



Rating:
BUY

Lululemon athletica inc.

Forward Momentum, But We Are Not Alone Anymore

Our View: We are initiating coverage of LULULEMON with a BUY rating and December 2014 price target of \$78.84. In fiscal year 2013, the company weathered several public controversies that have depressed the stock's current valuation. Lululemon has addressed these challenges going into 2014 and have implemented strategies aimed at further increasing same-store sales. In absence of any further negative news, we anticipate the company's valuation will return to the higher multiples previously enjoyed by investors.

- **Stay calm and breathe on.** We believe Lululemon's distinctive brand remains a strong driving force of future growth in North America, currently only at 60% penetration. Niche, premium positioning with improved operational efficiencies will support planned international expansion, and is reinforced by double digit e-commerce growth. Finally, with new management in place for the men's line, the 2016 target of opening standalone stores for men is a compelling growth catalyst.
- **Beneath the Surface.** Lululemon's current financial performance is strong, as it enjoys high profit margins and exceptional sales per square foot. Cash reserves and operational profits allow for extended growth, though we project no dividends to be issued until 2020. A discounted cash flow model analysis leads to a share price of \$78.84, estimating declining growth rates from 32% to 12% over the next 5 years and a 6% growth in perpetuity. To maintain a strong share price Lululemon will have to maintain strong growth and keep costs under control.
- **The calm before, between, or after the storm.** We are optimistic that, following the appointment of a new CEO, many of the internal challenges facing the company will begin to fade. However, due to the uncertainty in the ability of Lululemon to supplant its successful North American operations into new markets, our longer-term views are restrained. Moreover, risks to the company's margins are relatively insignificant in the near term. We believe 2014 will be calm after the storm of 2013

Lululemon athletica inc. (LULU)

FYE Feb	2013A	2014E	2015E	2016E	2017E
EPS (Operating) (\$)	\$2.41	\$3.18	\$3.97	\$4.77	\$5.53
Estimated Growth	-	32%	25%	20%	16%
EBIT (incl. eq. inc.)	381,396	503,443	629,303	755,164	875,990
Div. Yield	-	-	-	-	-
FCF	213,365	281,642	352,053	422,463	490,057

Source: Company data, Bloomberg, Analyst Estimates

NASDAQ: LULU

Previous Close: \$69.72

Price Target: \$78.84

Retailing -- Specialty

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Source: Yahoo Finance

Company Data

Price	\$69.72
Date of Price	Nov-29
52-Week Range	\$60-\$83
Market Cap \$USD	\$10.11b
Fiscal Year-End	Feb 03
Shares O/S	112.371mm
Price Target End Date	Dec-14

Investment Theory

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- **Operational Efficiencies:-** Lululemon struggled in 2012 with email marketing issues, inefficient throughput management, and limited price points in 4Q12. Lululemon has resolved marketing issues and rolled out chain-wide handheld POS systems to improve throughput. In addition to these changes, increased offerings of products at multiple price points will boost Q4, a quarter that has historically represented 36% of sales since 2009.
- **CEO Change:** The announced departure of Christine Day in June was met with a -20% change in stock price. Shares also received negative feedback from the market to the tune of -5% in reaction to hiring Tara Poseley as Chief Product Officer. A new CEO is expected to be announced next year. Share prices are likely to change based on the reputation of the successor.
- **Women's Brand:** Over 60% (growth of 10% YOY) of consumers identify Lululemon as a "brand for women." Nike and Under Armour are still the most preferred brands by women, however, preference for Lululemon as the premier athletic apparel provider nearly doubled to 5%, and nearly tripled at 6% in the performance apparel category (Morgan Stanley Research, 2013).
- **New Lines Product Lines:** Management would like to own 80% of customer closet space and are introducing yoga-inspired daywear to do so. Men's clothing account for 13% of sales, but Lululemon is trying to grow this market through new initiatives and talent acquisitions. Lululemon's line for men is expected to grow modestly between 2014 and 2016, at which point Lululemon hopes to open up standalone stores for men.
- **Ecommerce:** Ecommerce sales have grown quickly and account for 16.1% of total revenue as of FY2013. This sales channel offers higher margins and is growing internationally.
- **Domestic Market:** Lululemon currently has access to nearly 60% of the North American market. Over 95% of revenue is derived from North America. Further expansion within North America is assured and has been factored into the current share price.
- **International Expansion:** Starting with London in 2014, international expansion will be a slow process that involves targeting specific communities through grassroots marketing and community involvement. Lululemon will continue to use showrooms and community feedback to assess desirability of expansion locations. Showrooms have been set up throughout Europe and Asia-Pacific to identify successful markets.

Company Description

Lululemon Athletica Inc. is a designer and retailer of athletic apparel looking to expand their product line to increase appeal to male athletes and athletic female youth. The company primarily targets affluent men and women through grassroots marketing, a strong social media presence and community involvement. Lululemon distributes primarily through its own retail stores (80% of all sales), but also offers Direct-to-Consumer (14% of sales) and select wholesale and showroom sales (6% of all sales). Lululemon has 53 locations and showrooms in Canada, 220 in the USA, and 26 in Oceania. Lululemon's is a high growth company trading at 35-40x P/E. 74% of Lululemon's stock price is attributed to the implied value of long-term growth (Morgan Stanley Research, 2013). Lululemon has been exceptionally successful at maintaining industry high margins (19.81% Net Profit Margin FY2013) on premium products.

Risks to Rating and Price Target

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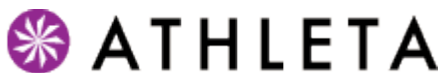
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- **Leadership Uncertainty:** The announced departure of CEO Christine Day in June was met with disappointment by investors. No replacement has been announced yet, and the market may react negatively to the board's chosen successor.
- **Quality and Media Spotlight:** Quality issues have plagued the company and have garnered wide media attention. A class action lawsuit has been filed against the company in response to the recent sheer pant recall. Lululemon has historically provided a high-quality product at a premium price. Quality is one of the most important characteristics of Lululemon products. As a result, the market has become sensitive to any news which may threaten brand perceptions.
- **Intensifying Competition:** Lululemon faces rising competition from both new entrants and established firms with greater capital and operational capabilities, given the attractiveness of the Yoga and Dance active sportswear segment. Competitors threaten Lululemon's high margins and market dominance by delivering innovative, quality, and lower priced alternatives. This trend may prove to threaten Lululemon's established retail locations and stymie its expansion plans.
- **Limits of Brand Identity:** Current investments into *product line extension* of menswear and new sporting categories may fail to meet expected consumer sales projections. Lululemon may be a victim of its own success, having built such a strong brand identity among female fitness apparel communities.
- **Consumer Preferences:** Lululemon's current international expansion and growth plans may fall short of achieving projected penetration targets in regions where it will not be able to rely on its brand power. Furthermore, fashion trends and the popularity and growth of Lululemon's core sporting segments vary across international markets. Lululemon's success is contingent on stable consumer preference because it still remains largely undiversified in sport categories.

Competitor Analysis



GAP: Gap is positioning its Athleta stores in direct competition to Lululemon stores, marketing comparable products using similar strategies at a lower price point. The Gap Inc. reported adding 25 new Athleta stores in the 2012 fiscal year, for a total of 35, with plans to continue opening additional store over time. In April 2013 Gap's CEO was quoted saying that Athleta is set to move from the "developing side" to the "global side", hinting at a possible increase in growth rate. If managed effectively, Athleta could turn out to be a significant limiting factor to Lululemon's growth plans.

Nike: Nike is targeting the women's sportswear market through its "Nike Training Club" initiative. Leveraging its dominance in the sports footwear market, Nike aims to become a "one-stop-shop" brand for women. Nike's women's division is showing signs of strong growth despite it already being a \$4B operation.

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Under Armour: Under Armour has continued to introduce various initiatives to become more women focused, including new store configurations and activity offerings that are similar to the ones introduced by Lululemon. Under Armour's new women's division creative director Leanne Fremar has a track record of focusing on fit and style, which are Lululemon's main areas of differentiation.

Victoria's Secret Sport: Forecasted for a meteoric growth, Victoria's Secret line of women's sportswear is attracting its existing women's underwear and lingerie customers. Victoria Secret's advantage is its expertise in bras, promising women comfortable, well-fitting and supportive sports bras and sports tops. Victoria's Secret sportswear is available in over 400 stores and counting.

Multiples	Nike	Under Armour	Average	Lululemon
EPS	2.96	1.38	2.17	1.85
P/E	27.08	58.4	42.74	37.47
BETA	0.53	0.96	0.75	1.27
NET INCOME/REV	9.8%	7.0%	8.0%	19.8%
LTM Change	63.02%	52.60%	58%	-1.77%

Financial Outlook

Strong cash reserves and operational revenues fund Lulu's current growth. Given the company's prospects of gaining market share in North America and abroad, and taking into account risks and growing competition, we estimate revenue growth rates to gradually decline from 32% to 12% over the next 5 years. Cash flows are currently directed into expansion, as expected of a firm in its growth stage. We project Lululemon to declare dividends in 2020, as growth moderates. Lululemon's enterprise value of \$8.9B is derived from a 6% growth assumption in perpetuity and a 10.16% discount rate (based on a CAPM model). This presents a stock price of \$78.84. Sensitivity analysis shows that stock price may vary significantly with changes to long-term growth assumption and discount rate assumptions, and would also depend on Lululemon's ability to control costs and avoid dis-economies of scale.

Beta (NASDAQ)	1.27
R _f	0.01%
R _m	8%
CAPM/R	10.16%
Perpetuity	6.0%
CF value in 2019*	\$ 15,829,701
CF value	\$ 8,859,170
TV	\$ 8,524,828
Firm Value	\$ 8,859,170
TV as %	96.2%
Debt	-
Cash	-
Equity Value	\$ 8,859,170
Shares	112,371
Price/share	\$ 78.84

Dividend Discount Model

Forecasted Earnings Growth	32%						25%					20%				16%			12%	
	(\$M)	2013A	2014E	2015E	2016E	2017E	2018E	2019E	2020E	2021E	2022E	2023E	2024E	2025E	2026E	2027E	2028E	2029E	2030E	
EBIT (incl. eq. inc.)	\$ 381,396	\$ 503,443	\$ 629,303	\$ 755,164	\$ 875,990	\$ 981,109														
EBITx(1-Tax rate)	\$ 271,363	\$ 358,199	\$ 447,749	\$ 537,299	\$ 623,267	\$ 698,059														
D&A	\$ 43,000	\$ 56,760	\$ 70,950	\$ 85,140	\$ 98,762	\$ 110,614														
CapX	\$ 51,698	\$ 68,241	\$ 85,302	\$ 102,362	\$ 118,740	\$ 132,989														
Change in NWC	\$ 49,300	\$ 65,076	\$ 81,345	\$ 97,614	\$ 113,232	\$ 126,820														
FCF	\$ 213,365	\$ 281,642	\$ 352,053	\$ 422,463	\$ 490,057	\$ 548,864														

Sensitivity Analysis

		Perpetuity Growth Rate									
		\$78.84	1.0%	2.0%	4.0%	5.5%	6.0%	6.5%	7.0%	8.0%	12.0%
Discount Rate	7.3%	61	72	116	213	295	480	1279	-548	-82	
	7.8%	55	64	98	162	207	287	466	-1866	-89	
	8.3%	50	58	84	130	158	202	279	1210	-98	
	8.8%	45	52	74	107	126	154	196	441	-110	
	9.3%	41	47	65	90	104	123	149	264	-127	
	9.8%	38	43	58	78	88	101	119	186	-152	
	10.3%	35	39	52	68	76	86	99	141	-191	
	10.8%	32	36	47	60	66	74	83	113	-264	
	11.3%	30	33	42	53	58	64	72	93	-440	