chief Human Resources Officer of Baxter Healthcare, Inc. where she worked for 15 years. Before her move into Human Resources, she served in a variety of Finance and Accounting roles at Baxter, including as VP of Corporate Audit, VP of International Finance, and VP of Finance (Controller) of the Hospital Supply Division. Ms. May received a Bachelor of Science degree in Accountancy from the University of Illinois at Urbana Champaign in 1980.

Mark J. Schulein is President of an 18-store operation across Southern California, Arizona and Hawaii, a position he has held since 2004. Mr. Schulein has worked in this family business since 1994. Mr. Schulein has a Bachelor's Degree from the University of San Diego.

David C. Barker is President of BBCO, LLC, a four-store chain in Texas, a position he has held since 2013. Before opening his first Ace store in 2013, he was a Division Vice President for Dollar General, and from 2000 to 2003 he was Vice President – Information Systems of Everyday Stores. In 2009, Mr. Barker retired from the United States Air Force Reserve where he served as a logistics officer. Mr. Barker received a Bachelor of Arts degree from Saint Leo University in Business Information Systems.

Richard W. Bennet III is the Co-Chief Executive Officer of CCA Global Partners ("CCA"), an international cooperative that provides retail infrastructure to over 2,700 independent and franchise operations in the flooring industry and other home improvement industries. He is also a member of the CCA board of directors and has prior experience as a member of both public and private company boards of directors. Mr. Bennet also has significant private equity experience and serves as the Executive Chairman of the Franklin Madison Group. He spent 27 years with May Department Stores, including serving as its Vice Chairman. Mr. Bennet received a Bachelor of Science degree in Business Administration from the University of Central Missouri and a Master of Business Administration degree from Washington University in St. Louis.

Brett G. Stephenson is President of Ace Hardware Home Centers, Inc., a six-store chain in Wyoming and Colorado, a position he has held since 2004. Mr. Stephenson earned a Bachelor of Science degree from Colorado State University. Mr. Stephenson has held the position of Vice Chairman of the Board since August 2018.

Committees of the Board of Directors

The Board of Directors has five committees: Audit, Compensation and Human Resources, Finance, Retail Supply Chain and Nominating and Governance. Each holds regular meetings, generally in connection with scheduled Board meetings. Each committee operates under a written charter that may be found on ACENET, our intranet site, which is available and accessible by all Ace members.

Audit Committee. The Audit Committee assists the Board in its oversight responsibilities with respect to the integrity of Ace's financial statements; Ace's compliance with legal requirements; the effectiveness of internal controls and procedures; the independent auditors' qualifications and independence; and the performance of Ace's internal audit function and independent auditors. The Audit Committee met four times in 2018.

Compensation and Human Resources Committee. The Compensation and Human Resources Committee provides oversight and evaluation of the executive officers' relative pay, from both an internal and external point of view, and considers each officer's relative performance to support such compensation. This committee strives to ensure that our executives are compensated fairly compared to their peers within the retail sector. The Compensation and Human Resources Committee annually reviews data from Korn Ferry Retail Industry Total Remuneration Survey as its primary benchmark source of compensation data. The Compensation and Human Resources Committee met four times in 2018.

Finance Committee. The Finance Committee assists the Board in developing the Company's short- and long-term financial goals, capital requirements, patronage distribution plan, credit policies and related matters. The Finance Committee met three times in 2018.

Retail Supply Chain Committee. The Retail Supply Chain Committee assists the Board in fulfilling its responsibilities relating to oversight of significant operational and retail focused initiatives affecting the Company and its member retailers. The Retail Supply Chain Committee met three times in 2018.

Nominating and Governance Committee. The Nominating and Governance Committee assists the Board in fulfilling its responsibilities with respect to corporate governance, Board organization and procedures, individual director and full Board performance evaluations and nomination of directors. The Nominating and Governance Committee met four times in 2018.

The Nominating and Governance Committee will consider nominees recommended by member retailers and its process for doing so is the same as its process for screening and evaluating candidates suggested by directors or management of the Company.

The procedures for election of directors to Ace's Board of Directors are set forth in the By-laws. The following describes the process of nominating board members from a practical perspective in layman's terms. It is, however, qualified in its entirety by reference to the By-laws.

The Nominating and Governance Committee maintains a list of candidates who have expressed interest, who have been recommended or who are believed to have the potential to bring a fresh perspective to the Board. When a Board member is near to

completing his or her term, it is customary for the Board to endorse a candidate to fill the seat in the next term. Endorsements are generally made at least four months – often six months in the case of continuing directors – prior to the annual meeting. Endorsements of continuing directors and new directors are made by the full Board, after receiving a recommendation from the Nominating and Governance Committee.

Qualifications considered when evaluating potential candidates include their understanding of, and perceived likelihood of contributing to, the Ace enterprise at the Board level. Board members must be forward-thinking, innovative, articulate and financially astute. They must be able to think strategically versus tactically on a wide variety of issues. Participation in retailer groups, advisory groups, industry groups, etc., is desirable. A solid credit relationship, consistent with the “prompt payment” standards to which existing directors are held, is critical. Education and other outside experiences are also considered. Ultimately, a candidate must be able to perform financial and other oversight responsibilities and to engage in the formulation of the Company’s strategic direction. Above all, candidates must have the ability to place the greater good of the organization and its members generally over the needs or desire of any individual or special group. Because Board members are eligible to serve three terms, election to the Board is generally viewed as involving a nine-year commitment. Being a member of the Board requires a significant amount of effort and time to prepare for and attend meetings, Ace conventions and other events and otherwise to fulfill one’s responsibilities.

It is also possible for an Ace retailer to nominate himself or herself or another eligible person for election to the Board by giving written notice to the Secretary of the Company no less than 150 days before the annual meeting, in accordance with the specific requirements of the By-laws, and then nominating that individual at the annual meeting. Such a nominee would, in effect, run against the Board-endorsed candidate(s).

The table below provides membership information for each of the Board committees:

Name	Audit	Compensation and Human Resources	Finance	Nominating and Governance	Retail Supply Chain
James W. Ackroyd	X	X			
Dave C. Barker	X		X	X	
Richard W. Bennet, III		X			X
Brett G. Stephenson	X	Chair			
Stewart C. Elliott Jr.	X		X	X	
Kristin A. Grunder			X	Chair	X
Amy E. Kaplanis		X			Chair
David F. Karsten			Chair	X	X
Karen J. May	Chair	X			
Mark J. Schulein			X	X	X

How to Communicate with the Board of Directors

Any Ace stockholder that wishes to communicate with the Board of Directors may do so by sending a written communication addressed to the Board or to any director in care of Ace Hardware Corporation, 2200 Kensington Court, Oak Brook, IL 60523, Attention: Chairman. Stockholders also may contact a director directly by written communication, telephone or e-mail. Store contact information, telephone number and e-mail address for each director can be found on ACENET. Any communication addressed to a director received at Ace’s corporate headquarters will be forwarded to such director as soon as practicable. Ace’s practice is to forward all communications received from holders of its capital stock that are addressed simply to the Board of Directors to the chairman of the committee of the Board whose purpose and function is most closely related to the subject matter of the communication.

Senior Management

The Company's executive officers are identified below. Ages are as of March 1, 2019.

Name	Age	Position
John S. Venhuizen	48	President and Chief Executive Officer
Lori L. Bossmann	58	Executive Vice President, Chief Supply Chain Officer
William M. Guzik	59	Executive Vice President, Chief Financial Officer and Chief Risk Officer
John J. Surane	50	Executive Vice President, Chief Merchandising & Sales Officer
Kane C. Calamari	52	Senior Vice President, Chief Human Resources Officer
Kimberly S. Lefko	45	Senior Vice President, Chief Marketing Officer
Kerilyn M. Johnson	48	Vice President, General Counsel and Secretary
William R. Kiss, III	49	Vice President, Digital, Social & CRM
Thomas J. Molleur	52	Vice President, Retail Support
John R. Tovar	40	Vice President, Retail Operations & New Business
Brian R. Wiborg	46	Vice President, Merchandising
Richard G. Williams	53	Vice President, Information Technology

John S. Venhuizen was named President and Chief Executive Officer in April 2013.

Lori L. Bossmann was named Executive Vice President, Chief Supply Chain Officer in May 2018. She was the Executive Vice President, Supply Chain, Inventory, Retail Support and Loss Prevention from June 2017 to May 2018. She was the Executive Vice President, Supply Chain and Retail Support from January 2014 to June 2017.

William M. Guzik was named Executive Vice President, Chief Financial Officer and Chief Risk Officer in January 2014. From July 2012, when he joined Ace, to December 2013 he was Senior Vice President, Chief Financial Officer.

John J. Surane was named Executive Vice President, Chief Merchandising and Sales Officer in May 2018. He was Executive Vice President, Merchandising, Retail Operations, Business to Business and Wholesale Holdings from January 2017 to May 2018. From January 2014 to December 2016 he was the Executive Vice President, Marketing, Merchandising and Sales.

Kane C. Calamari was named Senior Vice President, Chief Human Resources Officer in May 2018. He was Senior Vice President, Human Resources, Organizational Development and Communications from December 2017 to May 2018. He was Vice President, Human Resources, Organizational Development, Communications and Customer Care from June 2015 to November 2017. From July 2014 to June 2015, he was Vice President, Human Resources, Organizational Development and Communications.

Kimberly S. Lefko joined Ace as the Senior Vice President, Chief Marketing Officer in July 2018. Prior to joining the Company, Ms. Lefko was the Chief Marketing Officer of Weber Stephen Products from June 2013 to December 2017.

Kerilyn M. Johnson was named Vice President General Counsel and Secretary in April 2017. She joined Ace in 2013 as Senior Corporate Counsel and was promoted to Assistant General Counsel in 2015.

William R. Kiss III was named Vice President, Digital, Social & CRM in May 2018. From June 2016 to April 2018, he was Senior Director, Head of Ecommerce, Digital Marketing & Omni-Channel Strategy. Prior to joining Ace, he was the Chief Marketing Officer for Sears Holding Company.

Thomas J. Molleur was named Vice President, Retail Support in June 2017. He was Vice President Distribution from June 2015 to May 2017. From August 2014 to June 2015, he was Director of Distribution. From August 2012 to August 2014, he was Chief Operating Officer of LeanCor Supply Chain Group.

John R. Tovar joined Ace as our Vice President, Retail Operations and New Business in May 2018. Prior to joining the Company, he was Vice President Merchandising for GameStop, a position held since May 2016. Mr. Tovar was the Executive Vice President Operations for 24 Hour Fitness from December 2009 to May 2016.

Brian R. Wiborg was named Vice President, Merchandising in June 2018. He was Vice President of Marketing, Retail Training and Store Operations from January 2017 to June 2018. From December of 2014 to December 2016, he was Vice President, Retail Development and Supply.

Richard G. Williams was named Vice President, Information Technology in May 2015. From February 2014 to May 2015, he was Senior Director, Information Technology.

FINANCIAL INFORMATION

Report of Independent Auditors

The Board of Directors
Ace Hardware Corporation

Report on the Financial Statements

We have audited the accompanying consolidated financial statements of Ace Hardware Corporation, which comprise the consolidated balance sheets as of December 29, 2018 and December 30, 2017, and the related consolidated statements of income, comprehensive income, equity, and cash flows for each of the three fiscal years in the period ended December 29, 2018, and the related notes to the consolidated financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in conformity with U.S. generally accepted accounting principles; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free of material misstatement, whether due to fraud or error.

Auditor's Responsibility

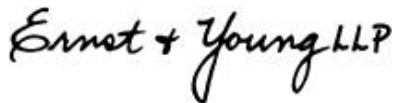
Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Ace Hardware Corporation at December 29, 2018 and December 30, 2017, and the consolidated results of its operations and its cash flows for each of the three fiscal years in the period ended December 29, 2018, in conformity with U.S. generally accepted accounting principles.



Chicago, Illinois
February 13, 2019

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

	December 29, 2018	December 30, 2017
Assets		
Cash and cash equivalents	\$ 25.6	\$ 23.0
Marketable securities	50.4	51.1
Receivables, net of allowance for doubtful accounts of \$6.7 and \$5.8, respectively	434.4	415.7
Inventories	931.8	777.5
Prepaid expenses and other current assets	50.4	41.5
Total current assets	1,492.6	1,308.8
Property and equipment, net	368.6	356.6
Notes receivable, net of allowance for doubtful accounts of \$2.8 and \$5.4, respectively	11.8	8.4
Goodwill and other intangible assets	94.2	90.7
Other assets	91.3	93.3
Total assets	<u>\$ 2,058.5</u>	<u>\$ 1,857.8</u>
Liabilities and Equity		
Current maturities of long-term debt	\$ 60.6	\$ 49.0
Accounts payable	748.9	685.0
Patronage distributions payable in cash	55.0	61.5
Patronage refund certificates payable	10.2	5.7
Accrued expenses	173.6	170.7
Total current liabilities	1,048.3	971.9
Long-term debt	267.1	173.0
Patronage refund certificates payable	95.6	82.5
Other long-term liabilities	79.7	69.5
Total liabilities	1,490.7	1,296.9
Member Retailers' Equity:		
Class A voting common stock, \$1,000 par value, 10,000 shares authorized, 2,719 and 2,722 issued and outstanding, respectively	2.7	2.7
Class C nonvoting common stock, \$100 par value, 6,000,000 shares authorized, 4,648,554 and 4,412,989 issued and outstanding, respectively	464.8	441.3
Class C nonvoting common stock, \$100 par value, issuable to retailers for patronage distributions, 439,591 and 488,858 shares issuable, respectively	44.0	48.9
Contributed capital	18.5	18.3
Retained earnings	24.8	33.2
Accumulated other comprehensive income (loss)	(1.2)	3.5
Equity attributable to Ace member retailers	553.6	547.9
Equity attributable to noncontrolling interests	14.2	13.0
Total equity	567.8	560.9
Total liabilities and equity	<u>\$ 2,058.5</u>	<u>\$ 1,857.8</u>

See accompanying notes to the consolidated financial statements.

ACE HARDWARE CORPORATION
CONSOLIDATED STATEMENTS OF INCOME
(In millions)

	Years Ended		
	December 29, 2018 (52 Weeks)	December 30, 2017 (52 Weeks)	December 31, 2016 (52 Weeks)
Revenues:			
Wholesale revenues	\$ 5,341.6	\$ 5,091.2	\$ 4,863.2
Retail revenues	375.4	297.2	262.3
Total revenues	<u>5,717.0</u>	<u>5,388.4</u>	<u>5,125.5</u>
Cost of revenues:			
Wholesale cost of revenues	4,707.4	4,466.9	4,268.2
Retail cost of revenues	214.5	167.2	144.5
Total cost of revenues	<u>4,921.9</u>	<u>4,634.1</u>	<u>4,412.7</u>
Gross profit:			
Wholesale gross profit	634.2	624.3	595.0
Retail gross profit	160.9	130.0	117.8
Total gross profit	<u>795.1</u>	<u>754.3</u>	<u>712.8</u>
Distribution operations expenses	163.6	147.7	134.7
Selling, general and administrative expenses	187.7	182.2	167.1
Retailer success and development expenses	159.1	149.3	138.4
Retail operating expenses	156.1	115.1	99.0
Warehouse facility closure costs	0.1	4.0	3.3
Total operating expenses	<u>666.6</u>	<u>598.3</u>	<u>542.5</u>
Operating income	<u>128.5</u>	<u>156.0</u>	<u>170.3</u>
Interest expense	(20.4)	(14.6)	(12.8)
Interest income	9.6	4.3	3.4
Other income, net	8.0	6.4	5.7
Income tax benefit (expense)	2.5	(4.7)	(5.4)
Net income	<u>128.2</u>	<u>147.4</u>	<u>161.2</u>
Less: net income attributable to noncontrolling interests	<u>0.5</u>	<u>0.8</u>	<u>0.3</u>
Net income attributable to Ace Hardware Corporation	<u>\$ 127.7</u>	<u>\$ 146.6</u>	<u>\$ 160.9</u>
Patronage distributions accrued	<u>\$ 141.8</u>	<u>\$ 155.5</u>	<u>\$ 157.9</u>
Patronage distributions accrued for third party retailers	<u>\$ 135.4</u>	<u>\$ 150.6</u>	<u>\$ 152.8</u>

See accompanying notes to the consolidated financial statements.

ACE HARDWARE CORPORATION
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(In millions)

	Years Ended		
	December 29, 2018 (52 Weeks)	December 30, 2017 (52 Weeks)	December 31, 2016 (52 Weeks)
Net income	\$ 128.2	\$ 147.4	\$ 161.2
Other comprehensive income, net of tax:			
Unrecognized postretirement cost	-	-	(0.1)
Unrealized (loss) gain on investments	(6.5)	1.7	0.4
Unrealized gain on derivative financial instrument	1.1	1.3	-
Total other comprehensive (loss) income, net	(5.4)	3.0	0.3
Comprehensive income	122.8	150.4	161.5
Less: Comprehensive income attributable to noncontrolling interests	0.5	0.8	0.3
Comprehensive income attributable to Ace Hardware Corporation	\$ 122.3	\$ 149.6	\$ 161.2

See accompanying notes to the consolidated financial statements.

ACE HARDWARE CORPORATION
CONSOLIDATED STATEMENTS OF EQUITY
(In millions)

Shareholders of Ace Hardware Corporation

	Capital Stock		Class C Stock Issuable to Retailers for Patronage Dividends	Additional Stock Subscribed	Contributed Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Noncontrolling Interests	Total Equity
	Class A	Class C							
Balances at January 2, 2016	\$ 2.7	\$ 375.7	\$ 56.4	\$ -	\$ 20.7	\$ 28.4	\$ 0.2	\$ 12.0	\$ 496.1
Net income	-	-	-	-	-	160.9	-	0.3	161.2
Other comprehensive income	-	-	-	-	-	-	0.3	-	0.3
Net payments on subscriptions	-	-	-	1.0	-	-	-	-	1.0
Stock issued	0.1	56.2	(56.4)	(1.0)	-	-	-	-	(1.1)
Change in noncontrolling interests	-	-	-	-	(0.9)	0.7	-	0.2	-
Repurchase of noncontrolling interests	-	-	-	-	(2.0)	0.1	-	(3.3)	(5.2)
Stock repurchased	(0.1)	(18.7)	-	-	-	-	-	-	(18.8)
Patronage distributions issuable	-	-	52.3	-	-	-	-	-	52.3
Patronage distributions payable	-	-	-	-	-	(152.8)	-	-	(152.8)
Other	-	-	-	-	0.4	(0.1)	-	-	0.3
Balances at December 31, 2016	\$ 2.7	\$ 413.2	\$ 52.3	\$ -	\$ 18.2	\$ 37.2	\$ 0.5	\$ 9.2	\$ 533.3
Net income	-	-	-	-	-	146.6	-	0.8	147.4
Other comprehensive income	-	-	-	-	-	-	3.0	-	3.0
Net payments on subscriptions	-	-	-	1.0	-	-	-	-	1.0
Stock issued	0.1	52.7	(52.3)	(1.0)	-	-	-	-	(0.5)
Change in noncontrolling interests	-	-	-	-	(0.2)	-	-	3.0	2.8
Stock repurchased	(0.1)	(24.6)	-	-	(0.1)	-	-	-	(24.8)
Patronage distributions issuable	-	-	48.9	-	-	-	-	-	48.9
Patronage distributions payable	-	-	-	-	-	(150.6)	-	-	(150.6)
Other	-	-	-	-	0.4	-	-	-	0.4
Balances at December 30, 2017	\$ 2.7	\$ 441.3	\$ 48.9	\$ -	\$ 18.3	\$ 33.2	\$ 3.5	\$ 13.0	\$ 560.9
Net income	-	-	-	-	-	127.7	-	0.5	128.2
Other comprehensive loss	-	-	-	-	-	-	(5.4)	-	(5.4)
Net payments on subscriptions	-	-	-	1.2	-	-	-	-	1.2
Stock issued	0.1	49.1	(48.9)	(1.2)	-	-	-	-	(0.9)
Change in noncontrolling interests	-	-	-	-	(0.2)	-	-	0.7	0.5
Stock repurchased	(0.1)	(25.6)	-	-	-	-	-	-	(25.7)
Patronage distributions issuable	-	-	44.0	-	-	-	-	-	44.0
Patronage distributions payable	-	-	-	-	-	(135.4)	-	-	(135.4)
Reclassifications to retained earnings in accordance with ASU 2018-02	-	-	-	-	-	(0.7)	0.7	-	-
Other	-	-	-	-	0.4	-	-	-	0.4
Balances at December 29, 2018	\$ 2.7	\$ 464.8	\$ 44.0	\$ -	\$ 18.5	\$ 24.8	\$ (1.2)	\$ 14.2	\$ 567.8

See accompanying notes to the consolidated financial statements.

ACE HARDWARE CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS
(In millions)

	Years Ended		
	December 29, 2018 (52 Weeks)	December 30, 2017 (52 Weeks)	December 31, 2016 (52 Weeks)
Operating Activities			
Net income	\$ 128.2	\$ 147.4	\$ 161.2
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	55.7	48.4	51.1
Amortization of deferred financing costs	0.5	0.5	0.5
Gain on disposal of assets, net	(4.9)	(0.6)	(0.1)
Credit for doubtful accounts	(0.3)	(0.8)	(0.8)
Warehouse facility closure costs	-	0.2	0.1
Other, net	1.1	0.4	(0.3)
Changes in operating assets and liabilities, exclusive of effect of acquisitions:			
Receivables	(45.2)	(31.3)	(43.7)
Inventories	(144.6)	(26.3)	(23.8)
Other current assets	(8.9)	1.3	2.7
Other long-term assets	6.7	(0.3)	2.4
Accounts payable and accrued expenses	66.6	55.1	61.8
Other long-term liabilities	10.9	8.3	4.9
Deferred taxes	(2.1)	1.9	1.2
Net cash provided by operating activities	<u>63.7</u>	<u>204.2</u>	<u>217.2</u>
Investing Activities			
Purchases of marketable securities	(27.8)	(4.3)	(6.5)
Proceeds from sale of marketable securities	25.4	5.4	5.1
Purchases of property and equipment	(61.1)	(64.6)	(70.8)
Cash paid for acquired businesses, net of cash acquired	(18.5)	(57.5)	(4.2)
Increase in notes receivable, net	(5.8)	(7.3)	(1.3)
Other, net	(1.1)	(3.5)	0.1
Net cash used in investing activities	<u>(88.9)</u>	<u>(131.8)</u>	<u>(77.6)</u>
Financing Activities			
Net borrowings (payments) under revolving lines of credit	104.8	2.6	(56.4)
Principal payments on long-term debt	(11.0)	(9.2)	(8.1)
Payments of cash portion of patronage distribution	(58.0)	(58.7)	(53.7)
Payments of patronage refund certificates	(6.4)	-	(9.9)
Repurchase of stock	(2.5)	(1.7)	(1.7)
Purchase of noncontrolling interests	(0.2)	(0.1)	(5.2)
Other, net	1.1	0.9	0.9
Net cash provided by (used in) financing activities	<u>27.8</u>	<u>(66.2)</u>	<u>(134.1)</u>
Increase in cash and cash equivalents	2.6	6.2	5.5
Cash and cash equivalents at beginning of period	23.0	16.8	11.3
Cash and cash equivalents at end of period	<u>\$ 25.6</u>	<u>\$ 23.0</u>	<u>\$ 16.8</u>
Supplemental disclosure of cash flow information:			
Interest paid	<u>\$ 17.7</u>	<u>\$ 11.0</u>	<u>\$ 10.5</u>
Income taxes paid	<u>\$ 2.1</u>	<u>\$ 1.7</u>	<u>\$ 3.7</u>

See accompanying notes to the consolidated financial statements.

ACE HARDWARE CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(In millions)

(1) Summary of Significant Accounting Policies

The Company and Its Business

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

In September 2017, the Company formed the Ace Ecommerce Holdings LLC (“AEH”) legal entity. On September 30, 2017, AEH acquired 94.3 percent of the issued and outstanding capital stock of The Daily Grommet Inc. (“The Grommet”). See Note 2 for additional details of this acquisition.

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

Ace Retail Holdings LLC (“ARH”) is the owner of the 123 store Westlake Ace Hardware retail chain. As a result, the Company is also a retailer of hardware, paint and other related products.

The Company’s international operations are a stand-alone legal entity with its own management team and board of directors. The entity, Ace Hardware International Holdings, Ltd. (“AIH”), is a majority-owned and controlled subsidiary of the Company with a 20.5 percent noncontrolling interest owned by its international retailers. International retailers do not own shares of stock in the Company nor receive patronage dividends.

Basis of Presentation

The accompanying consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles (“GAAP”). The Company’s fiscal year ends on the Saturday nearest December 31. Accordingly, fiscal years 2018, 2017 and 2016 ended on December 29, 2018, December 30, 2017 and December 31, 2016, respectively. Unless otherwise noted, all references herein for the years 2018, 2017 and 2016 represent fiscal years ended December 29, 2018, December 30, 2017 and December 31, 2016, respectively. Fiscal years 2018, 2017 and 2016 consisted of 52 weeks each.

Subsequent events have been evaluated through February 13, 2019, the date these statements were issued.

Principles of Consolidation

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

Use of Estimates

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

Cash, Cash Equivalents and Marketable Securities

In the normal course of business, the Company has outstanding checks that exceed the cash balances in the Company’s bank accounts, which create a book overdraft and are recorded as a liability. As of December 29, 2018 and December 30, 2017, the Company had outstanding checks in excess of bank balances totaling \$63.1 million and \$66.0 million, respectively, which have been included in accounts payable in the accompanying consolidated balance sheets. These outstanding amounts were subsequently funded through cash receipts and borrowings under the Company’s debt facilities during the following fiscal year.

The Company classifies all highly liquid investments with original maturities of three months or less as cash equivalents.

The Company determines the appropriate classification of its investments in marketable securities, which are predominately held by the Company’s New Age Insurance, Ltd. (“NAIL”) subsidiary, at the time of purchase and evaluates such designation at each balance sheet date. All marketable securities have been classified and accounted for as available for sale. The Company may hold debt securities until maturity. In response to changes in the availability of and the yield on alternative investments as well as liquidity requirements, securities are occasionally sold prior to their stated maturities. Debt securities with maturities beyond twelve months are viewed by the Company as available to support current operations and are therefore classified as current assets in the accompanying Consolidated Balance Sheets. Marketable securities are carried at fair value based on quoted market prices, with unrealized gains and

ACE HARDWARE CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)
(In millions)

losses, net of taxes, reported as a component of Accumulated other comprehensive income (“AOCI”). Realized gains and losses on securities are determined using the specific identification method.

In the normal course of NAIL’s operations, standby letters of credit totaling \$11.7 million and \$12.1 million at December 29, 2018 and December 30, 2017, respectively, were issued in favor of the insurance companies that reinsure a portion of NAIL’s loss exposure. At December 29, 2018, NAIL has pledged substantially all of its cash and cash equivalents and marketable securities as collateral for these letters of credit.

Revenue Recognition

The Company recognizes wholesale revenue when products are shipped and the customer takes ownership and assumes risk of loss and when services are rendered, provided collection of the resultant receivable is probable, persuasive evidence of an arrangement exists and the sales price is fixed and determinable. The Company records shipping and handling amounts billed to customers as wholesale revenues, with the related costs recorded in cost of revenues. Direct expenses related to retail services are included in cost of revenues and indirect expenses from these activities are included in operating expenses. The Company also records amounts billed to customers for advertising activities, brand building initiatives and fees generated for various retail services as wholesale revenues. Revenues at retail locations operated by the Company are recognized when the customer takes ownership of the products sold and assumes ownership and the risk of loss. Revenue from ecommerce sales by AEH are recorded as retail revenue when products are shipped and the customer has taken ownership and assumes the risk of loss. Provisions for sales returns are provided at the time the related sales are recorded.

Receivables

Receivables from customers include amounts invoiced for the sale of merchandise, services and equipment used in the operation of customers’ businesses.

Notes Receivable

The Company makes available to its retailers various lending programs whose terms exceed one year. The notes bear interest at various rates based on market rates, the loan program or the retailer’s credit quality and are recorded at face value. Interest is recognized over the life of the note on the effective interest method. Loan origination fees were not material for any period presented.

Allowance for Doubtful Accounts

Management records an allowance for doubtful accounts based on judgments considering a number of factors, primarily historical collection statistics, current customer credit information, the current economic environment, the aging of receivables, the evaluation of compliance with lending covenants and the offsetting amounts due to members for stock, notes, interest and anticipated but unpaid patronage distributions. The Company considers accounts and notes receivable past due if invoices remain unpaid past their due date and provides for the write-off of uncollectible receivables after exhausting all commercially reasonable collection efforts.

Inventories

Wholesale inventories are valued at the lower of cost or net realizable value. Cost is determined primarily using the last-in, first-out (“LIFO”) method for all inventories.

Inventories at retail locations operated by the Company and at AEH are valued at the lower of cost or net realizable value. Inventory cost is determined using the moving average method, which approximates the first-in, first-out (“FIFO”) method.

Vendor Funds

The Company receives funds from vendors in the normal course of business principally as a result of purchase volumes, sales, early payments or promotions of vendors’ products. Based on the provisions of the vendor agreements in place, management develops accrual rates by estimating the point at which the Company will have completed its performance under the agreement and the amount agreed upon will be earned. Due to the complexity and diversity of the individual vendor agreements, the Company performs analyses and reviews of historical trends throughout the year to ensure the amounts earned are appropriately recorded. As part of these analyses, the Company validates its accrual rates based on actual purchase trends and applies those rates to actual purchase volumes to determine the amount of funds that should be accrued by the Company and receivable from the vendor. Amounts accrued throughout the year could be impacted if actual purchase volumes differ from projected annual purchase volumes, especially in the case of programs that provide for increased funding when graduated purchase volumes are met. At year-end, the accrual reflects actual purchases made throughout the year.

ACE HARDWARE CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)
(In millions)

Vendor funds are treated as a reduction of inventory cost, unless they represent a reimbursement of specific, incremental and identifiable costs incurred by the Company to sell the vendor's product, in which case the costs would be netted. The majority of the vendor funds that the Company receives do not meet the specific, incremental and identifiable criteria. Therefore, the Company treats a majority of these funds as a reduction in the cost of inventory as the amounts are accrued and recognizes these funds as a reduction of cost of revenues when the inventory is sold.

Property and Equipment

Property and equipment are stated at cost less accumulated depreciation and amortization. Expenditures for maintenance, repairs and renewals of relatively minor items are generally charged to expense. Significant improvements or renewals are capitalized.

Depreciation expense is computed on the straight-line method based on estimated useful lives as follows:

Buildings and improvements	6 – 40 years
Equipment	3 - 20 years

Leasehold improvements are generally amortized on a straight-line basis over the lesser of the lease term or the estimated useful life of the asset.

The Company evaluates long-lived assets, such as property and equipment, for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated future cash flows, an impairment charge is recognized in the amount by which the carrying amount of the asset exceeds its fair value.

Goodwill and Other Intangible Assets

Goodwill represents the excess of the cost of an acquired business over the fair value of the net tangible assets acquired and identified intangible assets. Goodwill is not amortized but is tested for impairment at a reporting unit level on an annual basis or more frequently, if circumstances change or an event occurs that would more likely than not reduce the fair value of a reporting unit below its carrying amount. No impairment charges were recorded for any periods presented.

The Company's other intangible assets primarily relate to trademarks, tradenames, customer and vendor relationships and developed technology. The intangibles are amortized over their estimated useful lives. For additional information, see Notes 2 and 7.

Internal-Use Software

Included in fixed assets is the capitalized cost of internal-use software. The Company capitalizes costs incurred during the application development stage of internal-use software and amortizes these costs over its estimated useful life. Costs incurred related to design or maintenance of internal-use software are expensed as incurred. For fiscal year 2018, 2017 and 2016, the Company capitalized \$8.1 million, \$5.4 million and \$4.6 million, respectively, of software development costs related to internal programming time. Amortization of these capitalized costs was \$3.0 million, \$2.6 million and \$2.2 million for fiscal 2018, 2017 and 2016, respectively. As of December 29, 2018 and December 30, 2017, the Company had \$1.5 million and \$1.4 million, respectively, of capitalized costs for internal-use software that had not been placed into service.

Leases

The Company leases certain warehouse and distribution space, office space, retail locations, equipment and vehicles. All of the Company's leases are operating leases. As leases expire, management expects that in the normal course of business, certain leases will be renewed or replaced.

Certain lease agreements include escalating rent over the lease terms and rent holidays and concessions. The Company expenses rent on a straight-line basis over the life of the lease, which commences on the date the Company has the right to control the property. The cumulative expense recognized on a straight-line basis in excess of the cumulative payments is included in Other long-term liabilities in the Consolidated Balance Sheets.

Advertising Expense

The Company expenses advertising costs when incurred. Gross advertising expenses amounted to \$207.6 million, \$187.1 million, and \$167.7 million in fiscal 2018, 2017 and 2016, respectively.

Gift Cards

The Company sells gift cards to customers through its retailers, the Company website and select third parties. The gift cards do not expire. A liability is initially established for the value of the gift card when sold. Gift card breakage income is recognized ratably

ACE HARDWARE CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)
(In millions)

over the average redemption period of 18 months based on historical gift card redemption patterns and represents the balance of gift cards for which the Company believes the likelihood of redemption by the customer is remote. The breakage income calculation takes into account any legal obligation to remit the unredeemed portion to relevant jurisdictions. During fiscal years 2018, 2017 and 2016, the Company recognized gift card breakage income of \$2.1 million, \$0.4 million and \$0.7 million, respectively, which is included in the accompanying Consolidated Statements of Income as Other income, net. The Company does not believe there is a reasonable likelihood that there will be a material change in the future estimates or assumptions that we use to record breakage.

Retirement Plans

The Company sponsors health benefit plans for its retired officers and a limited number of retired non-officer employees. The Company and its subsidiaries also sponsor defined contribution plans for substantially all employees. The Company's contributions under these plans is determined annually by the Board of Directors and charged to expense in the period in which it is earned by employees.

Income Taxes

The Company accounts for income taxes using the asset and liability method. Under this approach, deferred taxes are recognized for the future tax consequences of differences between the financial statement and income tax bases of existing assets and liabilities, and measured based upon enacted tax laws and rates.

Self-Insurance

The Company has a wholly-owned subsidiary, NAIL, which operates as a captive insurance company. This entity provides the reinsurance of property and casualty insurance policies for some retailer members and is the direct insurer for certain property and casualty insurance policies of the Company. These insurance programs are subject to varying retention levels of self-insurance. Such self-insurance relates to losses and liabilities primarily associated with property, general liability, workers' compensation and auto liability insurance programs. Losses are accrued based upon the Company's estimates of the aggregate liability for claims incurred using certain actuarial assumptions based on Company experience and insurance industry metrics.

Concentration of Credit Risk

Credit risk pertains primarily to the Company's trade and notes receivables. The Company extends credit to its customers as part of its day-to-day operations. Management believes that as no specific receivable or group of receivables comprises a significant percentage of total trade accounts, its concentration of credit risk with respect to trade receivables is limited. Additionally, management believes that its allowance for doubtful accounts is adequate with respect to overall customer credit risks. Also, the Company's certificate of incorporation and by-laws specifically provide that the Company may set-off its obligation to make any payment to a member for such member's stock, notes, interest and declared and unpaid distributions against any obligation owed by the member to the Company. The Company, but not the member, may at its sole discretion exercise these set-off rights when any such funds become due to former members with outstanding accounts and notes receivable owed to the Company and current members with past due receivables owed to the Company.

Impact of New Accounting Standards

New Accounting Pronouncements – Adopted

In August 2018, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2018-15, "Intangibles—Goodwill and Other— Internal-Use Software (Subtopic 350-40): Customer's Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract". ASU 2018-15 requires an entity to capitalize the implementation costs incurred in a hosting arrangement that is a service contract. ASU 2018-15 is effective for the Company for fiscal 2021 year-end financial statements and quarterly financial statements in fiscal 2022. The Company adopted ASU 2018-15 prospectively in the third quarter of 2018 as early adoption is permitted and the Company has previously accounted for these costs in this manner. There was no impact on the Company's consolidated financial statements.

In August 2018, the FASB issued ASU No. 2018-13, "Fair Value Measurement (Topic 820): Disclosure Framework – Changes to the Disclosure Requirements for Fair Value Measurement". ASU 2018-13 removes the disclosure requirements for transfers between Level 1 and Level 2 instruments, the policy for the timing of transfers between levels, the valuation processes for Level 3 fair value measurements, and the changes in unrealized gains and losses for the period included in earnings for recurring Level 3 fair value measurements held at the end of the period. Under ASU 2018-13, the Company is required to disclose transfers into and out of Level 3 of the fair value hierarchy, and purchases and issuances of Level 3 assets and liabilities, but is no longer required to reconcile the opening balances to the closing balances of recurring Level 3 fair value measurements. ASU 2018-13 is effective for the Company for fiscal

ACE HARDWARE CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)
(In millions)

2020 quarterly and year-end financial statements. The Company adopted ASU 2018-13 prospectively in the third quarter of 2018 as early adoption is permitted. There was no impact on the Company's consolidated financial statements or footnotes.

In February 2018, the FASB issued ASU No. 2018-02, "Income Statement—Reporting Comprehensive Income (Topic 220)". ASU 2018-02 allows for the reclassification from AOCI to retained earnings for the stranded tax effects resulting from the change in the U.S. federal statutory income tax rate to 21 percent from 35 percent. ASU 2018-02 is effective for the Company for fiscal 2019 quarterly and year-end financial statements. The Company adopted ASU 2018-02 prospectively in the first quarter of 2018 as early adoption is permitted and elected to make the reclassification. This resulted in a reclassification adjustment of a \$0.7 million net loss from AOCI to retained earnings and is related to the unrealized gains and losses on the Company's investments, postretirement benefits and derivative financial instruments. The Company's policy for releasing income tax effects from AOCI is to utilize a portfolio approach.

New Accounting Pronouncements - Issued

In May 2014, the FASB issued ASU No. 2014-09, "Revenue from Contracts with Customers (Topic 606)" along with amendments issued in 2015 and 2016. The purpose of the new guidance is to develop a common revenue recognition standard for GAAP and International Financial Reporting Standards. The guidance affects any entity that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets unless those contracts are within the scope of other standards. The core principle of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. ASU 2014-09 allows either full retrospective adoption, meaning the standard is applied to all periods presented, or modified retrospective adoption, meaning the standard is applied only to the most current period presented in the financial statements. This guidance is effective for the Company for fiscal 2019 year-end financial statements and quarterly financial statements in fiscal 2020. The Company plans to adopt this standard for fiscal 2019 quarterly and year-end financial statements using the modified retrospective method. The Company's adoption assessment included a detailed review of each material revenue stream and a comparison of historical accounting policies to the new standard. Based on the assessment, the Company believes the impact of adopting the new standard will be immaterial to the consolidated financial statements. However, the Company will have expanded revenue recognition disclosures based on the new qualitative and quantitative disclosure requirements in the first quarter of 2019.

In January 2016, the FASB issued ASU No. 2016-01, "Financial Instruments – Overall (Subtopic 825-10), Recognition and Measurement of Financial Assets and Financial Liabilities." ASU 2016-01 requires the change in fair value measurement for certain equity investments to be recognized in net income, simplifies the impairment assessment for equity investments without readily determinable fair values, eliminates disclosure requirements related to fair value of financial instruments measured at amortized cost for non-public entities, eliminates the requirement to disclose methods and assumptions used to estimate fair value of financial instruments measured at amortized cost for public entities and requires public entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes. Additionally, ASU 2016-01 provides disclosure presentation guidance and clarification related to valuations allowances on deferred tax assets related to available-for-sale securities. ASU 2016-01 is effective for the Company for fiscal 2019 year-end financial statements and quarterly financial statements in fiscal 2020, with early adoption permitted in fiscal 2018. The Company is evaluating the impact that ASU 2016-01 will have on its consolidated financial statements.

In February 2016, the FASB issued ASU No. 2016-02, "Leases (Topic 842)" along with amendments issued in 2018. The guidance requires that lessees recognize assets and liabilities for leases with lease terms greater than twelve months in the statement of financial position. The guidance also requires improved disclosures to help users of financial statements better understand the amount, timing and uncertainty of cash flows arising from leases. ASU 2016-02 is effective for the Company for fiscal 2020 year-end financial statements and quarterly financial statements in fiscal 2021. The Company has begun evaluating its contracts under this guidance to determine the impact ASU 2016-02 will have on its consolidated financial statements and believes the standard will have a material impact to the Company's balance sheet.

In June 2016, the FASB issued ASU No. 2016-13, "Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments" along with amendments issued in 2018. The guidance requires financial assets measured at amortized cost basis to be presented at the net amount expected to be collected. The amortized cost basis of financial assets should be reduced by expected credit losses to present the net carrying value in the financial statements at the amount expected to be collected. The measurement of expected credit losses is based on past events, historical experience, current conditions and forecasts that affect the collectability of the financial assets. Additionally, credit losses relating to available-for-sale debt securities should be recorded through an allowance for credit losses. ASU 2016-13 is effective for the Company for year-end financial statements and quarterly financial statements in fiscal 2022. The Company is evaluating the impact that ASU 2016-13 will have on the Company's consolidated financial statements.

In August 2017, the FASB issued ASU No. 2017-12, "Derivatives and Hedging (Topic 815)." ASU 2017-12 changes the designation and measurement guidance for qualifying hedging relationships and the presentation of hedge results. The guidance expands

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)
(In millions)

and refines hedge accounting for financial and nonfinancial risk components and aligns the recognition and presentation of the effects of the hedging instrument with the hedged item in the financial statements. ASU 2017-12 is effective for the Company for fiscal 2020 year-end financial statements and quarterly financial statements in fiscal 2021. The guidance in ASU 2017-12 will not have a material impact on the Company's consolidated financial statements.

(2) Acquisition

On September 30, 2017, AEH acquired 94.3 percent of the issued and outstanding capital stock of The Grommet, an e-commerce startup that operates a website that markets and sells new and innovative products created by independent entrepreneurs, for \$45.8 million. The Grommet's original founders retained a 5.7 percent noncontrolling voting interest. The acquisition has been accounted for as a business combination. The Company recorded the allocation of the purchase price to acquired tangible assets and liabilities assumed based on their fair value at the acquisition date. As a result, the Company recorded \$30.7 million of goodwill and \$17.7 million for the fair value of other intangible assets with varying amortization periods from 3 to 10 years. During fiscal year 2018, the Company recorded \$4.5 million of amortization on the identified intangible assets as part of the final purchase accounting valuation. Goodwill has an indefinite life and, therefore, is not amortized. The goodwill and other intangible assets are expected to be deductible for tax purposes.

The following table summarizes the consideration paid for The Grommet and the purchase price allocation:

Fair value of assets acquired and liabilities assumed:	
Cash	\$ 0.3
Receivables	0.7
Inventories	6.4
Other current assets	0.4
Property and equipment	0.2
Goodwill and other intangible assets:	
Developed technology	2.2
Trade name	2.3
Makers relationships	7.7
Customer relationships	4.9
Wholesale relationships	0.6
Goodwill	30.7
Other assets	0.1
Current liabilities	(7.9)
	48.6
Less: noncontrolling interest	(2.8)
Acquisition purchase price	<u>\$ 45.8</u>

During fiscal year 2018, ARH acquired additional retail stores for consideration of \$18.5 million, prior to working capital adjustments. These acquisitions resulted in ARH recording \$8.8 million of goodwill.

(3) Receivables, net

Receivables, net include the following amounts:

	December 29, 2018	December 30, 2017
Trade	\$ 365.7	\$ 345.4
Other	63.0	63.6
Notes receivable – current portion	12.4	12.5
Less: allowance for doubtful accounts	(6.7)	(5.8)
Receivables, net	<u>\$ 434.4</u>	<u>\$ 415.7</u>

Other receivables are principally amounts due from suppliers for promotional and advertising allowances.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)
(In millions)

(4) Inventories

Inventories consist of wholesale merchandise inventories held for sale to customers and retail merchandise inventory held for resale at Company-operated retail locations and at AEH's warehouse locations. Substantially all of the Company's wholesale inventories are valued on the LIFO method. The excess of replacement cost over the LIFO value of inventory was \$85.7 million and \$80.7 million at December 29, 2018 and December 30, 2017, respectively. An actual valuation of inventory under the LIFO method can be made only at the end of each year based on the inventory levels and costs at that time. Inventories at retail locations operated by the Company and at AEH's warehouses are valued at the lower of cost or net realizable value. Inventory cost is determined using the moving average method, which approximates the FIFO method. The Company periodically reviews its inventory and establishes a reserve for excess and obsolete inventory based on a number of factors, including historical sales, sales forecasts, obsolescence due to technology changes and defective goods.

Inventories consisted of:

	December 29, 2018	December 30, 2017
Wholesale merchandise inventory (LIFO)	\$ 824.5	\$ 689.3
Retail merchandise inventory at Company-operated stores and AEH warehouses (FIFO)	107.3	88.2
Inventories	\$ 931.8	\$ 777.5

(5) Property and Equipment, net

Property and equipment, net is summarized as follows:

	December 29, 2018	December 30, 2017
Land	\$ 14.7	\$ 15.9
Buildings and improvements	289.1	306.4
Warehouse equipment	188.2	162.9
Computer hardware and software and other office equipment	307.5	282.7
Transportation equipment	38.9	43.0
Leasehold improvements	48.6	45.5
Construction in progress	6.0	17.5
Property and equipment, gross	893.0	873.9
Accumulated depreciation and amortization	(540.2)	(517.3)
Assets held for sale, net	15.8	-
Property and equipment, net	\$ 368.6	\$ 356.6

Depreciation and amortization expense related to property and equipment for fiscal years 2018, 2017 and 2016 was \$50.0 million, \$47.3 million and \$49.4 million, respectively.

As of December 29, 2018, the Company has ceased operations at its Prince George Retail Support Center ("RSC") and in accordance with Accounting Standards Codification ("ASC"), "Property, Plant and Equipment," (Topic 360) has met the criteria to classify the long-lived assets (land and building) as assets held for sale. As of December 29, 2018, the Company evaluated the land and building at Prince George for impairment under ASC 360 for indicators of impairment. Based upon observable market prices of similar properties and bids obtained through its marketing of the property for sale, the Company determined that the carrying value of the property did not exceed the fair value and therefore was not impaired at December 29, 2018.

ACE HARDWARE CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)
(In millions)

(6) Notes Receivable, net

The Company makes available to its retailers various lending programs whose terms exceed one year. At December 29, 2018 and December 30, 2017, the outstanding balance of the notes was \$27.0 million and \$26.3 million, respectively, of which the current portion of \$12.4 million and \$12.5 million, respectively, was recorded in Receivables, net.

	December 29, 2018	December 30, 2017
Notes receivable, gross	\$ 38.4	\$ 37.2
Less: estimated patronage applications from 2018 and 2017, respectively	(11.4)	(10.9)
Net	27.0	26.3
Less: current portion	(12.4)	(12.5)
Less: allowance for doubtful accounts	(2.8)	(5.4)
Notes receivable, net	<u>\$ 11.8</u>	<u>\$ 8.4</u>

For substantially all of the Company's Notes receivable, the amounts due are generally expected to be collected through the non-cash portion of the patronage distribution. In the event a retailer cancels its membership with the Company, any outstanding loans are transferred from Notes receivable to Accounts receivable and are due immediately. As the non-cash portion of the patronage distribution is used to settle the Notes receivable, there are no loans that are currently past due. The patronage distribution for each retailer can vary from year to year based on the Company's financial performance as well as the volume of patronage-based merchandise that each retailer purchases from the Company. The estimated maturities of the Notes receivable are as follows:

	December 29, 2018
0 – 4 years	\$ 12.9
5 – 8 years	13.9
9 – 10 years	11.6
Total	<u>\$ 38.4</u>

Pursuant to the Company's Amended and Restated Certificate of Incorporation and the Company's by-laws, notes receivable (like all obligations owed to the Company by the Company's retailers) are secured by the Company stock owned by the retailers. However, for some retailers, the redemption value of their stock does not fully cover their obligations.

The Company evaluates risk on its loan portfolio by categorizing each loan into an internal risk category. The Company's risk categories include:

Low – The retailer possesses a strong financial position, above average payment record to both Ace and other vendors, and the business is well established.

Medium – The retailer possesses an average financial position, an average payment record to both Ace and other vendors, and the business is somewhat established.

High – The retailer possesses a weak financial position, a substandard payment record to Ace or other vendors, or the business is somewhat new.

Based upon these criteria, the Company has classified its loan portfolio as follows:

	December 29, 2018	December 30, 2017
Corporate Credit Exposure:		
Low risk	\$ 19.2	\$ 17.0
Moderate risk	7.7	7.7
High risk	11.5	12.5
Total	<u>\$ 38.4</u>	<u>\$ 37.2</u>

ACE HARDWARE CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)
(In millions)

The Company applies a consistent practice of establishing an allowance for notes that it feels may become uncollectible by monitoring the financial strength of its retailers. The collectability of certain notes is evaluated on an individual basis while the remaining notes are evaluated on a collective basis. The breakdown at December 29, 2018 and December 30, 2017 of notes evaluated individually versus notes evaluated collectively was as follows:

	December 29, 2018	December 30, 2017
Notes receivable:		
Ending balance individually evaluated for impairment	\$ 2.8	\$ 5.3
Ending balance collectively evaluated for impairment	35.6	31.9
Ending principal balance	<u>\$ 38.4</u>	<u>\$ 37.2</u>

The Company has evaluated the collectability of the notes and has established an allowance for doubtful accounts of \$2.8 million and \$5.4 million at December 29, 2018 and December 30, 2017, respectively. Management records the allowance for doubtful accounts based on the above information as well as judgments made considering a number of factors, primarily historical collection statistics, current member retailer credit information, the current economic environment and the offsetting amounts due to members for stock, notes, interest and declared and unpaid patronage distributions. The components of changes to the Notes receivable allowance for doubtful accounts for 2018 and 2017 were as follows:

	December 29, 2018	December 30, 2017
Allowance for doubtful accounts:		
Beginning balance	\$ 5.4	\$ 7.7
Provision (Reversal)	(1.5)	(1.1)
Reclassifications to accounts receivable allowance for doubtful accounts	(1.6)	(1.4)
Reclassifications from accounts receivable allowance for doubtful accounts	0.5	0.2
Ending balance	<u>\$ 2.8</u>	<u>\$ 5.4</u>

Notes bear interest at various rates based on the retailer's credit quality and are recorded at face value. Interest is recognized over the life of the note based on the outstanding balance and stated interest rate, which approximates the effective interest method. During fiscal years 2018, 2017 and 2016, \$2.0 million, \$1.7 million and \$1.5 million respectively, were recorded as interest income related to the notes.

Generally, in the event a retailer cancels their membership with the Company, any outstanding Notes receivable, and related allowance for doubtful accounts, are transferred to trade receivables and the retailer is billed for any unpaid principal and interest balances. In fiscal 2018 and 2017, \$10.3 million and \$9.3 million, respectively, of Notes receivable were transferred to trade receivables as an event occurred which made the notes due immediately. Upon transfer of the Notes receivable to trade receivables, \$1.6 million and \$1.4 million in fiscal 2018 and 2017, respectively, of the Notes receivable allowance for doubtful accounts was transferred to the Receivables allowance for doubtful accounts to properly match the reserve against the asset on the Consolidated Balance Sheet.

ACE HARDWARE CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)
(In millions)

(7) Goodwill and Other Intangible Assets

The carrying value of Goodwill and other intangible assets as of December 29, 2018 and December 30, 2017 are as follows:

	December 29, 2018	December 30, 2017
Intangible assets:		
Goodwill (1)	\$ 74.0	\$ 83.0
Trademarks and trade name	9.9	7.6
Customer relationships	8.1	3.2
Maker relationships	7.7	-
Developed technology	2.2	-
Wholesale relationships	0.6	-
Total intangible assets	102.5	93.8
Less: accumulated amortization	(8.3)	(3.1)
Goodwill and other intangible assets	<u>\$ 94.2</u>	<u>\$ 90.7</u>

- (1) Goodwill as of December 30, 2017 was reclassified based upon the finalization of the purchase accounting valuation for The Grommet.

The trademarks and trade name are being amortized over 10-20 years. The customer and maker relationships are being amortized over 3-10 years. Developed technology and wholesale relationships are being amortized over three years. Net amortization expense related to all intangible assets was \$5.2 million, \$0.7 million and \$0.7 million for fiscal years 2018, 2017 and 2016, respectively. The estimated net amortization expense over the next five fiscal years is \$13.0 million.

(8) Patronage Distributions and Refund Certificates Payable

The Company operates as a cooperative organization and has paid or may pay patronage distributions to member retailers on a portion of patronage-based income derived from business done with such retailers. Patronage distributions are allocated in proportion to the volume of purchases by member retailers during the period. The cash portion of the patronage distribution was approximately 40 percent for all years presented.

The accrued patronage distributions composition is summarized as follows:

	Years Ended		
	December 29, 2018	December 30, 2017	December 31, 2016
Cash portion	\$ 55.0	\$ 61.5	\$ 62.2
Class C stock	44.0	48.9	52.3
Patronage refund certificates	23.7	27.9	27.3
Patronage financing deductions	12.7	12.3	11.0
Total patronage distributions accrued for third party retailers	<u>\$ 135.4</u>	<u>\$ 150.6</u>	<u>\$ 152.8</u>

Patronage distributions are allocated on a fiscal year basis with issuance in the following year.

In those instances where the maximum Class C stock requirements have been met, the non-cash portion of the patronage distribution is distributed in the form of patronage refund certificates with a five-year term and bearing interest at 4 percent.

ACE HARDWARE CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)
(In millions)

The patronage refund certificates outstanding at December 29, 2018 are payable as follows:

	Amount	Interest Rate
2019	\$ 10.2	4.00%
2020	17.6	4.00%
2021	26.8	4.00%
2022	27.5	4.00%
2023	23.7	4.00%
Total patronage refund certificates payable	\$ 105.8	
Less current portion	(10.2)	
Net patronage refund certificates payable	<u>\$ 95.6</u>	

(9) Debt

The Company has a \$600.0 million line of credit that is expandable to \$750.0 million through a \$150.0 million accordion that is exercisable without the consent of existing lenders provided that the Company is not in default of the credit agreement and further provided that none of the existing lenders are required to provide any portion of the increased facility. At the Company's discretion, borrowings under the credit facility bear interest at a rate of either 25 to 100 basis points over the prime rate or 125 to 200 basis points over the London Interbank Offered Rate ("LIBOR") depending on the Company's leverage ratio as defined under the agreement. The credit facility was priced at LIBOR plus 150 basis points at December 29, 2018. The credit facility expires on May 29, 2020 and requires maintenance of certain financial covenants including a maximum allowable average leverage ratio and a minimum fixed charge coverage ratio. As of December 29, 2018, the Company was in compliance with its covenants and \$251.7 million was outstanding under the credit facility.

The credit facility includes a \$175.0 million sublimit for the issuance of standby and commercial letters of credit. As of December 29, 2018, a total of \$13.7 million in commercial letters of credit were outstanding. The credit facility requires the Company to pay fees based on the unused portion of the line of credit at a rate of 15 to 30 basis points per annum depending on the Company's leverage ratio.

The credit facility allows the Company to make revolving loans and other extensions of credit to AIH in an aggregate principal amount not to exceed \$75.0 million at any time. As of December 29, 2018, there were no loans or other extensions of credit provided to AIH.

The Company entered into an interest rate swap derivative agreement to reduce the risk of interest rate volatility for the remaining term of the credit facility. The interest rate swap started on March 13, 2017 and expires on May 13, 2020. The swap agreement fixes the LIBOR rate on \$150.0 million of the revolving credit facility at 2.18 percent, resulting in an effective rate of 3.68 percent after adding the 1.50 percent margin based on the current pricing tier per the credit agreement. The swap arrangement has been designated as a cash flow hedge and has been evaluated to be highly effective. As a result, the after-tax change in the fair value of the swap is recorded in AOCI as a gain or loss on derivative financial instruments.

On February 1, 2019 the Company amended its credit facility. The February 2019 amendment extended the maturity to February 1, 2024, lowered the interest rate credit spread 25 basis points, increased the capacity of the facility by \$100.0 million to \$700.0 million and increased the amount of the accordion feature to \$300.0 million.

The Company's ARH subsidiary has a \$75.0 million asset-based revolving credit facility ("ARH Facility"). The ARH Facility matures on October 23, 2022 and is expandable to \$100.0 million under certain conditions. In addition, the Company's ARH subsidiary has the right to issue letters of credit up to a maximum of \$7.5 million. At the Company's discretion, borrowings under this facility bear interest at a rate of either the prime rate plus an applicable spread of 25 basis points to 50 basis points, or LIBOR plus an applicable spread of 125 basis points to 150 basis points, depending on the Company's average availability under the ARH Facility as measured on a trailing 12-month basis. The ARH Facility was priced at LIBOR plus 125 basis points at December 29, 2018.

The ARH Facility is collateralized by substantially all of ARH's personal property and intangible assets. Borrowings under the facility are subject to a borrowing base calculation consisting of certain advance rates applied to eligible collateral balances (primarily consisting of certain receivables and inventories). This agreement requires maintenance of certain financial covenants including a minimum fixed charge coverage ratio. As of December 29, 2018, ARH was in compliance with its covenants and had \$49.5 million in loans outstanding under the ARH Facility.

The ARH Facility requirements include a lender-controlled cash concentration system that results in all of ARH's daily available cash being applied to the outstanding borrowings under this facility. Pursuant to FASB ASC 470-10-45, "Classification of

ACE HARDWARE CORPORATION
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(In millions)

Revolving Credit Agreements Subject to Lock-Box Arrangements and Subjective Acceleration Clauses,” the borrowings under the ARH Facility have been classified as a Current maturity of long-term debt as of December 29, 2018.

Total debt outstanding is comprised of the following:

	December 29, 2018	December 30, 2017
Revolving Credit Facility	\$ 251.7	\$ 157.2
ARH Facility	49.5	39.2
Installment notes with maturities through 2022 at a fixed rate of 6.00%	26.5	25.6
Total debt	327.7	222.0
Less: maturities within one year	(60.6)	(49.0)
Long-term debt	\$ 267.1	\$ 173.0

The aggregate scheduled maturities of total debt at December 29, 2018 are as follows:

<u>Fiscal Year</u>	<u>Amount</u>
2019	\$ 60.6
2020	258.8
2021	5.7
2022	2.6
Total debt	\$ 327.7

(10) Retirement Plans

The Company has healthcare plans under which a limited number of qualified retired employees receive certain health care, dental care, life insurance or related benefits. Amounts expensed under these plans were \$0.1 million or less in each of the fiscal years 2018, 2017 and 2016.

The Company and its subsidiaries maintain profit sharing and 401k retirement plans for substantially all employees. Amounts expensed under these plans totaled \$22.8 million, \$23.7 million and \$23.7 million during fiscal 2018, 2017 and 2016, respectively.

(11) Accrued Expenses

Accrued expenses include the following components:

	December 29, 2018	December 30, 2017
Salaries and wages	\$ 50.3	\$ 44.9
Insurance reserves	19.9	13.1
Deferred income	3.5	5.3
Vendor funds	4.0	14.2
Taxes	15.1	15.7
Profit sharing	9.7	12.6
Gift card	10.3	10.2
Interest	4.5	3.5
Advertising and marketing	17.2	16.4
Other	39.1	34.8
Accrued expenses	\$ 173.6	\$ 170.7

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(12) Fair Value

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. There is a three-level hierarchy for disclosure to show the extent and level of judgment used to estimate fair value measurements.

Level 1 – Uses unadjusted quoted prices that are available in active markets for the identical assets or liabilities as of the reporting date.

Level 2 – Uses inputs other than Level 1 that are either directly or indirectly observable as of the reporting date through correlation with market data, including quoted prices for similar assets and liabilities in active markets and quoted prices in markets that are not active. Level 2 also includes assets and liabilities that are valued using models or other pricing methodologies that do not require significant judgment since the input assumptions used in the models, such as interest rates and volatility factors, are corroborated by readily observable data.

Level 3 – Uses inputs that are unobservable and are supported by little or no market activity and reflect the use of significant management judgment. These values are generally determined using pricing models for which the assumptions utilize management's estimates of market participant assumptions.

The tables below set forth, by level, the Company's financial assets, liabilities and derivative instruments that were accounted for at fair value as of December 29, 2018 and December 30, 2017. The tables do not include cash on hand and also do not include assets and liabilities that are measured at historical cost or any basis other than fair value. The carrying values for other current financial assets and liabilities, such as accounts receivable and accounts payable, approximate fair value due to the short maturity of such instruments. Long-term notes receivable approximate fair value because the Company charges its retailers an interest rate and a significant portion of the notes have the Company's stock as collateral.

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

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)
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Items measured at fair value on a recurring basis	Carrying Value Measured at Fair Value December 30, 2017	Level 1	Level 2	Level 3
Assets:				
Cash equivalents:				
Money market funds	\$ 5.7	\$ 5.7	\$ -	\$ -
Marketable securities:				
Corporate fixed income securities	15.4	-	15.4	-
Equity mutual fund securities	15.1	15.1	-	-
Mortgage-backed securities	5.5	-	5.5	-
U.S. government notes	11.8	11.2	0.6	-
Other	3.3	-	3.3	-
Total marketable securities	<u>\$ 51.1</u>	<u>\$ 26.3</u>	<u>\$ 24.8</u>	<u>\$ -</u>
Other long-term liabilities:				
Interest rate swap derivative	\$ 0.7	\$ -	\$ 0.7	\$ -

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

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

The fair value of the Company’s marketable securities was less than their cost by \$2.3 million at December 29, 2018 and exceeded the cost by \$6.0 million at December 30, 2017.

Gross proceeds from the sale of marketable securities and the related realized gains and losses for the fiscal years ended December 29, 2018, December 30, 2017 and December 31, 2016 were as follows:

	Years Ended		
	December 29, 2018	December 30, 2017	December 31, 2016
Gross proceeds	\$ 25.4	\$ 5.4	\$ 5.1
Gross realized gains	5.6	0.7	0.1
Gross realized losses	(0.3)	(0.1)	-

Gross realized gains and losses were determined using the specific identification method. For the fiscal year ended December 29, 2018, the Company reclassified \$5.5 million of unrealized gains and \$0.1 million of unrealized losses on marketable securities that were recorded in AOCI as of December 30, 2017 into realized income. These amounts were recorded to Other income, net in the Consolidated Statement of Income.

ACE HARDWARE CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)
(In millions)

The following table summarizes the contractual maturity distributions of the Company's debt securities at December 29, 2018. Actual maturities may differ from the contractual or expected maturities since borrowers may have the right to prepay obligations with or without prepayment penalties.

Fair value of available-for-sale debt securities	Due in One Year or Less	Due After One Year through Five Years	Due After Five Years through Ten Years	Due After Ten Years	Total
Corporate fixed income securities	\$ 1.5	\$ 5.4	\$ 4.2	\$ 3.0	\$ 14.1
Mortgage-backed securities	-	0.3	1.2	5.0	6.5
U.S. government notes	1.2	4.6	4.6	2.0	12.4
Other	-	0.3	0.6	2.0	2.9
Total	\$ 2.7	\$ 10.6	\$ 10.6	\$ 12.0	\$ 35.9

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

The Company entered into an interest rate swap derivative agreement, which started on March 13, 2017 and expires on May 13, 2020. The swap agreement fixes the LIBOR rate on \$150.0 million of the revolving credit facility at 2.18 percent, resulting in an effective rate of 3.68 percent after adding the 1.50 percent margin based on the current pricing tier per the credit agreement – see Note 9 for more information. Prior to this swap arrangement taking effect on March 13, 2017, the Company had a separate swap arrangement that fixed the LIBOR rate on a portion of the debt facility at 1.13 percent.

The fair value of the Company's interest rate swap is estimated using Level 2 inputs, which are based on model-derived valuations in which all significant inputs and significant value drivers are observable in active markets. The Company also considers counterparty credit risk and bilateral or "own" credit risk adjustments in estimating fair value, in accordance with the requirements of GAAP. As of December 29, 2018, the fair value of the interest rate swap was an asset balance of \$0.8 million. As of December 30, 2017, the fair value of the interest rate swap was a liability balance of \$0.7 million. The Company classifies long-term derivative assets as Other assets, current derivative liabilities as Accrued expenses and long-term derivative liabilities as Other long-term liabilities on the Consolidated Balance Sheets.

Because the interest rate swap has been designated as a cash flow hedge and has been evaluated to be highly effective, the change in the fair value is recorded in AOCI as a gain or loss on derivative financial instruments. The amount in AOCI is reclassified to earnings if the derivative instrument is sold, extinguished or terminated, or at the time it becomes expected to be sold, extinguished or terminated. The net of tax amount recorded in AOCI for the fair value adjustment of the interest rate swaps was an unrealized gain of \$0.6 million as of December 29, 2018 and an unrealized loss of \$0.5 million as of December 30, 2017. This unrealized gain is not expected to be reclassified into interest expense within the next 12 months. The impact of any ineffectiveness is recognized in earnings. However, there was no hedge ineffectiveness related to the interest rate swaps for the years ended December 29, 2018 and December 30, 2017.

The Company's debt instruments are recorded at cost on the Consolidated Balance Sheets. The fair value of the Company's debt was approximately \$328.6 million at December 29, 2018, compared to the carrying value, including accrued interest, of \$328.9 million. The estimated fair value of long-term debt is based on estimated rates for similar instruments and discounted cash flow analysis using the Company's weighted-average interest rate and is, therefore, classified as Level 3 within the fair value hierarchy.

ACE HARDWARE CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)
(In millions)

(13) Income Taxes

Income tax expense includes the following components:

	Years Ended		
	December 29, 2018	December 30, 2017	December 31, 2016
Current:			
Federal	\$ 1.6	\$ (1.0)	\$ (3.2)
State	(0.2)	(0.4)	(0.4)
Foreign	(1.1)	(1.1)	(0.7)
Current income tax benefit (expense)	0.3	(2.5)	(4.3)
Deferred:			
Federal	2.2	(2.8)	(0.4)
State	-	0.6	(0.4)
Foreign	-	-	(0.3)
Deferred income tax benefit (expense)	2.2	(2.2)	(1.1)
Total income tax benefit (expense)	\$ 2.5	\$ (4.7)	\$ (5.4)

Income tax differs from the amount computed by applying the statutory U.S. Federal income tax rate of 21 percent, 35 percent and 35 percent for December 29, 2018, December 30, 2017 and December 31, 2016 respectively, to pre-tax income because of the effect of the following items:

	Years Ended		
	December 29, 2018	December 30, 2017	December 31, 2016
Expected tax at U.S. Federal income tax rate	\$ (26.4)	\$ (53.2)	\$ (58.3)
Patronage distribution deductions	28.4	52.7	53.5
Net deferred tax asset re-measurement	-	(4.1)	-
Other, net	0.5	(0.1)	(0.6)
Income tax benefit (expense)	\$ 2.5	\$ (4.7)	\$ (5.4)

ACE HARDWARE CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)
(In millions)

Deferred income taxes reflect the tax effects of temporary differences between the carrying amounts of existing assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Significant components of the Company's deferred tax assets and liabilities are as follows:

	December 29, 2018	December 30, 2017
Deferred tax assets:		
AMT and other tax credit carryforwards	\$ 8.8	\$ 8.5
Net operating loss carryforwards	9.9	9.4
Unearned insurance premium and loss reserves	0.9	0.6
Allowance for doubtful accounts	1.8	2.5
Inventory reserves	4.9	4.8
Deferred vendor rebates	9.2	7.8
Accrued compensation and benefits expense	11.5	10.2
Net unrealized losses	0.5	-
Other reserves	6.9	8.3
Total deferred tax assets	54.4	52.1
Less: valuation allowance	(8.0)	(7.7)
Deferred tax assets	46.4	44.4
Deferred tax liabilities:		
Depreciation and deferred gains on property and equipment	10.9	11.1
Amortization of intangibles	1.8	1.5
Net unrealized gains	-	1.2
Fair market value of leases	0.5	0.6
Prepaid expenses and deferred income	5.7	6.2
Inventory valuation	16.7	16.7
Deferred tax liabilities	35.6	37.3
Net deferred tax assets	\$ 10.8	\$ 7.1

Net deferred tax assets are included in Other assets on the Consolidated Balance Sheets.

At December 29, 2018, the Company has federal and state net operating loss carryforwards of \$52.1 million available for offset against future taxable income. The pre-2018 federal and state net operating losses can be carried forward to the tax years 2034 through 2037. The 2018 federal net operating loss can be carried forward indefinitely. For those states not conforming to the indefinite federal carryforward provisions, the 2018 state net operating losses can, generally, be carried forward through the 2038 tax year.

At December 29, 2018, the Company has state tax credit carryforwards of \$8.8 million available to offset future state income tax expense. The state tax credits may be carried forward to tax years 2019 through 2023. A valuation allowance of \$8.0 million has been established against the state tax credits as it is more likely than not that the benefit of the tax credits will not be realized.

The federal income tax returns of the consolidated group are subject to examination by the Internal Revenue Service ("IRS"), generally for three years after the returns are filed. The 2014 through 2018 tax years remain subject to examination by the IRS. For state purposes, the 2013 through 2018 tax years remain subject to examination.

The Company recognizes interest and penalties related to uncertain tax positions in Income tax expense. Accrued interest and penalties included in the reserve for uncertain tax positions were \$0.3 million at December 29, 2018 and December 30, 2017. The Company recognized immaterial amounts related to interest and penalties within Income tax expense for the years ended December 29, 2018, December 30, 2017 and December 31, 2016. It is reasonably possible that the total amount of unrecognized tax benefits will increase or decrease within the next twelve months. The Company currently estimates that such increases and decreases will not be significant.

ACE HARDWARE CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)
(In millions)

(14) Capital Stock

The Company's classes of stock are described below (not in millions):

	Number of Shares at	
	December 29, 2018	December 30, 2017
Class A stock, voting, redeemable at par value:		
Authorized	10,000	10,000
Issued and outstanding	2,719	2,722
Class C stock, nonvoting, redeemable at not less than par value:		
Authorized	6,000,000	6,000,000
Issued and outstanding	4,648,554	4,412,989
Issuable as patronage distributions	439,591	488,858

No dividends can be declared on any shares of any class of the Company's stock.

Upon termination of the Company's membership agreement with any retail outlet, all shares of stock of the Company held by the retailer owning or controlling such outlet must be sold back to the Company, unless a transfer of such shares is made to another party accepted by the Company as a member retailer with respect to the same outlet. A single Class A share is issued to a member retailer only when the share subscribed has been fully paid and Class C shares are issued only when all shares subscribed with respect to a retail outlet have been fully paid. Additional stock subscribed in the accompanying consolidated financial statements represents the paid portion of stock subscribed for stores that have not opened. All shares of stock are currently issued and repurchased at par value.

(15) Commitments and Contingencies

Lease commitments

The Company rents certain warehouse and distribution space, office space, retail locations, equipment and vehicles under operating leases. At December 29, 2018, annual minimum rental commitments under leases that have initial or remaining noncancelable terms in excess of one year, net of sublease income, are as follows:

<u>Fiscal Year</u>	<u>Amount</u>
2019	\$ 67.5
2020	63.3
2021	50.4
2022	40.1
2023	36.4
Thereafter	145.6
Minimum lease payments	<u>\$ 403.3</u>

Minimum lease payments include \$1.8 million of minimum lease payments for store leases that the Company has assigned to member retailers. As a condition of the sale of the former Company-owned stores, the Company remains contingently liable for payment under two lease arrangements. The leases have varying terms, the latest of which expires in 2023. The Company believes that due to the nature of the agreements, the possibility of payment on these leases is remote.

All other leases expire prior to the end of 2033. Under certain leases, the Company pays real estate taxes, insurance and maintenance expenses in addition to rental expense. ARH rents a majority of its retail store location properties, as well as its corporate headquarters, under long-term operating leases that generally provide for payment of minimum annual rent payments, real estate taxes, insurance and maintenance and, in some cases, contingent rent (calculated as a percentage of sales) in excess of minimum rent. The amount of contingent rent paid by ARH during 2018 was not material. With the exception of store leases assigned to member retailers, management expects that in the normal course of business, leases that expire will be renewed or replaced by other leases. Rent expense was \$79.6 million, \$69.4 million and \$68.8 million in fiscal 2018, 2017 and 2016, respectively.

AIH has entered into service agreements for the receipt, handling, warehousing and re-dispatch of all shipments of merchandise for its Colon, Panama, Ningbo, China and Dubai, United Arab Emirates operations. Annual minimum service payments under these agreements are not significant.

ACE HARDWARE CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)
(In millions)

Contingencies

The Company has certain contingent liabilities resulting from litigation and claims incident to the ordinary course of business. Management believes that the probable resolution of such contingencies will not materially affect the financial position, results of operations, or liquidity of the Company. The Company expenses legal fees as they are incurred.

Other guarantees

In the normal course of business, the Company enters into commercial commitments including standby letters of credit and guarantees that could become contractual obligations. Letters of credit are issued generally to insurance agencies and financial institutions in direct support of the Company's corporate and retailer insurance programs as well as to international vendors for imported inventory purchases. As of December 29, 2018, the Company had outstanding standby letters of credit of \$11.7 million and commercial letters of credit of \$13.7 million.

(16) Warehouse Facility Closure Costs

The Company closed its crossdock operation near Baltimore, Maryland, ceased operations at its Prince George, Virginia RSC and intends to close the Emery wholesale distribution warehouses in Portland, Maine and Pittston, Pennsylvania. For the twelve months ended December 30, 2017, the Company recorded \$4.0 million of net Warehouse facility closure costs primarily for post-employment benefits. In connection with these actions, the Company reduced the remaining liability for post-employment benefits by \$0.7 million during the twelve months ended December 29, 2018 to reflect the updated estimated liability. The Company also recorded \$2.4 million of expense in Wholesale cost of revenues during the twelve months ended December 30, 2017 for inventory markdowns the Company believes will be required to dispose of the inventory in these facilities. In 2018, \$1.4 million was applied to offset these markdowns when they occurred. Additionally, in 2018, the Company paid \$0.5 million to terminate the Pittston, Pennsylvania lease in order to exit the facility earlier than the original term of the lease.

The Company has ceased using the ARH distribution center in Lenexa, Kansas and recorded an additional \$0.3 million of charges in 2018 related to the true-up of the remaining net lease liability based on expected sublease income. Accrued warehouse facility closure costs activity for the twelve months ended December 29, 2018 is as follows:

	Post- employment Benefits	Inventory Markdown Reserves	Lease Termination Fee	Remaining Net Lease Liability	Total
Balance at December 30, 2017	\$ 3.6	\$ 2.4	\$ -	\$ 2.3	\$ 8.3
Warehouse facility closure charges	(0.7)	-	0.5	0.3	0.1
Wholesale cost of revenues	-	(1.4)	-	-	(1.4)
Payments	(1.4)	-	(0.5)	(0.5)	(2.4)
Balance at December 29, 2018	\$ 1.5	\$ 1.0	\$ -	\$ 2.1	\$ 4.6

ACE HARDWARE CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS – (Continued)
(In millions)

(17) Summary of Quarterly Results

The following table provides a summary of quarterly results (unaudited) for the eight quarters prior to and including the quarter ended December 29, 2018:

	2018			
	Fourth Quarter	Third Quarter	Second Quarter	First Quarter
Revenues	\$ 1,390.0	\$ 1,427.2	\$ 1,587.7	\$ 1,312.1
Gross profit	192.4	204.9	229.1	168.7
Operating expenses	171.9	169.2	171.9	153.6
Net income attributable to Ace Hardware Corporation	25.1	36.3	54.5	11.8

	2017			
	Fourth Quarter	Third Quarter	Second Quarter	First Quarter
Revenues	\$ 1,315.6	\$ 1,342.4	\$ 1,492.2	\$ 1,238.2
Gross profit	172.5	197.2	213.3	171.3
Operating expenses	155.9	142.6	159.7	140.1
Net income attributable to Ace Hardware Corporation	14.0	53.6	50.9	28.1

(18) Supplemental Disclosures of Cash Flow Information

During fiscal 2018, 2017 and 2016, accrued patronage distributions of \$13.6 million, \$13.3 million and \$10.5 million, respectively, were offset against trade receivables and notes receivable owed to the Company by its member retailers with no net impact in the Consolidated Statements of Cash Flows. In addition, the Company had \$5.2 million in patronage refund certificates which were included in Accounts payable pending payment in Fiscal 2019 as of December 29, 2018 and had no net impact in the Consolidated Statements of Cash Flows.

During fiscal 2018, 2017 and 2016, non-cash repurchases of stock from retailers of \$23.1 million, \$23.1 million and \$17.1 million, respectively, were offset against trade receivables of \$5.2 million, \$3.7 million and \$5.0 million, respectively, and notes receivable of \$6.0 million, \$5.6 million and \$2.2 million, respectively. The remaining \$11.9 million, \$13.8 million and \$9.9 million, respectively, were primarily issued as notes payable with no net impact in the Consolidated Statements of Cash Flows.

In June 2015, the Company entered into a forward interest rate swap derivative agreement, which started on March 13, 2017 and expires on May 13, 2020. The fair value adjustments for the interest rate swap derivatives were recorded as Other assets of \$0.8 million in fiscal 2018, Other long-term liabilities of \$0.7 million in fiscal 2017, and Accrued expenses and Other long-term liabilities of \$2.8 million in fiscal 2016. The Company offsets these adjustments in fair value, net of tax, against AOCI with no net impact in the Consolidated Statements of Cash Flows.

During fiscal 2018, the Company received \$2.5 million of property and equipment prior to year-end and accrued for these items as no cash payments were made. These capital expenditures were not included in the Purchases of property and equipment in the Consolidated Statement of Cash Flows for fiscal year 2018. During fiscal 2018, the Company paid \$2.2 million for property and equipment that was purchased and accrued during the year ended December 30, 2017. These capital expenditures were included in the Purchases of property and equipment in the Consolidated Statement of Cash Flows for fiscal year 2018.

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

The following discussion and analysis summarizes the significant factors affecting the Company's consolidated operating results and financial condition during the three-year period ended December 29, 2018 (the Company's fiscal years 2018, 2017 and 2016). Fiscal years 2018, 2017 and 2016 each contain 52 weeks of operating results. Unless otherwise noted, all references herein for the years 2018, 2017 and 2016 represent fiscal years ended December 29, 2018, December 30, 2017 and December 31, 2016, respectively. This discussion and analysis should be read in conjunction with the consolidated financial statements and the related notes included in this annual report that have been prepared in accordance with U.S. generally accepted accounting principles ("GAAP").

Company Overview

The Company is a wholesaler of hardware and other related products and provides services and best practices for retail operations. The overall home improvement industry is estimated to be almost \$400 billion and consists of a broad range of products and services, including lawn and garden products, paint and sundries, certain building supplies and general merchandise typically used in connection with home and property improvement, remodeling, repair and maintenance. The industry is fragmented and competition exists between the large home improvement centers, retail hardware stores and other chains offering hardware merchandise. In addition, we face growing competition from online and multichannel retailers.

The Company's retailers generally compete in the \$51 billion "convenience hardware" segment which is characterized by purchases primarily of products related to home improvement and repair, including paint and related products, lawn and garden equipment, and those products less focused on large-scale building, renovation and remodeling projects. The Company believes that the following competitive strengths distinguish it from its peers and contribute to its success in the convenience hardware market: (1) strong consumer recognition of the Ace Brand; (2) well-regarded for exceptional customer service and convenience; (3) strength of distribution operations; (4) consolidated purchasing power; (5) differentiated and localized product and service offerings; and (6) a diversified network of independent retailers.

The Company strives to be the best provider of products, services and operating methods for convenience hardware retailers. The four main drivers that support that goal and the Company's efforts to grow the business are improving the store model, accelerating new store openings, increasing store projects that drive store sales and profitability and reducing the number of store closings.

In September 2017, the Company formed the Ace Ecommerce Holdings LLC ("AEH") legal entity. On September 30, 2017, AEH acquired 94.3 percent of the issued and outstanding capital stock of The Daily Grommet Inc. ("The Grommet"), an e-commerce startup company. See Note 2 for additional details of this acquisition. The Company began a collaboration in 2016 with The Grommet to bring new, unique and otherwise undiscovered products from independent entrepreneurs into select Ace stores.

The Company's Ace Wholesale Holdings LLC ("AWH") legal entity was created to pursue sales to non-member retailers. Through acquisition, AWH has become a distributor of hardlines products for independent lumber, paint, industrial and hardware outlets throughout the country. The Company believes that AWH will serve as a catalyst to further leverage wholesale purchasing power and advance the Company's strategic plans to be a leader in the wholesale distribution industry.

Ace Retail Holdings LLC ("ARH") is the owner of the 123 store Westlake Ace Hardware retail chain. As a result, the Company is also a retailer of hardware, paint and other related products.

Ace Hardware International Holdings, Ltd. ("AIH") is a majority-owned and controlled subsidiary of the Company with a 20.5 percent noncontrolling interest owned by its international retailers. AIH has wholesale distribution capabilities in Ningbo, China; Colon, Panama; and Dubai, United Arab Emirates. AIH customers operate approximately 800 stores located in approximately 68 countries.

Worldwide Store Count

The number of worldwide Ace retail outlets during the past three fiscal years is summarized as follows:

	Fiscal Years		
	2018	2017	2016
Retail outlets at beginning of period	5,121	4,994	4,890
New retail outlets	257	236	207
Retail outlet cancellations	(125)	(109)	(103)
Retail outlets at end of period	5,253	5,121	4,994

Results of Operations

Comparison of the Year Ended December 29, 2018 to the Year Ended December 30, 2017

The following data summarizes the Company's performance in 2018 as compared to 2017 (in millions):

	2018		2017		Favorable/ (Unfavorable)	
	\$	% of Revenues*	\$	% of Revenues*	\$	%
Revenues:						
Wholesale revenues	5,341.6	93.4%	5,091.2	94.5%	250.4	4.9%
Retail revenues	375.4	6.6%	297.2	5.5%	78.2	26.3%
Total revenues	5,717.0	100.0%	5,388.4	100.0%	328.6	6.1%
Gross profit:						
Wholesale gross profit	634.2	11.9%	624.3	12.3%	9.9	1.6%
Retail gross profit	160.9	42.9%	130.0	43.7%	30.9	23.8%
Total gross profit	795.1	13.9%	754.3	14.0%	40.8	5.4%
Operating expenses:						
Wholesale operating expenses	510.4	9.6%	479.2	9.4%	(31.2)	(6.5%)
Retail operating expenses	156.1	41.6%	115.1	38.7%	(41.0)	(35.6%)
Warehouse facility closure costs	0.1	-	4.0	0.1%	3.9	97.5%
Total operating expenses	666.6	11.7%	598.3	11.1%	(68.3)	(11.4%)
Operating income	128.5	2.2%	156.0	2.9%	(27.5)	(17.6%)
Interest expense	(20.4)	(0.4%)	(14.6)	(0.2%)	(5.8)	(39.7%)
Other income, net	19.6	0.4%	5.2	-	14.4	276.9%
Net income attributable to Ace Hardware Corporation	127.7	2.2%	146.6	2.7%	(18.9)	(12.9%)

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

A reconciliation of consolidated revenues follows (in millions):

	Amount	% Change vs. 2017
2017 Revenues	\$ 5,388.4	
<i>Wholesale Merchandise Revenues change based on new and cancelled domestic stores:</i>		
Revenues increase from new stores added since January 2017	154.4	2.9%
Revenues decrease from stores cancelled since January 2017	(40.9)	(0.8%)
Increase in wholesale merchandise revenues to comparable domestic stores	115.3	2.1%
Increase in AWH revenues	13.8	0.3%
Increase in AIH revenues	4.5	0.1%
Increase in ARH revenues	54.1	1.0%
Increase in AEH retail revenues	24.1	0.4%
Other revenue changes, net	3.3	0.1%
2018 Revenues	\$ 5,717.0	6.1%

Consolidated revenues for the year ended December 29, 2018 totaled \$5.7 billion, an increase of \$328.6 million, or 6.1 percent, as compared to the prior year. Total wholesale revenues were \$5.3 billion for fiscal 2018, an increase of \$250.4 million, or 4.9 percent, as compared to the prior year. The categories with the largest revenue gains were paint, grilling, power tools, lawn and garden and electrical. New stores are defined as stores that were activated from January 2017 through December 2018. In 2018, the Company had an increase in wholesale merchandise revenues from new domestic stores of \$154.4 million. This increase was partially offset by a decrease in wholesale merchandise revenues due to domestic store cancellations of \$40.9 million. As a result, the Company realized a net increase in wholesale merchandise revenues of \$113.5 million related to the impact of both new stores affiliated with the Company and from stores that cancelled their membership in 2017 and 2018. Wholesale merchandise revenues to comparable domestic stores increased \$115.3 million. Warehouse sales represented 79.2 percent of wholesale merchandise revenue in 2018 compared to 79.7 percent in 2017, while direct ship sales were 20.8 percent, up from 20.3 percent in 2017.

AWH revenues were \$402.7 million during fiscal 2018. This is an increase of \$13.8 million from fiscal 2017 and was primarily driven by higher direct ship revenues and increased warehouse revenues in the plumbing, heating and lawn and garden departments.

AIH revenues were \$259.5 million during fiscal 2018. This is an increase of \$4.5 million from fiscal 2017 and was primarily driven by higher direct ship and service revenues.

Total retail revenues were \$375.4 million, an increase of \$78.2 million, or 26.3 percent, as compared to the prior year. Retail revenues from ARH were \$329.7 million during fiscal 2018, an increase of \$54.1 million or 19.6 percent. The increase was primarily the result of new retail stores added during 2018. Retail revenues from AEH, which was formed in the third quarter of 2017 to acquire The Grommet, were \$45.7 million during fiscal 2018.

Wholesale gross profit for fiscal 2018 was \$634.2 million, an increase of \$9.9 million from fiscal 2017. The wholesale gross margin percentage was 11.9 percent of wholesale revenues in fiscal 2018, a decrease from the fiscal 2017 gross margin percentage of 12.3 percent. This decrease in the wholesale gross margin percentage was primarily the result of higher receiving costs due to lower Retail Support Center ("RSC") productivity as well as unfavorable inventory reserve adjustments and LIFO expense. These decreases were partially offset by an increase in vendor funds earned.

Retail gross profit for fiscal 2018 was \$160.9 million, an increase of \$30.9 million from fiscal 2017. The retail gross margin percentage was 42.9 percent of retail revenues in fiscal 2018, down from 43.7 percent in fiscal 2017. The decline in margin was primarily the result of the inclusion of lower margin revenues realized by AEH for all of 2018 versus only in the fourth quarter of 2017. Excluding the impact of The Grommet, the retail gross margin as a percentage of retail revenues was 44.3 percent in fiscal 2018 compared to 44.6 percent in fiscal 2017. Retail gross profit as reported in the Ace financial statements is based on the Ace wholesale acquisition cost of product rather than the ARH acquisition cost which includes Ace's normal markup from cost.

Wholesale operating expenses increased \$31.2 million, or 6.5 percent in fiscal 2018, as compared to fiscal 2017. As a percentage of wholesale revenues, wholesale operating expenses increased to 9.6 percent in fiscal 2018 from 9.4 percent in fiscal 2017. The increase includes higher payroll expenses than the prior year to support higher revenues, lower RSC productivity due to high employee turnover and increased labor costs incurred to setup the new Fredericksburg RSC while shutting-down the Prince George RSC. In addition, marketing and advertising expenses increased from prior year to support the Ace U.S. business.

Retail operating expenses increased \$41.0 million, or 35.6 percent in fiscal 2018, as compared to fiscal 2017. ARH's retail operating expenses of \$120.3 million increased \$19.6 million, or 19.4 percent, in fiscal 2018 as compared to fiscal 2017. This increase was primarily driven by expenses from new retail stores added in 2018. The remainder of the increase was due to the inclusion of retail operating expenses from AEH for a full twelve months which was an increase of \$21.4 million. Included in AEH's operating expenses was \$4.5 million of amortization of intangible assets identified as part of the final purchase accounting valuation. Retail operating expenses as a percentage of retail revenue increased to 41.6 percent in fiscal 2018 from 38.7 percent in fiscal 2017. Excluding the impact of The Grommet, retail operating expenses as a percentage of retail revenues was 38.6 percent in fiscal 2018 compared to 39.0 percent in fiscal 2017.

During fiscal 2018, the Company recorded a \$0.1 million charge for warehouse facility closure costs to update its estimates from fiscal 2017. During fiscal 2017, the Company recorded warehouse facility closure costs of \$4.0 million related to the future closing of certain warehouse and distribution facilities.

Interest expense increased \$5.8 million or 39.7 percent compared to fiscal 2017 primarily due to an increase in the Company's revolver balance to support growth in inventories and receivables as well as higher rates. In addition, an increase in patronage refund certificates outstanding throughout the year contributed to the increase.

Other income, net increased \$14.4 million primarily due to a tax benefit in the current year compared to tax expense in fiscal 2017 caused by the new tax legislation enacted in 2017. In addition, interest income increased due to a realized gain on the sale of investments in fiscal 2018.

Comparison of the Year Ended December 30, 2017 to the Year Ended December 31, 2016

The following data summarizes the Company's performance in 2017 as compared to 2016 (in millions):

	2017		2016		Favorable/ (Unfavorable)	
	\$	% of Revenues*	\$	% of Revenues*	\$	%
Revenues:						
Wholesale revenues	5,091.2	94.5%	4,863.2	94.9%	228.0	4.7%
Retail revenues	297.2	5.5%	262.3	5.1%	34.9	13.3%
Total revenues	5,388.4	100.0%	5,125.5	100.0%	262.9	5.1%
Gross profit:						
Wholesale gross profit	624.3	12.3%	595.0	12.2%	29.3	4.9%
Retail gross profit	130.0	43.7%	117.8	44.9%	12.2	10.4%
Total gross profit	754.3	14.0%	712.8	13.9%	41.5	5.8%
Operating expenses:						
Wholesale operating expenses	479.2	9.4%	440.2	9.0%	(39.0)	(8.9%)
Retail operating expenses	115.1	38.7%	99.0	37.7%	(16.1)	(16.3%)
Warehouse facility closure costs	4.0	0.1%	3.3	0.1%	(0.7)	(21.2%)
Total operating expenses	598.3	11.1%	542.5	10.6%	(55.8)	(10.3%)
Operating income	156.0	2.9%	170.3	3.3%	(14.3)	(8.4%)
Interest expense	(14.6)	(0.2%)	(12.8)	(0.2%)	(1.8)	(14.1%)
Other income, net	5.2	-	3.4	-	1.8	52.9%
Net income attributable to Ace Hardware Corporation	146.6	2.7%	160.9	3.1%	(14.3)	(8.9%)

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

A reconciliation of consolidated revenues follows (in millions):

	Amount	% Change vs. 2016
2016 Revenues	\$ 5,125.5	
<i>Wholesale Merchandise Revenues change based on new and cancelled domestic stores:</i>		
Revenues increase from new stores added since January 2016	96.3	1.9%
Revenues decrease from stores cancelled since January 2016	(40.6)	(0.8%)
Increase in wholesale merchandise revenues to comparable domestic stores	98.0	1.9%
Increase in AWH revenues	23.7	0.5%
Increase in AIH revenues	24.0	0.5%
Increase in ARH revenues	13.3	0.2%
Increase in AEH retail revenues	21.6	0.4%
Other revenue changes, net	26.6	0.5%
2017 Revenues	\$ 5,388.4	5.1%

Consolidated revenues for the year ended December 30, 2017 totaled \$5.4 billion, an increase of \$262.9 million, or 5.1 percent, as compared to the prior year. Total wholesale revenues were \$5.1 billion for fiscal 2017, an increase of \$228.0 million, or 4.7 percent, as compared to the prior year. The categories with the largest revenue gains were outdoor living, power tools, and lawn and garden. New stores are defined as stores that were activated from January 2016 through December 2017. In 2017, the Company had an increase in wholesale merchandise revenues from new domestic stores of \$96.3 million. This increase was partially offset by a decrease in wholesale merchandise revenues due to domestic store cancellations of \$40.6 million. As a result, the Company realized a net increase in wholesale merchandise revenues of \$55.7 million related to the impact of both new stores affiliated with the Company and from stores that cancelled their membership in 2016 and 2017. Wholesale merchandise revenues to comparable domestic stores increased \$98.0 million. Warehouse sales represented 79.7 percent of wholesale merchandise revenue in 2017 compared to 80.6 percent in 2016, while direct ship sales were 20.3 percent, up from 19.4 percent in 2016.

AWH revenues were \$388.9 million during fiscal 2017. This is an increase of \$23.7 million from fiscal 2016 and was primarily caused by increased warehouse revenues in the paint, power tools, electrical and seasonal departments.

AIH revenues were \$255.0 million during fiscal 2017. This is an increase of \$24.0 million from fiscal 2016 and was primarily driven by higher sales to key retailers in Saudi Arabia, Ecuador, Puerto Rico, Israel and New Zealand.

Total retail revenues were \$297.2 million, an increase of \$34.9 million, or 13.3 percent, as compared to the prior year. Retail revenues from ARH were \$275.6 million during fiscal 2017, an increase of \$13.3 million or 5.1 percent. The increase was primarily the result of new retail stores added since January 2016. Retail revenues from AEH, which was formed in the third quarter of 2017 to acquire The Grommet, were \$21.6 million during fiscal 2017.

Wholesale gross profit for fiscal 2017 was \$624.3 million, an increase of \$29.3 million from fiscal 2016. The wholesale gross margin percentage was 12.3 percent of wholesale revenues in fiscal 2017, a slight increase from the fiscal 2016 gross margin percentage of 12.2 percent.

Retail gross profit for fiscal 2017 was \$130.0 million, an increase of \$12.2 million from fiscal 2016. The retail gross margin percentage was 43.7 percent of retail revenues in fiscal 2017, down from 44.9 percent in fiscal 2016. The decline in margin was primarily the result of the inclusion of lower margin revenues realized by AEH. Excluding the impact of The Grommet, the retail gross margin as a percentage of retail revenues was 44.6 percent in fiscal 2017. Retail gross profit as reported in the Ace financial statements is based on the Ace wholesale acquisition cost of product rather than the ARH acquisition cost which includes Ace's normal markup from cost.

Wholesale operating expenses increased \$39.0 million, or 8.9 percent in fiscal 2017, as compared to fiscal 2016. As a percentage of wholesale revenues, wholesale operating expenses increased to 9.4 percent in fiscal 2017 from 9.0 percent in fiscal 2016. The increase includes higher payroll expenses from prior year changes to Company benefit policies, a higher incentive accrual in fiscal 2017 and increased marketing and advertising expenses to support the Ace U.S. business.

Retail operating expenses increased \$16.1 million, or 16.3 percent in fiscal 2017, as compared to fiscal 2016. ARH's retail operating expenses of \$107.6 million increased \$8.6 million, or 8.7 percent, in fiscal 2017 as compared to fiscal 2016. The increase was primarily driven by expenses from new retail stores added in 2016 and 2017. The remainder of the increase was due to the inclusion of \$7.5 million of retail operating expenses from The Grommet. Retail operating expenses as a percentage of retail revenue increased to 38.7 percent in fiscal 2017 from 37.7 percent in fiscal 2016. Excluding the impact of The Grommet, retail operating expenses as a percentage of retail revenues were 39.0 percent in fiscal 2017.

In fiscal 2017 and fiscal 2016, the Company recorded warehouse facility closure charges of \$4.0 million and \$3.3 million, respectively, related to the future closing of certain warehouse and distribution facilities.

Interest expense increased \$1.8 million or 14.1 percent compared to fiscal 2016 primarily due to increased patronage refund certificates outstanding throughout the year.

Other income, net increased \$1.8 million primarily due to lower current tax expense caused by lower subsidiary earnings and a gain from the sale of marketable securities, partially offset by an increased deferred tax expense of \$4.1 million as a result of the new tax legislation enacted in 2017.

Liquidity and Capital Resources

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

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

The Company has a \$600.0 million line of credit that is expandable to \$750.0 million through a \$150.0 million accordion that is exercisable without the consent of existing lenders provided that the Company is not in default of the credit agreement and further provided that none of the existing lenders are required to provide any portion of the increased facility. At the Company's discretion, borrowings under the credit facility bear interest at a rate of either 25 to 100 basis points over the prime rate or 125 to 200 basis points over the London Interbank Offered Rate ("LIBOR") depending on the Company's leverage ratio as defined under the agreement. The credit facility was priced at LIBOR plus 150 basis points at December 29, 2018. The credit facility expires on May 29, 2020 and requires maintenance of certain financial covenants including a maximum allowable average leverage ratio and a minimum fixed charge coverage ratio. As of December 29, 2018, the Company was in compliance with its covenants and \$251.7 million was outstanding under the credit facility.

The credit facility includes a \$175.0 million sublimit for the issuance of standby and commercial letters of credit. As of December 29, 2018, a total of \$13.7 million in commercial letters of credit were outstanding. The credit facility requires the Company to pay fees based on the unused portion of the line of credit at a rate of 15 to 30 basis points per annum depending on the Company's leverage ratio.

The credit facility allows the Company to make revolving loans and other extensions of credit to AIH in an aggregate principal amount not to exceed \$75.0 million at any time. As of December 29, 2018, there were no loans or other extensions of credit provided to AIH.

The Company entered into an interest rate swap derivative agreement to reduce the risk of interest rate volatility for the remaining term of the credit facility. The interest rate swap started on March 13, 2017 and expires on May 13, 2020. The swap agreement fixes the LIBOR rate on \$150.0 million of the revolving credit facility at 2.18 percent, resulting in an effective rate of 3.68 percent after adding the 1.50 percent margin based on the current pricing tier per the credit agreement. The swap arrangement has been designated as a cash flow hedge and has been evaluated to be highly effective. As a result, the after-tax change in the fair value of the swap is recorded in accumulated other comprehensive income ("AOCI") as a gain or loss on derivative financial instruments.

On February 1, 2019, the Company amended its credit facility. The February 2019 amendment extended the maturity to February 1, 2024, lowered the interest rate credit spread 25 basis points, increased the capacity of the facility by \$100.0 million to \$700.0 million and increased the amount of the accordion feature to \$300.0 million.

The Company's ARH subsidiary has a \$75.0 million asset-based revolving credit facility ("ARH Facility"). The ARH Facility matures on October 23, 2022 and is expandable to \$100.0 million under certain conditions. In addition, the Company's ARH subsidiary has the right to issue letters of credit up to a maximum of \$7.5 million. At the Company's discretion, borrowings under this facility bear interest at a rate of either the prime rate plus an applicable spread of 25 basis points to 50 basis points or LIBOR plus an applicable spread of 125 basis points to 150 basis points, depending on the Company's average availability under the ARH Facility as measured on a trailing 12-month basis. The ARH Facility was priced at LIBOR plus 125 basis points at December 29, 2018.

The ARH Facility is collateralized by substantially all of ARH's personal property and intangible assets. Borrowings under the facility are subject to a borrowing base calculation consisting of certain advance rates applied to eligible collateral balances (primarily consisting of certain receivables and inventories). This agreement requires maintenance of certain financial covenants including a minimum fixed charge coverage ratio. As of December 29, 2018, ARH was in compliance with its covenants and had \$49.5 million in loans outstanding under the ARH Facility.

The ARH Facility requirements include a lender-controlled cash concentration system that results in all of ARH's daily available cash being applied to the outstanding borrowings under this facility. Pursuant to Financial Accounting Standards Board ("FASB") Accounting Standards Codification Section 470-10-45, "Classification of Revolving Credit Agreements Subject to Lock-Box Arrangements and Subjective Acceleration Clauses," the borrowings under the ARH Facility have been classified as a Current maturity of long-term debt as of December 29, 2018.

Total debt, the majority of which is comprised of the \$301.2 million borrowed on lines of credit, was \$327.7 million as of December 29, 2018, compared to \$222.0 million as of December 30, 2017.

Cash Flows

The Company had \$25.6 million and \$23.0 million of cash and cash equivalents at December 29, 2018 and December 30, 2017, respectively. Following is a summary of the Company's cash flows from operating, investing and financing activities for fiscal years 2018 and 2017, respectively (in millions):

	2018	2017
Cash provided by operating activities before changes in assets and liabilities	\$ 180.3	\$ 195.5
Net changes in assets and liabilities	(116.6)	8.7
Net cash provided by operating activities	63.7	204.2
Net cash used in investing activities	(88.9)	(131.8)
Net cash provided by (used) in financing activities	27.8	(66.2)
Net change in cash and cash equivalents	\$ 2.6	\$ 6.2

The Company's operating activities generated \$63.7 million of cash in fiscal 2018 compared to \$204.2 million in fiscal 2017. Excluding the impact of net changes in assets and liabilities, cash provided by operating activities decreased from \$195.5 million in fiscal 2017 to \$180.3 million in fiscal 2018. This \$15.2 million decrease was the result of lower net income in 2018.

The net change in assets and liabilities used \$116.6 million of cash in fiscal 2018 compared to providing \$8.7 million in fiscal 2017. This \$125.3 million decrease in net working capital was the result of higher revenues, which drove a \$13.9 million larger increase in receivables. The increase in inventory was \$118.3 million larger than the increase in the prior year. The Company invested approximately \$54.0 million in additional inventory in 2018 to mitigate longer lead times and transportation delays and approximately \$25.0 million for inventory to support the warehouse reconfiguration. The remainder of the increase was due to higher revenues. These increases in receivables and inventory were partially funded by an \$11.5 million increase in accounts payable and accrued expenses.

Net cash used for investing activities was \$88.9 million in 2018 compared to \$131.8 million in fiscal 2017. Investing activities in 2018 consisted of \$61.1 million in capital expenditures, including \$13.7 million for the new Fredericksburg RSC, and \$18.5 million paid for the acquisition of retail stores by ARH. Investing activities in 2017 consisted of \$64.6 million in capital expenditures, including \$18.3 million spent on expanding the Wilton, NY RSC and constructing the new Fredericksburg, PA RSC, \$45.5 million for the acquisition of The Grommet, and \$12.0 million paid for the acquisition of retail stores by ARH.

Net cash provided by financing activities was \$27.8 million in fiscal 2018 compared to using \$66.2 million in fiscal 2017. During 2018, the Company had \$104.8 million of net borrowings under the revolving lines of credit, paid \$58.0 million for the cash portion of the 2017 patronage distributions, and had \$11.0 million in payments on long-term debt. During 2017, the Company paid \$58.7 million for the cash portion of the 2016 patronage distributions, and had \$9.2 million in payments on long-term debt.

Off-balance sheet arrangements

In accordance with GAAP, operating leases for the Company's real estate and other assets are not reflected in the Consolidated Balance Sheets. In addition, the Company has certain other guarantees, as further described in the Notes to the Consolidated Financial Statements – Note 15 – Commitments and Contingencies. The Company believes the likelihood of any such payment under these guarantees is remote.

Contractual Obligations and Commitments

Contractual obligations and commitments at December 29, 2018 are as follows (in millions):

	Payments Due by Period				
	Total	Less than 1 Year	1-3 Years	3-5 Years	More than 5 Years
Long-term debt (1)	\$ 327.7	\$ 60.6	\$ 264.5	\$ 2.6	\$ -
Interest payments on long-term debt (2)	22.8	11.8	9.1	1.9	-
Patronage refund certificates payable	105.8	10.2	44.4	51.2	-
Operating leases (3)	403.3	67.5	113.7	76.5	145.6
Purchase commitments (4)	49.5	21.4	19.2	5.9	3.0
Total	\$ 909.1	\$ 171.5	\$ 450.9	\$ 138.1	\$ 148.6

- (1) Reflects principal payments.
- (2) Reflects interest that would be paid if LIBOR rates and interest rate spreads remain unchanged from the December 29, 2018 rates and assumes consistent outstanding revolving line of credit balances until the expiration of the facilities in 2020 and 2022.
- (3) Total operating lease payments include \$1.8 million of minimum lease payments for store leases that the Company has assigned to member retailers.
- (4) Represents minimum purchase commitments pursuant to contracts.

The table above does not include any reserves for uncertain tax positions (including penalties and interest) as the Company is unable to make a reasonably reliable estimate of the timing of payments due to uncertainties in the timing of the effective settlement of tax positions.

Application of Critical Accounting Policies and Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses in the consolidated financial statements. On an ongoing basis, the Company evaluates its estimates and judgments based on historical experience and various other factors that are believed to be reasonable under the circumstances. Actual results may differ from these estimates, and these estimates would vary under different assumptions or conditions. Management believes these estimates and assumptions are reasonable.

The Company annually reviews its financial reporting and disclosure practices and accounting policies to ensure that they provide accurate and comprehensive information relative to the current economic and business environment. The Company's significant accounting policies are described in the Notes to the Consolidated Financial Statements. The following represents those critical accounting policies which involve a relatively higher degree of judgment, estimation and complexity and where materially different amounts could be reported under different conditions or using different assumptions.

Valuation of Inventories When necessary, the Company provides allowances to adjust the carrying value of inventories to the lower of cost or market, including costs to sell or dispose of surplus or damaged/obsolete inventory, and for estimated shrinkage. Estimates of the future demand for the Company's products are key factors used by management in assessing the net realizable value of the inventories. While management believes that the estimates used are appropriate, an unanticipated decline in revenues at retail outlets or a significant decline in demand for products in selected product categories could result in valuation adjustments.

Vendor Funds The Company receives funds from vendors in the normal course of business principally as a result of purchase volumes, revenues or promotions of vendors' products. Based on the provisions of the vendor agreements in place, management develops accrual rates by estimating the point at which the Company will have completed its performance under the agreement and the amount agreed upon will be earned. Due to the complexity and diversity of the individual vendor agreements, the Company performs analyses and reviews of historical trends throughout the year to ensure the amounts earned are appropriately recorded. As part of these analyses, the Company validates its accrual rates based on actual purchase trends and applies those rates to actual purchase volumes to determine the amount of funds that should be accrued by the Company and receivable from the vendor. Amounts accrued throughout the year could be impacted if actual purchase volumes differ from projected annual purchase volumes, especially in the case of programs that provide for increased funding when graduated purchase volumes are met. At year-end, the accrual reflects actual purchases made throughout the year.

Vendor funds are treated as a reduction of inventory cost, unless they represent a reimbursement of specific, incremental and identifiable costs incurred by the customer to sell the vendor's product, in which case the costs would be netted. The majority of the vendor funds that the Company receives do not meet the specific, incremental and identifiable criteria. Therefore, the Company treats a majority of these funds as a reduction in the cost of inventory as the amounts are accrued and recognized as a reduction of cost of revenues when the inventory is sold.

Allowance for Doubtful Accounts The allowance for doubtful accounts reflects management's estimate of the future amount of accounts and notes receivable that will not be collected. Management records allowances for doubtful accounts based on judgments made considering a number of factors, primarily historical collection statistics, current member retailer credit information, the current economic environment, the aging of receivables, the evaluation of compliance with lending covenants and the offsetting amounts due to members for stock, notes, interest and anticipated but unpaid patronage distributions. While the Company believes it has appropriately considered known or expected outcomes, its customers' ability to pay their obligations, including those to the Company, could be adversely affected by declining revenues at retail resulting from such factors as contraction in the economy or competitive conditions in the wholesale and retail industry including increased competition from omni-channel retailers, discount stores, chain stores and other mass merchandisers.

The Company's allowance for doubtful accounts at December 29, 2018 and December 30, 2017 was \$9.5 million and \$11.2 million, respectively. Actual credit losses could vary materially from the Company's estimates.

Insurance Reserves Insurance reserves for claims related to the Company's self-insured property, general liability, workers' compensation and auto liability insurance programs are dependent on assumptions used in calculating such amounts. These assumptions include projected ultimate losses and confidence levels of the reserve requirement and consider historical loss levels and other factors.

While management believes that the assumptions used are appropriate, differences in actual claims experience or changes in assumptions may affect the Company's insurance reserves.

Goodwill Goodwill represents the excess of the cost of an acquired business over the fair value of net tangible assets acquired and identified intangible assets. Goodwill is not amortized but is tested for impairment at a reporting unit level on an annual basis or more frequently, if circumstances change or an event occurs that would more likely than not reduce the fair value of a reporting unit below its carrying amount.

Qualitative factors may be assessed to determine whether it is more likely than not that the fair value of the reporting unit is less than its carrying amount. If an election is made to not perform the qualitative assessment, or the qualitative assessment indicates that the carrying amount is more likely than not higher than the fair value, goodwill is tested for impairment. If the fair value of a reporting unit exceeds its carrying amount, goodwill of the reporting unit is considered not impaired. If the carrying amount of a reporting unit exceeds its fair value, an impairment loss shall be recognized in an amount equal to that excess.

Significant judgment is applied when goodwill is assessed for impairment. This judgment includes developing cash flow projections, selecting appropriate discount rates, identifying relevant market comparables, incorporating general economic and market conditions and selecting an appropriate control premium. The income approach is based on discounted cash flows, which are derived from internal forecasts and economic expectations for each respective reporting unit. In 2018, the Company did not recognize any goodwill impairments. The balance of goodwill was \$74.0 million at December 29, 2018. Significant adverse changes to the Company's business environment and future cash flows could cause the Company to record impairment charges in future periods.

Impact of New Accounting Standards

New Accounting Pronouncements – Adopted

In August 2018, the FASB issued Accounting Standards Update ("ASU") No. 2018-15, "Intangibles—Goodwill and Other—Internal-Use Software (Subtopic 350-40): Customer's Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract". ASU 2018-15 requires an entity to capitalize the implementation costs incurred in a hosting arrangement that is a service contract. ASU 2018-15 is effective for the Company for fiscal 2021 year-end financial statements and quarterly financial statements in fiscal 2022. The Company adopted ASU 2018-15 prospectively in the third quarter of 2018 as early adoption is permitted and the Company has previously accounted for these costs in this manner. There was no impact on the Company's consolidated financial statements.

In August 2018, the FASB issued ASU No. 2018-13, "Fair Value Measurement (Topic 820): Disclosure Framework—Changes to the Disclosure Requirements for Fair Value Measurement". ASU 2018-13 removes the disclosure requirements for transfers between Level 1 and Level 2 instruments, the policy for the timing of transfers between levels, the valuation processes for Level 3 fair value measurements, and the changes in unrealized gains and losses for the period included in earnings for recurring Level 3 fair value measurements held at the end of the period. Under ASU 2018-13, the Company is required to disclose transfers into and out of Level 3 of the fair value hierarchy, and purchases and issuances of Level 3 assets and liabilities, but is no longer required to reconcile the opening balances to the closing balances of recurring Level 3 fair value measurements. ASU 2018-13 is effective for the Company for fiscal 2020 quarterly and year-end financial statements. The Company adopted ASU 2018-13 prospectively in the third quarter of 2018 as early adoption is permitted. There was no impact on the Company's consolidated financial statements or footnotes.

In February 2018, the FASB issued ASU No. 2018-02, "Income Statement—Reporting Comprehensive Income (Topic 220)". ASU 2018-02 allows for the reclassification from AOCI to retained earnings for the stranded tax effects resulting from the change in the U.S. federal statutory income tax rate to 21 percent from 35 percent. ASU 2018-02 is effective for the Company for fiscal 2019 quarterly and year-end financial statements. The Company adopted ASU 2018-02 prospectively in the first quarter of 2018 as early adoption is permitted and elected to make the reclassification. This resulted in a reclassification adjustment of a \$0.7 million net loss from AOCI to retained earnings and is related to the unrealized gains and losses on the Company's investments, postretirement benefits and derivative financial instruments. The Company's policy for releasing income tax effects from AOCI is to utilize a portfolio approach.

New Accounting Pronouncements - Issued

In May 2014, the FASB issued ASU No. 2014-09, "Revenue from Contracts with Customers (Topic 606)" along with amendments issued in 2015 and 2016. The purpose of the new guidance is to develop a common revenue recognition standard for GAAP and International Financial Reporting Standards. The guidance affects any entity that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets unless those contracts are within the scope of other standards. The core principle of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. ASU 2014-09 allows either full retrospective adoption, meaning the standard is applied to all periods presented, or modified retrospective adoption, meaning the standard is applied only to the most current period presented in the financial statements. This guidance is effective for the Company for fiscal 2019 year-end financial statements and quarterly financial statements in fiscal 2020. The Company plans to adopt this standard for fiscal 2019 quarterly and year-end financial statements using the modified

retrospective method. The Company's adoption assessment included a detailed review of each material revenue stream and a comparison of historical accounting policies to the new standard. Based on the assessment, the Company believes the impact of adopting the new standard will be immaterial to the consolidated financial statements. However, the Company will have expanded revenue recognition disclosures based on the new qualitative and quantitative disclosure requirements in the first quarter of 2019.

In January 2016, the FASB issued ASU No. 2016-01, "Financial Instruments—Overall (Subtopic 825-10), Recognition and Measurement of Financial Assets and Financial Liabilities." ASU 2016-01 requires the change in fair value measurement for certain equity investments to be recognized in net income, simplifies the impairment assessment for equity investments without readily determinable fair values, eliminates disclosure requirements related to fair value of financial instruments measured at amortized cost for non-public entities, eliminates the requirement to disclose methods and assumptions used to estimate fair value of financial instruments measured at amortized cost for public entities and requires public entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes. Additionally, ASU 2016-01 provides disclosure presentation guidance and clarification related to valuations allowances on deferred tax assets related to available-for-sale securities. ASU 2016-01 is effective for the Company for fiscal 2019 year-end financial statements and quarterly financial statements in fiscal 2020, with early adoption permitted in fiscal 2018. The Company is evaluating the impact that ASU 2016-01 will have on its consolidated financial statements.

In February 2016, the FASB issued ASU No. 2016-02, "Leases (Topic 842)" along with amendments issued in 2018. The guidance requires that lessees recognize assets and liabilities for leases with lease terms greater than twelve months in the statement of financial position. The guidance also requires improved disclosures to help users of financial statements better understand the amount, timing and uncertainty of cash flows arising from leases. ASU 2016-02 is effective for the Company for fiscal 2020 year-end financial statements and quarterly financial statements in fiscal 2021. The Company has begun evaluating its contracts under this guidance to determine the impact ASU 2016-02 will have on its consolidated financial statements and believes the standard will have a material impact to the Company's balance sheet.

In June 2016, the FASB issued ASU No. 2016-13, "Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments" along with amendments issued in 2018. The guidance requires financial assets measured at amortized cost basis to be presented at the net amount expected to be collected. The amortized cost basis of financial assets should be reduced by expected credit losses to present the net carrying value in the financial statements at the amount expected to be collected. The measurement of expected credit losses is based on past events, historical experience, current conditions and forecasts that affect the collectability of the financial assets. Additionally, credit losses relating to available-for-sale debt securities should be recorded through an allowance for credit losses. ASU 2016-13 is effective for the Company for year-end financial statements and quarterly financial statements in fiscal 2022. The Company is evaluating the impact that ASU 2016-13 will have on the Company's consolidated financial statements.

In August 2017, the FASB issued ASU No. 2017-12, "Derivatives and Hedging (Topic 815)." ASU 2017-12 changes the designation and measurement guidance for qualifying hedging relationships and the presentation of hedge results. The guidance expands and refines hedge accounting for financial and nonfinancial risk components and aligns the recognition and presentation of the effects of the hedging instrument with the hedged item in the financial statements. ASU 2017-12 is effective for the Company for fiscal 2020 year-end financial statements and quarterly financial statements in fiscal 2021. The guidance in ASU 2017-12 will not have a material impact on the Company's consolidated financial statements.

Qualitative and Quantitative Disclosure About Market Risk

Inflation and Changes in Prices The Company's business is not generally governed by contracts that establish prices substantially in advance of the receipt of goods or services. As vendors increase or decrease their prices for merchandise supplied to the Company, the Company generally increases or decreases the price to its customers in an equal amount plus the normal handling charge on such amounts. In the past, these increases and decreases have provided adequate gross profit to offset the impact of inflation.

Foreign Currency Although the Company has international operating entities, its exposure to foreign currency rate fluctuations is not significant to its financial condition and results of operations.

Customer Credit Risk The Company is exposed to the risk of financial non-performance by customers. The Company's ability to collect on sales to its customers is dependent on the liquidity of its customer base. Volatility in credit markets may reduce the liquidity of the Company's customer base. To manage customer credit risk, the Company monitors historical collection statistics, current member retailer credit information, the current economic environment, the aging of receivables, the evaluation of compliance with lending covenants and the offsetting amounts due to members for stock, notes, interest and anticipated but unpaid patronage distributions. From certain customers, the Company also obtains collateral as considered necessary to reduce risk of loss. The Company does not believe the loss of any single customer would have a material adverse effect on its results of operations.

Interest Rate Volatility The Company has exposure to fluctuations in interest rates on its floating rate debt. In order to reduce the risk of interest rate volatility, the Company has entered into interest rate swap agreements to fix the LIBOR rate on a portion of its revolving credit facility. As a result of the interest rate swap agreements, the Company's exposure to interest rate fluctuations is not significant to its financial condition and results of operations.

Disclosure Regarding Forward-Looking Statements

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

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

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

FIVE YEAR SUMMARY OF EARNINGS AND DISTRIBUTIONS

	Years Ended				
	December 29, 2018	December 30, 2017	December 31, 2016	January 2, 2016	January 3, 2015
	(52 Weeks)	(52 Weeks)	(52 Weeks)	(52 Weeks)	(53 Weeks)
Revenues	\$ 5,717.0	\$ 5,388.4	\$ 5,125.5	\$ 5,045.0	\$ 4,700.5
Cost of revenues	4,921.9	4,634.1	4,412.7	4,343.3	4,048.3
Gross profit	795.1	754.3	712.8	701.7	652.2
Total operating and other expenses, net	667.4	607.7	551.9	547.5	511.3
Net income attributable to Ace Hardware Corporation	<u>\$ 127.7</u>	<u>\$ 146.6</u>	<u>\$ 160.9</u>	<u>\$ 154.2</u>	<u>\$ 140.9</u>
Distribution of net income:					
Patronage distributions to third party retailers	\$ 135.4	\$ 150.6	\$ 152.8	\$ 141.3	\$ 131.7
Net income (loss) of non-patronage activities	(7.0)	(4.0)	8.1	12.9	9.2
Adoption of accounting standard	(0.7)	-	-	-	-
Net income attributable to Ace Hardware Corporation	<u>\$ 127.7</u>	<u>\$ 146.6</u>	<u>\$ 160.9</u>	<u>\$ 154.2</u>	<u>\$ 140.9</u>

MANAGEMENT'S RESPONSIBILITY FOR FINANCIAL STATEMENTS

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

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

The consolidated financial statements of the Company have been audited by Ernst & Young LLP, independent accountants. Their accompanying report is based upon audits conducted in accordance with auditing standards generally accepted in the United States of America.

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

February 13, 2019

/s/ John Venhuizen

John Venhuizen

President and Chief Executive Officer

/s/ William M. Guzik

William M. Guzik

Executive Vice President and

Chief Financial Officer and Chief Risk Officer

/s/ Steven G. Locanto

Steven G. Locanto

Corporate Controller

MEMBERSHIP INFORMATION

Membership Application, Agreements and Stock Subscription

Membership Application and Agreements. All domestic member retailers have membership agreements with us that entitle them to purchase merchandise and services from us. Membership agreements entered prior to January 1, 2004, granted retailers a license to use some of our trademarks. After January 1, 2004, new retailers are granted a license to use some of our trademarks under a separate Ace brand agreement. Generally, retailers whose membership agreements are dated August 1993 or later are subject to “general member standards,” “Ace brand standards,” “member operational requirements” and other important requirements.

Only prospects who submit membership applications to us for designated retail outlets that we choose to accept may become Ace retailers and purchase our stock. If you apply to become an Ace retailer, you must complete and submit for each store location a membership application that contains extensive information about yourself and your proposed location, as well as the actual membership agreement, a stock subscription agreement for the purchase of our stock and a number of other agreements and instruments that we require. These include the Ace brand agreement if you propose to operate your store using the Ace name.

You must also pay a \$5,000 membership application processing fee. If we accept your application, we sign your stock subscription agreement and your membership agreement and, if applicable, your Ace brand agreement.

Ace Officers Control Membership. All membership decisions are subject to Officer approval. We employ various field sales personnel who contact and solicit existing and prospective member retailers and promote our business and programs; however, these individuals are not allowed to accept new members. We may pay commissions or other incentives to our personnel in connection with the acceptance of new members or the opening of new stores.

Stock Subscription Amount and Terms of Payment. To become a member, you are required to subscribe for \$5,000 of our stock per member store. For a first store location, the subscription is for one share of Class A voting stock at a price of \$1,000 per share (par value) plus 40 shares of Class C non-voting stock at a price of \$100 per share (par value). The subscription for shares for each additional store location owned or controlled by the same retailer consists entirely of 50 shares of Class C nonvoting stock at a price of \$100 per share. Billing for such shares in full will occur 30 days after the store’s activation date, and the certificates for these shares will be issued at that time. You must promptly pay in full for your share purchases.

Use of Proceeds. We use the proceeds that we receive from sales of our stock mainly for general working capital purposes, including the purchase of merchandise for resale and capital expenditures. We reserve the right to use such proceeds for any other proper corporate purpose, as well.

Termination of Membership upon Transfer of Shares. Unless we expressly consent to the continuation of your membership, it will automatically terminate if you attempt to transfer any of your shares of Ace stock (whether purchased or received as patronage distributions) to someone else. Your membership will also terminate if we repurchase your shares.

Retailer Assessments and Charges

In addition to the stock subscription amount and the membership application processing fee described above, we assess additional fees for both mandatory and optional services and programs. Our service and program offerings, and their respective fees, are listed below. All programs and fees are subject to change upon notice. Some of the services or programs listed below may not be available to our Individually Branded retailer members, or we may charge such retailers different fees than those shown below.

Type of Fee (1)	Amount	Due Date	Remarks
Late Payment	0.77% of the past due bi-weekly billing statement balance.	10 days after billing	Payable on all overdue amounts. See further explanation in Note (2) below.
Low Volume Service Charge	\$100 per bi-weekly billing period if annual volume purchased is less than \$200,000.	10 days after billing	Payable if you fail to make the \$200,000 minimum annual purchases. See further explanation in Note (3) below.
Freight Charge	The freight rate is billed as a fixed percentage of your warehouse purchases, adjusted annually.	10 days after billing	Freight percentages will be calculated and communicated in January and will become effective February 1st.

Type of Fee (1)	Amount	Due Date	Remarks
Fuel Surcharge	When the U.S. national average price for diesel fuel exceeds \$2.05 per gallon, a 0.50% fuel charge applies. The surcharge is adjusted (i.e., increased or decreased) weekly, 0.50% for every five-cent change (increase or decrease) in fuel price.	10 days after billing	The fuel surcharge percentage is applied to the net freight charge.
Core Retail Services	\$168 per month for all parent stores and \$37 per month for each branch store.	10 days after billing	See further explanation in Note (4) below.
Regulatory	Varies by state and product (e.g., paint recycling fee).	10 days after billing	Ace may be required by state law to collect and remit regulatory fees on your behalf based on certain product purchases from Ace.
Business Insurance	Will vary depending upon coverage purchased. Estimated annual cost of required coverage: \$2,500 - \$30,000.	11-month installment plan with 2 months' premium paid in month 1 and balance equally billed monthly over the next 10 months	Business insurance is required and may be purchased from our affiliate Ace Insurance Agency, Inc., or from unaffiliated third parties. See further explanation in Note (5) below.
Annual Brand Assessment	Store's first calendar year: \$6,000 flat fee per store. Subsequent years: 2% of prior year purchases subject to minimum and maximum assessments described in Note (6) below.	10 days after billing	See further explanation in Note (6) below.

Type of Fee (1)	Amount	Due Date	Remarks
Computer Hardware and Software for Point of Sale System Computer Hardware and Software Maintenance	\$45,000 - \$85,000. You will also incur charges for ongoing computer hardware and software maintenance services. Costs for these services will vary depending on the services selected by you, but are estimated to be \$500 per month. If you use a point of sale system from Epicor Software Corporation, you will also pay \$7.50 per payment device, per month, for transactional security (i.e. point to point encryption). If you use a different point of sale vendor, the fee for point to point encryption will vary.	Varies, depending upon the vendor you contract with	See further explanation in Note (7) below. We require that all merchandise orders be submitted to us through an electronic ordering process. You may purchase or lease (using your choice of leasing companies) or finance a computer system.
Store Planning Services	\$6,000 flat fee for Full Services Package. Additional fees will vary depending on project scope.	Completion of project or 180 days from start of fixture plan (26 equal installments for existing retailers upon request)	Store planning services are mandatory for a new store and are provided by us.
Ace Bankcard Program	\$35 annual fee per store. A monthly non-qualified fee will be assessed to your statement based on card type and volume.	10 days after billing	This program is optional.
Customer Check Verification Service (Telecheck)	1% of the face value of your customer's check.	10 days after billing (if billed through Ace)	This service is optional. This service is available from Ace or from third parties (e.g., VISA, MasterCard, etc.).
Ace Rewards® Program	\$850 initial fee; \$75 per month, per store thereafter. \$0.31 per direct mail piece. Each participating store is required to send three Ace Rewards specific direct mail promotions per year.	10 days after billing	Provided your technology is capable.

Type of Fee (1)	Amount	Due Date	Remarks
Grocery Format Add-on to Ace Rewards Program	If you are a grocery format, there is a one-time set-up fee of \$1,000 if you do not already use products provided by our chosen vendor. There is an additional program fee of \$300 per Cycle. There are 13 non-overlapping Cycles per calendar year.	10 days after billing	This add-on is required if you are a grocery format and you participate in the Ace Rewards program.
Ace Gift Card Program	\$51.50 initial sign kit fee plus \$0.50 per blank (inactivated) card stock. Additional point-of-service processing fees apply per credit card transaction; such fees vary by card processor (VISA, MasterCard, etc.) and by number of transactions processed. Cost will also vary depending upon type of card displays and accessories purchased.	10 days after billing	
Regional Advertising	Will vary depending on regional advertising programs.	10 days after billing	Program is market-specific. See further explanation in Note (8) below.
Ace Marketing Muscle	Will vary based on the services utilized.	10 days after billing	This service is optional. An online portal for retailers to customize local advertising, order printed supplies and manage social media.
Group Preprint Program	Price varies by page count and group participation. For example, group pricing for an 8 tab is \$48.00 per thousand copies, while individual store orders are \$76.00 per thousand copies.	10 days after billing	This program is optional. See further explanation in Note (8) below.
New Movers Program	\$0.23 per piece.	10 days after billing	This program is optional. You can join or opt out of the program at any time, subject to a three-month lag.
Monthly Sign Kit Program	\$175 per month per store for full kit; \$75 for mini-kit.	10 days after billing	This program is a recommended component of our overall marketing and advertising plan. The sign kit includes all point-of-purchase signage supporting Ace's consumer marketing plan.

Type of Fee (1)	Amount	Due Date	Remarks
Customer Insights Program (Mystery Shop, Customer Engagement, Employee Engagement)	For each in-store mystery shop the fee is \$46. For each phone mystery shop the fee is \$15. For each competitor mystery shop the fee is \$46. You can also purchase customer engagement and employee engagement services, in addition to the mystery shop services, for a monthly bundled fee of \$67 per month (which is billed as a \$46 mystery shop fee and a \$21 customer and employee engagement survey fee).	10 days after billing	This program is optional. The á la carte fee is assessed each month after the mystery shop service is completed. The bundled fee is assessed each month after customer surveys are returned.
Visual Merchandising Services	Price varies depending on project scope. All projects are set to bid to ensure lowest possible cost based on location and timeframes.	Project is billed upon completion. 10 days after billing	Services are provided by unaffiliated third parties.
Ace Rental Place	Will vary depending upon the rental equipment offered, fixtures needed, maintenance/repair shop needs and any optional exterior signs selected. Minimum cost of implementation begins at approximately \$30,000.	10 days after billing	This program is optional.
Business to Business	Will vary depending upon implementation method, marketing material and signage purchased to promote business to business.	10 days after billing	This program is optional.
Retail Loss Prevention	Will vary depending upon equipment or services utilized. Estimated cost range per service is \$30 - \$3,500. Costs do not include expenses for meeting rooms, travel, lodging, meals or tax where applicable.	As incurred or as agreed	These services and products are optional. See further explanation in Note (9) below.
National Catalogs	\$29 per month for one set of catalogs per year (18 total). Additional sets are billed at a rate of \$16 per month, per set.	10 days after billing	This service is optional.

Type of Fee (1)	Amount	Due Date	Remarks
Ace Catalog on DVD	One DVD is included with the Core Retail Services monthly fee. Additional DVDs cost \$15 per DVD.	10 days after billing	This service is optional.
Matching Funds	Member can contribute up to \$2,400 annually for group advertising.	Quarterly assessment on Ace statement	This is optional. See further explanation in Note (8) below.
Training Programs (Pre-Opening and Continuing)	The cost will vary depending upon the type of training, duration, and location of sessions. Price does not include expenses for meeting rooms, travel, lodging, meals, or tax where applicable.	Upon receipt of bill	Training programs are mandatory under certain new store incentive agreements. Other training programs are optional.
Liquidated Damages	\$10,000 per month.	As incurred	Payable on the first day of each month during which, for a period of one or more days, you fail to remove all Ace identification, signs, decals, displays or other materials bearing the Ace trademarks from your store after the termination of your membership. Such payments will continue until the first day of the month following the month in which all such Ace identification has been permanently removed from your store.
Costs and Attorney's Fees	Will vary under circumstances.	As incurred	Payable upon your failure to comply with the Membership Agreement, Brand Agreement and/or other agreements you enter into with us.
Indemnification	Will vary under circumstances.	As incurred	You may have to reimburse us if we are held liable for claims arising from your store's operations.

Notes:

- (1) Except as to fees designated as optional or voluntary, all fees are imposed by and, unless otherwise noted, payable to us. All fees are nonrefundable. Fees that we impose are subject to change upon notice to you.
- (2) Late payment fees apply on a national basis at the rate stated (i.e., 0.77 percent), except in Texas and Georgia, where the applicable bi-weekly percentage rates are 0.384 percent and 0.692 percent, respectively. Service charges are assessed on all past due balances according to the following guidelines: i) electronic payments must be initiated by 2 p.m. CST on Tuesday following the due date to avoid a past due service charge; and ii) manual checks must be posted in the bank lockbox by the bank cut-off time on Wednesday following the due date to avoid a past due service charge. Past due balances as of the end of day Wednesday will be assessed the past due service charge at the rate of 0.77 percent (with the same exceptions of 0.384 percent and 0.692 percent in Texas and Georgia, respectively). Certain charges are exempt from past due service charges where mandated by the state.
- (3) You must pay a low volume service charge if your purchases from us during a calendar year are less than our minimum purchase levels. The charge currently applies on a bi-weekly basis if your annual purchases from us are less than \$200,000. If your purchases are less than \$200,000 in any given year, a \$100 low volume service charge is billed to each of your bi-weekly billing statements during the following year. New stores must be active for a full calendar year before this charge is applicable. The minimum purchase threshold, as well as the amount and manner of calculating the low volume service charge, can be changed by our Board of Directors. Failure to meet our minimum purchase levels constitutes cause for termination of the membership agreement.
- (4) Core Retail Services simplifies the billing process by bundling several important programs or services into one monthly charge. These include:
 - ACENET: Our primary communications portal. ACENET provides back office and catalog applications such as product search, ordering, defective and returned goods processing, training, Ace statements, and numerous other applications.
 - Safety Data Sheets (SDS): Communicates the hazards of hazardous chemicals. Access is available 24/7 with unlimited single requests included.
 - Training Core Charge: This fee helps to fund the Ace Learning Place and the creation of educational content, as well as other selective strategic training.
 - NRHA Membership: Because Ace is a member of the North American Retail Hardware Association ("NRHA"), Ace retailers have access to NRHA online training and resources. From this site, retailers can access member newsletters, project brochures, NRHA studies and a variety of associate training tools including the Basic and Advanced Courses in Hardware Retailing.
 - Retail Pricing: Retailers have access to an assortment of pricing-related services designed to improve gross margin dollars and enhance price image. These include pricing services such as Tailored Pricing and Tailored Hotsheets, and the ongoing pricing research needed for establishing and maintaining suggested Ace retail prices.
- (5) We must be named as a loss payee party on your store's contents-insurance coverage. Your store must also have automotive and general liability insurance, each with no less than a \$1 million combined single limit, naming us as an additional insured. Your store's general liability insurance must also have a limit of no less than \$2 million in the aggregate. Your store must also carry statutory workers' compensation insurance and furnish evidence of insurance that is acceptable to us. Your store's insurance must be written with a carrier with an AM Best Key Rating of at least an A- and must provide us with at least 10 days' notice of cancellation. You must provide evidence of such insurance to Ace's Corporate Risk Management Department.
- (6) The amount of the brand assessment for a new store activated in 2019 and subsequent years is a flat fee of \$6,000. If the new store is activated by Ace in the first three (3) calendar year quarters, the flat fee brand assessment will be billed on the store's bi-weekly statement issued on or after the date that is sixty (60) days following the date of the new store's activation. The store's annual brand assessment for 2020 and subsequent years will be calculated based upon 2 percent of purchases made during the prior year, subject to the minimum and maximum assessments set forth below, which will be billed annually in twenty-six (26) equal installments on the store's bi-weekly statement from February to January.

If a new store is activated in the fourth (4th) calendar quarter, the billing of the \$6,000 flat fee brand assessment will be deferred until the following year. In addition, a brand assessment charge of \$6,000 for the calendar year following activation will be aggregated with the flat fee brand assessment for a total assessment of \$12,000, which will be billed in twenty-six (26) equal installments on its bi-weekly statement starting in February of the year following activation. Thereafter, the annual brand assessment will be calculated based upon 2 percent of purchases made during the prior year, subject to the minimum and maximum assessments set forth below, which will be billed annually in twenty-six (26) equal installments on the store's bi-weekly statement from February to January.

Annual minimum and maximum brand assessment fees for existing stores:

Assessment Year	Minimum Assessment	Maximum Assessment
2019	6,181	13,393
2020	6,274	13,594

The annual brand assessment, including, without limitation, the minimum and maximum assessment, is subject to change by our Board of Directors.

- (7) If you are opening a new store that is not a branch store or a conversion, and you do not also own an existing separate business that uses a point-of-sale computer system, we require that you purchase or lease or finance your point of sale computer system from Epicor Software Corporation (formerly Activant).
- (8) Participation in a regional advertising group is voluntary and each store decides whether or not to participate. Retailers from time to time form regional advertising groups that work together and contribute monies to fund regional marketing programs including digital advertising, paid search programs, social media marketing, regional television and audio spots, billboards, direct mail campaigns, sports sponsorships and sponsorship of local events. We currently support retailers' regional advertising efforts by offering 100 percent Matching Funds of up to \$2,400 per store per year for market level advertising plans. In addition, retailers participating in the Matching Funds program are eligible to receive additional funds under our 20/20 Vision strategy. If 50 percent of the regional advertising group achieves either Platinum or Pinnacle status, they receive one and one-half times the match. If 75 percent of the group achieves either Platinum or Pinnacle status, they receive two times the match. We retain the right to form, change, dissolve or merge groups of regional or local members for the purpose of advertising from time to time. Other than offering the Matching Funds program, which may be modified or discontinued at any time, our role in regional and local advertising is to help the retailers develop optional annual advertising strategies and plans. Ace bills the participating retailers on a quarterly basis and assists in the planning and execution of the advertising campaign.
- (9) Retail Loss Prevention is a part of the Property/Loss Prevention Department. Participation in the programs or services or purchase of products offered is optional, most of which are offered by unaffiliated third-party vendors. Prices will vary depending upon the equipment desired or level of service requested. For example, prices for background screening range from \$30 - \$43 for a single search. In-store loss prevention products start at \$50 and increase with product type, quality and quantity. Some of these services and products will be billed by Ace directly to your store statement. In-store consulting, auditing, training, and investigations are available for fees beginning at \$500, with fees increasing for additional services, if any, that you request. All in-store investigations are provided by unaffiliated third-party vendors and are billed directly to you by the vendor. General consulting, auditing, training and services through the Professional Retailer Services program will be billed directly to your store's statement.

Patronage Distributions

We operate as a retailer-owned cooperative. As a cooperative, we derive the majority of our revenues from transactions with our member retailers who are entitled to purchase merchandise and services from us. On an annual basis, we currently distribute substantially all of our net earnings (other than non-patronage income as described below) to our member retailers in the form of patronage distributions consisting of cash, capital stock and Patronage Refund Certificates. The amount of patronage distributions each member receives annually is based upon the volume of the patronage-based merchandise, if any, he or she purchases from us in the previous year.

Membership Interests. Under our cooperative structure, to become a member of Ace, a retailer must subscribe to purchase one share of Class A common stock. Only our Class A common stock has voting rights, and each of our members may hold only one share of Class A common stock. New members and members opening new stores are also required to subscribe for shares of Class C common stock, and additional shares of Class C common stock historically have been issued annually as part of the Company's patronage distribution. As is typical for a cooperative, Ace's common stock represents only the members' participation and membership interests in Ace and does not entitle holders to participate, as stockholders, in the earnings of Ace or realize Ace's value as an enterprise to the extent that it exceeds the aggregate stated par value of our outstanding common stock.

Favorable Corporate Tax Treatment. Generally, under Subchapter T of the Internal Revenue Code, we can deduct from our income for federal income tax purposes the entire amount of the patronage we distribute each year so long as we pay (or make available in the case of an allocation against any indebtedness owed to us) at least 20 percent of the patronage in cash. A similar deduction also is generally available for state income taxes. The cash payments and stated dollar amounts of Class C common stock and Patronage Refund Certificates comprising the patronage distributions we make to each member retailer must be included in a member's gross income for federal income tax purposes. However, members operating in partnership, proprietorship or S Corporation form may be eligible for a deduction under IRC Section 199A of up to 20 percent of qualified business income, subject to certain limitation.

Form of Patronage Distributions. Historically, patronage has been distributed in three currencies – cash, shares of Class C stock and, if the retailer has met the Company's stock requirements, interest-bearing five-year Patronage Refund Certificates. Patronage

distributions are made annually according to a specific plan that is adopted by our Board of Directors. This plan can be changed from time to time by the Board as it deems appropriate.

Since 2011, the first 40 percent of the patronage distribution is made in cash for all member retailers. The cash portion of any patronage distribution payable to a past due or terminated retailer is generally applied against the retailer's indebtedness or other obligations to us, if any. The remainder is distributed in shares of Class C common stock until the retailer meets the stock requirement. The stock requirement is equal to 20 percent of the most recent year purchases from the Company's RSCs (warehouses), including without limitation, bulletin, store-traffic-opportunity-program ("STOP") and private label liquid paint products plus 4 percent of the most recent year purchases shipped directly from the vendor to the retailer without any physical "handling" by the Company (i.e., dropship and less-than-truckload-plus ("LTL Plus") purchases) (See "Patronage Distributions Determinations"). Once the stock requirement has been satisfied, the remainder of the distribution is made in the form of a Patronage Refund Certificate. For any member retailer that has an outstanding loan due to us that is eligible to be satisfied from patronage distributions, any current amounts due (including principal and interest) are paid from the non-cash portion of the patronage distribution before Class C common stock or Patronage Refund Certificates are issued.

Patronage Distribution Determinations. The total patronage income available for distribution to members is determined after various expenses, including interest expense, and is based on net earnings on patronage business that we do with member retailers. Patronage distributions are allocated separately on each of our three basic categories of sales: handled sales (which include warehouse sales and bulletin sales), direct shipment sales and private label paint sales. The Company also maintains a fourth category of patronage-eligible sales (i.e., under the LTL Plus and STOP programs), for which the products' pricing incorporates the value of an 'upfront' dividend. Accordingly, this fourth category of sales generally operates at a break-even. However, were a net loss to occur with respect to this category (or any of the others), such loss would be offset against the profits of the primary handled sales pool in accordance with the Company's By-laws. Distribution percentage allocations are made with reference to our net earnings from each of the respective patronage pools.

The total patronage distributions distributed to members are based on net earnings on patronage business that we do with member retailers, calculated in accordance with GAAP. Our computation of patronage distributions excludes all of our income and expenses from activities that are not directly related to patronage transactions. The excluded items primarily consist of (1) profits or losses generated from non-shareholder retailers, and (2) profits or losses realized from our Ace Insurance Agency, Inc., New Age Insurance Ltd., Ace Hardware International Holdings, Ltd. and subsidiaries, Ace Retail Holdings LLC and subsidiaries, Ace Wholesale Holdings LLC and subsidiaries and Ace Ecommerce Holdings LLC and subsidiaries.

Patronage distributions are usually paid to member retailers within four months after the close of Ace's fiscal year; however, the Internal Revenue Code permits distributions of patronage as late as eight and one-half months after the close of Ace's fiscal year, and Ace may elect to distribute the annual patronage distribution at such later time.

DESCRIPTION OF CAPITAL STOCK

Dividend Rights

Our Certificate of Incorporation and By-laws prohibit us from declaring dividends on any shares of any class of our stock. However, we may distribute shares of Class C Stock to you as a part of your annual patronage distribution based on your purchases.

Voting Rights

Our Class A Stock is voting stock. Class C Stock is non-voting, except that holders can vote upon any increase or decrease in the number of authorized shares of that class, any change in the par value of those shares, or anything that would change the power, preferences or special rights of that class so as to adversely affect its shares. Any class of stock that has the right to vote has one vote per share. Cumulative voting of shares for the election of directors or on other matters is not allowed.

Liquidation Rights

If Ace voluntarily or involuntarily liquidates, our net assets after paying or providing for our liabilities (including Patronage Refund Certificates) will be distributed among the shareholders of all classes of our issued and outstanding stock. In that case, holders of Class C Stock would first receive the total amounts that we would have had to pay to repurchase all outstanding shares of that class at the price previously set by our Board of Directors. Were our net assets not sufficient to pay that amount, then each outstanding share of Class C Stock would share in the distribution of our net assets in the proportion which its purchase or redemption price would bear to the total available for payment. Next, our net assets would be distributed equally to each Class A stockholder up to the par value of \$1,000 per Class A share. Any remaining net assets would be distributed among the shareholders of all classes of stock proportionally in accordance with the amounts already allocated to them.

Preemptive Rights

Stockholders have no preemptive or similar rights to purchase shares of our stock or any securities that we might offer.

Redemption Provisions

Shares of Class A Stock are not redeemable. Shares of Class C Stock that have been issued as patronage distributions may be redeemed by the Company at any time. The redemption price for Class C Stock cannot be less than its \$100 par value per share. Were we to redeem stock as discussed above, we would mail notices to each stockholder at least 30 days before the redemption date. If fewer than all of the outstanding Class C shares were being redeemed, then the number of shares and the method of redemption, whether by lot or prorata or some other way, would be determined by our Board of Directors.

Limitations on Ownership of Stock

Our members own all of our outstanding shares of capital stock. Membership in Ace is limited to approved retailers in hardware and related products who have membership agreements with us. These are the only persons eligible to own or purchase shares of any class of our stock.

No member is allowed to own more than one share of our Class A voting stock, no matter how many store locations that member owns or controls. This ensures that each Class A stockholder in our cooperative has equal voting power. We treat a member that is a corporation, partnership or similar entity as being controlled by someone else if at least 50 percent of the capital stock (or 50 percent of the profit shares) of that member is owned or controlled by another person or entity.

Other Restrictions and Rights

There is no market for the sale or trading of our stock, and the redemption prices last established by our Board of Directors have not been adjusted since 1974 when Ace first became a cooperative.

(a) As security for your indebtedness to Ace, we retain a first lien upon all your shares of Ace stock and all amounts that you pay us under your Stock Subscription Agreement before your shares are issued. Your interest in your Ace stock and the amounts paid under your Stock Subscription Agreement are always offset by the amount of any indebtedness that you owe us. We will not transfer any of your shares or any funds in your stock subscription account unless you are free from all indebtedness to us. When we repurchase shares from a terminated member as described in section (h) below, the cash portion we would normally pay toward those shares is first applied toward any indebtedness that the terminated member owed to us. The portion of the purchase price of those shares that we would normally pay with an installment note would then be applied toward any indebtedness that remained.

(b) You are not allowed to transfer your shares of our stock or to sell, assign or pledge them, or to post them as collateral or give lien rights in them to anyone other than Ace without our prior consent. If we refuse to consent to a transfer or assignment of your stock to another hardware retailer, then we must purchase that stock back from you as described in section (h) below. You are not entitled to make a transfer or assignment to anyone who is ineligible to become a member of Ace. In other words, approved transfers can only be made to other retailers who either have Membership Agreements with us or whom we are willing to accept as members. Were you to propose to transfer the ownership of your store location to another Ace retailer, or to someone whom we are willing to accept as a member, you would have the option of either (i) selling or transferring to that person the same number of shares that we would have been required to offer him or her as a member for that store location, or (ii) selling those shares back to us. However, there are certain types of transfers of your business where you do not have the option of selling those shares back to us. These situations involve (x) any transfer which is not complete, unconditional and irrevocable; (y) any transfer to an entity in which you retain an ownership interest; or (z) any transfer to your spouse.

(c) If your membership terminates for your store location, we must repurchase your shares of Ace stock. Our repurchase obligation is subject to our first lien and our right to set off your indebtedness to us as described in section (a) above. If your stock has not yet been paid for and your shares have not yet been issued, we would instead refund the amounts that you paid under your Stock Subscription Agreement, again subject to our first lien and offset rights described in section (a) above. Your membership can be terminated by a formal notice of termination, and it can also be terminated automatically under our By-laws in each of the following three situations without a formal notice:

- (i) If your store permanently closes or ceases business, unless your store is relocated with our consent to another location, or unless your store is being acquired by another Ace retailer or by someone whom we are willing to accept as a member for operation under the same membership at another location;
- (ii) If an individual holder of our shares or a member of a partnership that is a holder of our shares dies, except where the store location having the Ace membership continues, with our consent, to be operated by the deceased person's estate, heirs or partnership successors. Changes in the legal form of ownership of the member store from an individual

proprietorship or partnership to a corporation or from a partnership to an individual proprietorship are not considered significant in these cases;

- (iii) If a court or other official body rules that a member is insolvent, or the member assigns the business to be operated for the benefit of creditors, or a voluntary or involuntary bankruptcy or similar petition is filed under the U.S. Bankruptcy Code regarding the member or the store or business unit for which our shares of stock are held.

(d) Under Delaware corporate law, we are not allowed to repurchase any of our shares if the value of our net assets is less than the aggregate par value of the outstanding shares of our capital stock or would be reduced below that amount by virtue of the repurchase.

(e) We do not need to consent to a transfer of shares of Ace stock that occurs when the shares are held jointly with others and the ownership of the shares automatically passes under law to the survivor(s), nor are we obligated to repurchase the shares in that case, unless the store location either (i) permanently closes, or (ii) stops being operated as a member of Ace.

(f) If you hold your Ace membership in the form of a corporation (the “member corporation”), you must give us written notice of any proposal where the holders of 50 percent or more of the voting stock of the member corporation propose to sell or transfer all of their shares of capital stock (both voting and non-voting) of that member corporation. If there is a member corporation but another corporation (the “controlling company”) holds 80 percent or more of the voting stock of the member corporation, then you must also give us written notice if the holders of 50 percent or more of the voting stock of the controlling company propose to sell or transfer all of their shares of capital stock (both voting and non-voting) in the controlling company. In these cases, when the sale or transfer occurs, the corporation whose shares were sold or transferred can either keep all the shares of Ace stock that it owns for the member corporation or sell all of those shares of Ace stock back to us. If it chooses to sell all of the shares of Ace stock back to us, it must give us notice within 15 days after the effective date of the sale or transfer and then the memberships for all of the store locations represented by that stock are considered terminated by the member’s voluntary action. Once terminated in this way, any store location that wishes to continue being a member must submit a new application for our acceptance. However, there are certain types of transfers of their own company stock by the shareholders of member corporations that do not result in an obligation by Ace to buy back the shares. These situations involve (i) any transfer which is not complete, unconditional and irrevocable; (ii) any transfer to an entity in which the person making the transfer retains an ownership interest; or (iii) any transfer to the spouse of the person making the transfer.

(g) The price that we pay when we repurchase shares of Ace stock is as follows:

- (i) For Class A Stock, the \$1,000 par value of the shares;
- (ii) For Class C Stock, the per share price last set by our Board of Directors, currently \$100 per share. This price may not be less than the \$100 par value of each of these shares.

As described above, any indebtedness owed us is set off against such proceeds.

(h) When we repurchase our stock from a terminated member, we pay the repurchase amount in the following manner:

- (i) we pay cash for the share of Class A stock and shares of Class C stock that the terminating member subscribed for in connection with entering into a Membership Agreement and for which shares the terminating member has already paid cash to us; and
- (ii) we issue a non-negotiable, 4-year installment note with an interest rate of 6 percent per annum for a principal amount equal to the amount of the purchase price to be paid by us for (a) shares of Class C stock which exceeds the amount the terminating member paid for such shares in cash, and (b) any shares of Class C stock issued to the terminating member as part of a patronage distribution.

(i) If the repurchase price of a terminating member’s capital stock as described above is not enough to satisfy all of such terminating member’s indebtedness to Ace, we will apply the face value of the terminating member’s Patronage Refund Certificates against such remaining indebtedness as permitted by our By-laws. The terminating member will receive cash for any remaining amount of any Patronage Refund Certificates used for this purpose.

(j) We do not have any conversion rights, sinking fund provisions, or liability to further calls or assessments for any shares of our stock.

FEDERAL INCOME TAXES

The following summaries are based on the Internal Revenue Code of 1986, as amended (the “Code”), legislative history, administrative pronouncements, judicial decisions and final, proposed and temporary Treasury Regulations, changes to any of which may affect the tax consequences that are described below. Any such changes may apply retroactively. You should consult with your own tax advisor with regard to the application of the United States federal income tax laws to your particular situation, as well as any tax consequences to you arising under the laws of any state, local or foreign taxing jurisdiction.

Status of Class A and Class C Shares

If your membership were to terminate for all of your retailer store locations, and we were to repurchase your shares of Ace stock, that repurchase would include your one share of Class A voting stock. Any such repurchase of such share of Class A Stock would be at its \$1,000 par value, the amount you paid for it. You would not realize taxable income from our repurchase of that share.

If we redeem or repurchase your shares of Class C Stock, you could realize taxable income under the Code if the price we paid were to exceed the \$100 par value. This could occur if our Board of Directors were to set a higher purchase price for Class C shares at some future date. In this event, unless you still owned our stock for other store locations that remained members, the taxable income you realized at the time of our redemption or repurchase of your Class C shares might qualify for capital gains treatment.

If you were to continue to own shares of Ace stock for other store locations after we redeemed or repurchased your shares for one or more of your locations, the amount we paid you for the redeemed or repurchased shares might be treated as a distribution under the Code and taxed to you as ordinary or dividend income. In that case, the income tax basis of your remaining Ace shares would be increased by an amount equal to your basis in the redeemed or repurchased shares.

“Unstated interest” that is taxable income to you under Section 483 of the Code could occur if your membership is terminated and you receive a four-year installment note from us in partial payment for your stock. (See “Description of Capital Stock – Other Restrictions and Rights.”) This would most likely happen if the interest rate payable on the note you received (currently 6 percent) were less than the “applicable federal rate” in effect as of the date of such note.

Tax Treatment of Patronage Distributions

The shares of Class C non-voting stock and the Patronage Refund Certificates that we use to pay patronage distributions are “qualified written notices of allocation” within the meaning of Sections 1381 through 1388 of the Code. These Sections of the Code deal with the income tax treatment of cooperatives and their patrons. The dollar amount stated on a qualified written notice of allocation must be included in the gross income of the person to whom the notice is issued, even though this dollar amount may not actually be paid to the person in the same year that it is taxed.

We receive a deduction for federal income tax purposes for the patronage distributions we pay to patrons (that is, to our eligible and qualifying retailers) in the form of qualified written notices of allocation if we pay (or apply against any indebtedness that a patron owes us) not less than 20 percent of each patron’s total patronage distribution in cash and the patron has consented to including the written notice of allocation at its stated dollar amount in his or her gross income for the taxable year in which he or she receives it. We must also make our patronage distributions to patrons within eight and one-half months after the end of the taxable year.

If you become a “member” by owning one share of Class A voting stock, you are deemed under the Company’s By-laws to have consented to include in your gross income the amounts specified in the written notices of allocation that we distribute to you. Pursuant to the Stock Subscription Agreement, retailers who have subscribed but not yet fully paid for shares of our stock are also deemed to have consented to include in their gross income the dollar amounts of the written notices of allocation distributed to them.

We may be required to backup withhold for federal income tax purposes with respect to your patronage distribution if (i) you have not provided us with a taxpayer identification number, (ii) we are notified by the IRS that your taxpayer identification number is incorrect, or (iii) we are notified by the IRS to subject your patronage distribution to backup withholding. In all instances where we are required to backup withhold, the amount subject to backup withholding is limited to the amount of the patronage distribution treated as paid in cash.

The portion of the patronage distribution that the Company pays you in cash may not be sufficient, depending upon your income tax bracket, to pay all of your income tax on your patronage distribution.

RISKS OF MEMBERSHIP

There are a number of risks that one should consider carefully before making a decision to open an Ace store. Some of the more important of those risks are described below. There may be other features, risks and benefits particularly relevant to you that are not summarized here.

Risks Associated With Retail Businesses Generally

Success is highly dependent on your individual skills as an independent business person, including your ability to relate to, deal with and "sell to" retail consumers, and generally your ability to lead and manage your store(s). Your success is also dependent on the level of effort you and your store associates put forth.

Success is also dependent on numerous other variables including merchandise selection and pricing, customer service, consumer preferences, store location and appearance, competition, store operations, labor and other costs, lease terms and costs, interest rates, etc. Some but not all of these variables are within your control.

The retail environment is intensely competitive with many purveyors offering consumers a vast range of different products. In addition, internet-based shopping portals are taking an ever-growing share of consumer wallets, placing additional pressures on traditional brick-and-mortar retailers.

Risks Associated With the Retail Hardware Business

The retail hardware business is highly fragmented and intensely competitive. Our retailers' competitors include many large companies that have substantially greater market presence, name recognition and financial, marketing and other resources than we do. They also include independent retail hardware stores, some of which are affiliated with other large retailer-based hardware cooperatives but others of which are not. These stores often have a strong local following. (See "Ace's Business – Competition.")

Sales of hardware and home improvement goods historically depend to some extent on consumers' discretionary spending. An economic downturn in your local area, or in general, could reduce your customers' willingness or ability to purchase the products you sell. This could cause your business and financial results to suffer.

It is relatively easy for other competitors to enter your market. Increased competition could also occur if existing competitors expand their operations in your market, or adopt innovative pricing strategies, store formats or retail sales methods. Any of these developments could adversely affect your market share, sales and profitability.

Newly opened hardware stores can generally expect to experience negative cash flow and pre-tax losses during their early years as business develops and grows.

Risks Specifically Related to the Ace Retail Hardware Business

While many new stores open each year, and most have done so successfully, a significant number of Ace retailers terminate their membership every year. A total of 116, 97, and 100 retail outlets terminated their membership in Ace in 2018, 2017 and 2016, respectively. These terminations include both stores that closed permanently and stores that left for a new supplier.

We believe that our trademarks and other proprietary rights are important to our success and our retailers' competitive position. Our failure or inability to adequately protect these rights could adversely affect the value of our brands and, in turn, the value of your store's Ace branding.

The Ace brand can be adversely affected by negative publicity about product quality or by operating issues at Ace or at one or more Ace-branded stores. All Ace-branded stores (with the exception of the 123 stores owned and operated by ARH, as of December 29, 2018) are owned by our members, not by Ace. Moreover, third parties could file lawsuits against Ace asserting claims for injuries or damages allegedly caused by products sold by us or by one of our retailers, or other claims. Any one or more of these developments could have an adverse effect on the Ace brand and image and, in turn, on your business results.

Risks Particularly Associated With Your Prospective Store

Although we may have provided you with preliminary information (e.g., retail sales forecasts, site analyses, demographic data, target penetration surveys and similar information) regarding one or more potential sites for your store and the market in which it is or will be located, you assume all responsibility for evaluating and investigating the commercial viability of your store, including its location, the market in which it is located, and your site's lease or purchase terms.

The proforma financial statement and other financial projections (collectively "Projections") that may be prepared for your store are estimates only, and are not guarantees of your store's future performance. It is your responsibility to determine whether these Projections are reasonable. Your store's actual financial results are likely to differ from those indicated in the Projections and may do so substantially.

The design and layout of your store can be expected to have a significant effect on its success or failure. While Ace can assist you with store design and layout, you assume responsibility for all aspects of your store's design and layout, including, without limitation, compliance with applicable laws, such as the Americans With Disabilities Act.

The assortment and prices of products you offer for sale in your store can be expected to have a significant effect on its success or failure. While Ace can assist you with recommended product assortment and pricing, you assume responsibility for all aspects of your store's product assortment and pricing.

We cannot predict the amount of funds that you will need in connection with the construction or conversion remodeling of your store or the ongoing operation of your business. You assume full responsibility for determining the amount and source of funds required to open and operate your store.

You will enjoy financial benefits if your store succeeds. However, if your store fails, you might lose your entire investment in the business. You may also owe others amounts in excess of the amount you invested, due to obligations you made to your landlord, your bank(s) and your suppliers, including Ace. We may repurchase merchandise from our retailers, but only in very limited circumstances and never in bulk.

Risks Associated With Ace as Wholesaler and Primary Supplier

You depend on Ace to anticipate and respond in a timely manner to changing consumer demand and preferences regarding hardware, paint and related home-improvement products. These products must appeal to a broad range of consumers whose preferences cannot be predicted with certainty and are subject to change. Additionally, Ace typically makes commitments to purchase products from our suppliers several months in advance of the proposed delivery. If we misjudge the market and fail to purchase the right products in the right quantities, you may not be able to obtain from us the types or quantities of merchandise best suited to your store location. This could cause your sales to decline and your financial results to suffer.

If our suppliers do not provide us with sufficient quantities of products, we may not be able to offer you competitively priced merchandise in the quantities or assortment that you desire. Although Ace purchases merchandise from approximately 4,100 suppliers and no such supplier represents more than 6 percent of our total purchases, our dependence on our principal suppliers involves risk. Ace does not have long-term agreements with our suppliers and cannot guarantee that we will be able to maintain our relationships with them. If there is a disruption in our supply sources, we may not be able to obtain the merchandise that you desire for your customers.

We import a significant portion of our inventory from manufacturers outside the United States, particularly in Asia. Importing involves risks including potential disruptions resulting from economic and political problems in countries from which merchandise is imported, and duties, tariffs and quotas on imported merchandise. Ace's ability to manage the importing of goods from overseas, their production, timing of deliveries and U.S. Customs-related compliance is an important component of our merchandising strategy. If we fail to manage our import activities well, you may not be able to purchase from us the products that your customers want to buy from you.

Ace needs to maintain substantial buying power in order to provide you with quality products at a competitive price so you can do the same for your customers. This requires Ace to continue to have a large number of retailers who purchase in large quantities from Ace. If a significant number of our retailers were to leave our cooperative for any reason, or were to remain as members but significantly reduce their purchases from us, Ace's ability to purchase in high volume would be negatively affected. This reduction in our buying volume could reduce our leverage with our suppliers, resulting in higher supplier prices to Ace and, in turn, higher prices for the merchandise you purchase from us.

As a wholesaler, Ace must maintain a highly developed and efficient warehouse and distribution network which, in turn, requires Ace's continued investment in facilities, technology, trucking and other equipment. Although we expect that our ongoing operations will enable us to make such investments, there is no guarantee that we will be able to do so.

Risks Associated With Being a Member of the Ace Hardware Cooperative

Although we distribute "patronage distributions" or "patronage rebates" to our stockholders based on the volume of business done with them, we are prohibited from declaring dividends on shares of Ace stock. Your ability to transfer these shares is limited and there is no trading market for them. If you have a store location that is a member of our cooperative and it permanently closes or if your Ace membership is terminated, you can sell your shares only to a new Ace retailer we approve as a member for your particular store location. If you do not sell your shares in this way, we must repurchase them at par value. We do not expressly set aside any funds to purchase these shares, and repurchases can be made only as permitted under Delaware corporate law. Therefore, except for the voting rights which Class A stock has, our stock has financial value to you only if your membership terminates or if Ace is liquidated.

If you become an Ace member, you must report the total amount of your patronage distributions from us as gross income on your federal income tax return. Therefore, your taxable income will include not only the cash portion of your distribution, but also the stated dollar amount of any shares of Class C Stock and Patronage Refund Certificates or the fair market value of any other property included in your patronage distributions. A minimum of 20 percent of your total annual patronage distributions must be paid in cash,

unless this cash portion has been applied against your indebtedness to us. Depending on your income tax bracket, this cash portion may not be sufficient to pay all of your income tax liability on your patronage distributions. (See “Membership Information-Patronage Distributions” and “Federal Income Taxes – Tax Treatment of Patronage Distributions.”)

Our Board of Directors has the authority to establish reasonable reserves, thereby reducing or even eliminating the amount of our net earnings available for distribution as patronage distributions. Our Board of Directors also has the authority to change the patronage distribution plan and, if they were to do so, the cash portion of your patronage distribution could be adversely affected.

Risks Associated With Your Prospective Store and Ace as a Wholesaler

We rely extensively on information technology systems, some of which are managed or provided by third-party service providers, to analyze, process, store, manage and protect transactions and data. In managing our business, we also rely heavily on the integrity of, security of and consistent access to this data for information such as customer data, merchandise planning and inventory replenishment, supplier purchases, sales to retailers, warehousing, distribution, inventory control, and various corporate-level financial and other functions including communication with our retailers. Our systems and the third-party systems on which we rely are subject to damage or interruption from a number of causes, including power outages; computer and telecommunications failures; computer viruses; security breaches or cyber-attacks. Although we and our third-party service providers seek to maintain our respective systems effectively and to successfully address the risk of compromise of the integrity, security and consistent operations of these systems, such efforts may not be successful. If our or our service providers’ systems are damaged, breached or cease to function properly, this could significantly disrupt our operations and be costly, time consuming and resource-intensive to remedy. Any disruption in the operation of these management information systems, or our failure or inability to continue to upgrade, integrate and expend capital on them, could have a material adverse effect on Ace’s ability to sell merchandise and provide cost-effective services to you, and, in turn, on your ability to order merchandise, operate your POS system at retail and/or manage and track your inventory levels.

Ace, our third-party system providers and our individual retail stores receive, collect and store personally identifiable, confidential, proprietary and other information from our vendors, customers and employees so that they may, among other things, purchase products or services and enroll in promotional programs.

Cyber threats are rapidly evolving and those threats and the means for obtaining access to information in digital and other storage media are becoming increasingly sophisticated. Any breach of Ace’s, our third-party system providers’ or our individual retail stores’ security could result in significant costs to protect any customers, vendors, employees, and other parties whose personal data is compromised. Loss of customer, supplier, employee or other business information could disrupt operations, damage Ace’s reputation and expose Ace to claims from customers, vendors, financial institutions, regulators, payment card associations, employees and others, any of which could have a material adverse effect on Ace, its financial condition and results of operations.