

Lululemon Athletica Inc.

NASDAQ: LULU

Analyst: Dylan Cirrilla

Sector: Consumer

Discretionary

Sell

Price Target: \$52.59

Key Statistics as of 3/28/2016

Market Price:	\$60.52
Industry:	Textiles, Apparel and Luxury Goods
Market Cap:	\$8.266b
52-Week Range:	\$70.00 – 43.14
Levered Beta:	.4

Thesis Points:

- Dominant competitors
- Inefficient management of inventories
- Fickle customer base; trendy product line

Company Description:

Lululemon Athletica Inc. is a designer and retailer of technical athletic apparel. Since their inception, lululemon has developed a distinctive corporate cultures with a mission to produce products which create “transformational experiences for people to live happy, healthy, fun lives.” The company has two main brands: lululemon and ivivva athletica. The lululemon brand is targeted to the general public, mostly female market for athleisure products. The ivivva product line is target towards a dancer market. Lululemon sells its products through brick and mortar corporate-owned stores (302 stores in 2015) or through a direct to consumer scheme through their website, lululemon.com.



Thesis

Lululemon atletica (LULU) is an up-and-coming competitor in a shark tank of global competitors. Nike (NKE) and Underarmour (UA), namely, are the biggest competitors and threats to LULU. With massive economies of scale, the greatest minds in the business, and unmatched brand loyalty, these companies are poised to overtake LULU in the athleisure sphere. These companies have pronounced products that directly compete with LULU products and with a lack of product differentiation, LULU will be drowned out by these two goliaths and the slew of copycat companies that pop up every year. In an attempt to keep up with these competitors, LULU has expanded in recent years, cutting margins by 27% since 2012. Intimidating competitors aside, LULU has shown to be led by inefficient management, especially when it comes to inventory. In recent years LULU has begun to hold onto inventory longer and longer, greatly reducing inventory and increasing finished goods to total assets. These metrics are beginning to converge on the large competitors of UA and NKE. As inventory on hand and turnover turn sour, LULU will suffer even further with operating costs and holding costs because of a lack of economies of scale compared to the larger competitors. The industry that LULU operates in isn't going to do it any favors, either. Fashion, as with many other consumer discretionary products, come and go with the seasons and can completely change in a month's time. With small brand recognition (goodwill is just 2% of total assets), LULU is more prone to falling to larger competitors when trends shift. This is a risk that is not easily diversified away and is reflected in the recent volatility of LULU stock. A short is recommended on LULU with a target of \$52.59. At the current market price of \$60.52 this represents a 13.1% downside.

Industry Outlook

LULU resides in the textiles, apparel and luxury goods industry. As an industry in the consumer discretionary sector, this is a very fickle industry and is quite sensitive to economic downturns. Despite this, the industry has outperformed the S&P 500 by nearly 3x returns since 2006 and has done so with similar volatility. This is due to the dynamic nature of consumer discretionary and is boosted by brand loyalty, present in companies like Apple (AAPL), Nike (NKE) and Coach Leather (COH). The presence of brand loyalty provides some protection

against economic downturn as these products are less likely to be dropped from consumer's baskets as a product they are not familiar with or feel no connection with. With the economy seemingly recovered from the recession of the late 2000's, consumer sentiment has improved. The prospect of low rates from the Fed has also fueled this. Continued expectations of a rate hike has fallen short, encouraging spending and fueling consumer spending habits. Textiles, apparel, and luxury goods is likely to have steady growth over the next few years, resulting in growth for those large brand loyalty companies like NKE and Underarmour (UA). Those without brand loyalty or with trendy product lines such as LULU may fall to the wayside as consumers side with more familiar or trendy options.

Philosophy and Business Model

LULU has developed a distinctive corporate culture since its inception to pair with its mission: creating components for people to live longer, healthier, fun lives. This statement is simple and simply aims to create transformational experiences for their customers. The company promotes a set of core values that include high quality products, operational integrity, leading a balanced and fun life, and nurturing an entrepreneurial spirit. The company hopes to accomplish this mission and fulfilling its values by expanding its product lines into other fitness related apparel such as bags, water bottles, and yoga mats. These newly diversified products and current products are primarily targeted towards "sophisticated and educated women" who is health conscious. LULU also aims to create value in their corporate-owned stores by creating an innovative retail experience. Corporate-owned stores have a 2015 margin of 25.8%, down from 36.4% in 2011. Aside from the direct to consumer and corporate-owned stores, LULU continues to grow and develop its less traditional channels of revenue such as wholesale, outlets, showrooms, and temporary locations. These are largely for brand awareness, aside from outlets, and are not expected to be a large contributor to total revenue. To produce their products, LULU works with approximately 57 suppliers and does not own or operate any manufacturing facilities. The majority of this production is done through two main suppliers.

Major Competitors

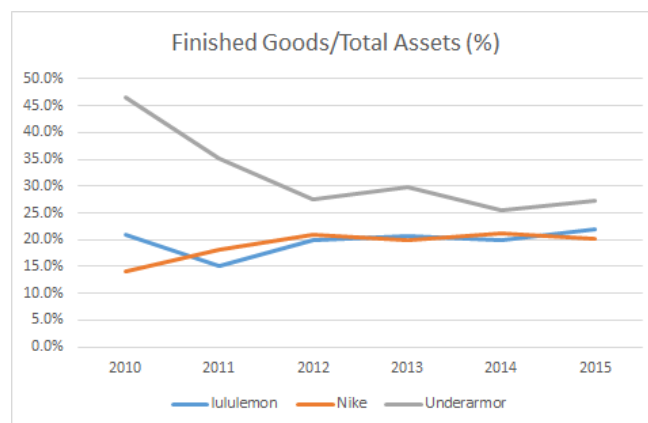
Lululemon's industry is one dictated by brand awareness, operating costs, cost, and quality. The first, and most threatening of competitors, is Nike (NKE). Nike is

undeniably the strongest brand in apparel, arguable the strongest brand across all industries. Such a strong brand is likely to withstand an economic downturn and has the ability to adapt without losing a tremendous amount of market share. Consumers will “buy anything with a swoosh on it”, regardless of what the product is. This gives Nike an advantage over other competitors. Nike has also been able to achieve economies of scale through their large-scale, global operations. Economies of scale paired with a long history of operations have smoothed out Nike’s operating margin, showing a standard deviation from 2010-2015 of .31%. These economies of scale have also allowed Nike to competitively price their products compared to LULU. When comparing best sellers between the two companies, LULU was outpriced by an average of 37%. With better prices, stronger brand recognition, and equal perceived quality, as well as true quality, Nike beats LULU in every arena. The same can be said of lululemon’s second large competitor, Underarmour. With similar brand recognition, especially with a strong presence in hardcore athletic wear, Underarmour competes with Nike for brand loyalty and, just as Nike had, dominates LULU. Just as Nike had, Underarmour has been able to achieve economies of scale and, through their long history and experience, Underarmour has smoothed their operating margins as well. Underarmour’s standard deviation of operating margin is .48% compared to 3.71% of lululemon. This shows more reliable operations which can indicate more efficient management, economies of scale, or reliable revenue streams. Again, similar to Nike, Underarmour dominates LULU on best sellers; this time LULU was outpriced by an average of 26%. Lululemon’s competitors are larger, more efficient, equal in terms of quality, and have greater brand recognition. In terms of the monster competitors in this industry, LULU is not best in class.

Inventory Issues

In recent years, LULU has struggled to effectively manage its inventory supply. In terms of total finished goods to total assets, LULU has increased from 15.2% to 21.9% of total assets from 2011. When compared to the two major competitors, Nike and Underarmour, lululemon sits between Underarmour’s 27.3% and Nike’s 20.1%. However, Nike has been able to achieve stability in this ratio and has continued to maintain this level of inventory from 2011. Underarmour, while holding more inventory, has been trending downward, quite

aggressively, since 2010. Reducing finished goods to total assets from 46.6% in 2010 to 27.3% in 2015.



A similar story is told through inventory turnover where LULU has plummeted in efficient from 6.24 in 2011 to 4.24 in 2016. This downward trend is consistent with lululemon’s inability to sell off inventory and is indicative of a decrease in consumer interest of LULU products and offerings. A decrease in turnover, resulting in an increase of finished goods to total assets, is resulting in items being sold off at discount. While this process has just began, indicated by the “we bought too much” tab on lululemon.com, it will cause the company’s attractive margins to fall, positioning the company’s goliath competitors even better in the market.

Financials

LULU has been fairly accurate with guidance since Q4 of 2014, resulting in a mean revenue surprise of .29% and EBITDA surprise of 2.99%. However, Q3 of 2015 had a -.53% surprise on revenue and -3.87% on EBITDA. With falling earnings surprises in EBITDA, especially towards the all-important holiday season, LULU may be facing a drop-off in consumer interest and, as a result, a drop-off in revenues. LULU also has a promising ROIC/WACC ratio of 2.16. However, this is because of the company’s conservative capital structure. With a total debt/common equity (LTM) ratio of .07, the company is holding nearly half as much debt as the industry average. This capital structure is not feasible for the foreseeable future of LULU. To compete with the large competitors and continue to grow at the pace the company has indicated they hope to, more debt will need to be added. While this will likely still result in an ROIC/WACC ratio greater than 1, cash flows available to shareholders will decrease as interest payments will take over portions of cash. This trend is indicated by lululemon’s invested capital/total capital ratio of 86.9%. This is compared to the 77% industry average that shows

the company is spending a large amount internally, trying to fund growth and keep up with the larger competitors.

Conclusion

Lululemon Athletica Inc. is an undifferentiated apparel company in an industry dominated by giants. With the scale and brand presence of these giants, LULU will need to fund growth to keep up with competitive prices and consistent quality. With weakness already showing in the company's management through inefficient inventory management, LULU will collapse under the pressure of growing inventories and impending debt payments as the company will require large amounts of capital for their prospective expansion. From a macro view, the industry is not conducive to many competitors. In fashion, especially a subset of fitness and "athleisure", trends come and go at the drop of a hat. One month lululemon can be the next big thing, the next month it could be yesterday's news. Without the scale and strong brand recognition that the competitors have, lululemon's revenues will fall, inventories will pile up, and margins will be pressed. The market has overpriced this stock because of past earnings surprises and prospective growth in the company's industry. Yoga, fitness, and athleisure appear to be the "new thing". However, this trend will give way to another trend and lululemon's presence in the apparel market will shrink and fall to the global giants. A recommendation is made for a short. With the current market price of \$60.52 and a target price of \$52.59, there is the potential for 13.1% gain.

Lululemon Athletica Inc.
(LULU)

CENTER FOR GLOBAL FINANCIAL STUDIES

NEUTRAL

Analysis by Dylan Cirrilla
3/28/2016

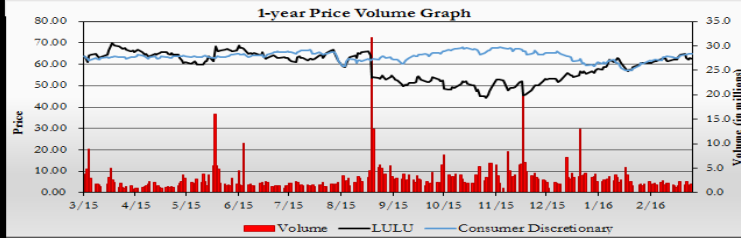
Current Price:
Divident Yield:

\$60.21
0.0%

Intrinsic Value
Target Price:

\$49.40
\$52.59

Target 1 year Return: -12.63%
Probability of Price Increase: 9.2%



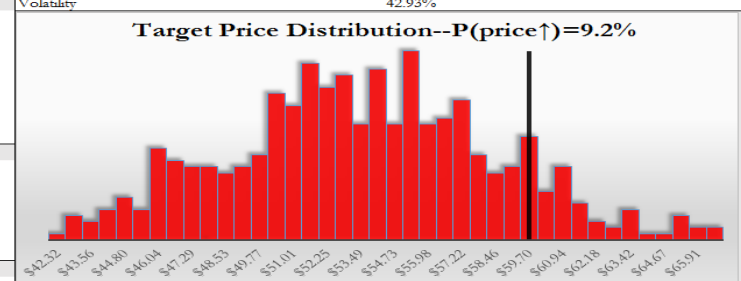
Description
lululemon athletica inc., together with its subsidiaries, designs, manufactures, and distributes athletic apparel and accessories for women, men, and female youth.

General Information	
Sector	Consumer Discretionary
Industry	Textiles, Apparel and Luxury Goods
Last Guidance	November 3, 2015
Next earnings date	March 30, 2016
Estimated Country Risk Premium	8.87%
Effective Tax rate	34%
Effective Operating Tax rate	33%

Market Data	
Market Capitalization	\$8,266.98
Daily volume (mil)	3.67
Shares outstanding (mil)	137.30
Diluted shares outstanding (mil)	141.69
% shares held by institutions	55%
% shares held by investments Managers	69%
% shares held by hedge funds	11%
% shares held by insiders	7.29%
Short interest	15.38%
Days to cover short interest	8.08
52 week high	\$70.00
52-week low	\$43.14
Levered Beta	-0.14
Volatility	42.93%

Past Earning Surprises	
Quarter ending	Revenue
11/2/2014	-1.23%
2/1/2015	0.45%
5/3/2015	1.16%
8/2/2015	1.61%
11/1/2015	-0.53%
Mean	0.29%
Standard error	0.5%

EBITDA	
11/2/2014	6.38%
2/1/2015	4.48%
5/3/2015	5.56%
8/2/2015	2.42%
11/1/2015	-3.87%
Mean	2.99%
Standard error	1.8%



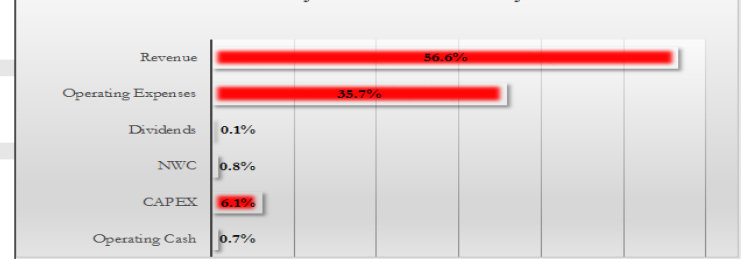
Management	
Potdevin, Laurent	Chief Executive Officer and Executive
Poseley, Tara	Chief Financial Officer
Haselden, Stuart	Senior Vice President of Mer
Gore, Larry	Senior Vice President of Sou
Battersby, Jennifer	Senior Vice President and He
Toro, Felix	

Total compensations growth	
11/2/2014	-100% per annum over 1y
2/1/2015	-100% per annum over 1y
5/3/2015	N/M
8/2/2015	N/M
11/1/2015	N/M
Mean	N/M
Standard error	N/M

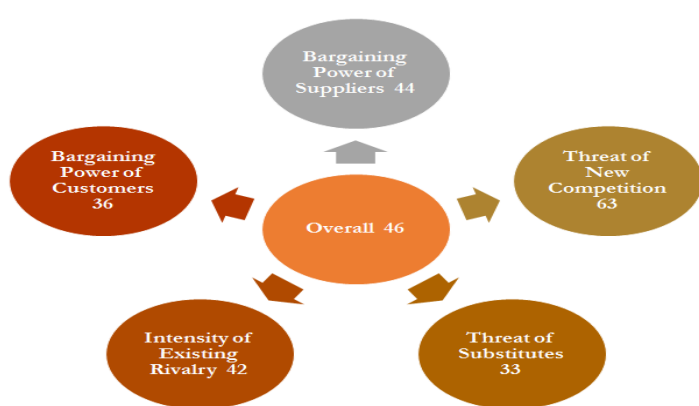
Sensitivity Attribution Analysis

Profitability	
ROIC	28.5%
NOPAT Margin	17%
Revenue/Invested Capital	1.71
ROE	20.7%
Adjusted net margin	16%
Revenue/Adjusted Book Value	1.27
Invested Funds	
Total Cash/Total Capital	24.0%
Estimated Operating Cash/Total Capital	11.0%
Non-cash working Capital/Total Capital	18.9%
Invested Capital/Total Capital	86.9%
Capital Structure	
Total Debt/Common Equity (LTM)	0.07
Cost of Existing Debt	2.41%
Estimated Cost of new Borrowing	2.41%
CGFS Risk Rating	2.41%
Unlevered Beta (LTM)	0.00%
WACC	2.41%

Total return to shareholders	
11/2/2014	44.98% per annum over 1y
2/1/2015	44.98% per annum over 1y
5/3/2015	N/M
8/2/2015	N/M
11/1/2015	N/M
Mean	N/M
Standard error	N/M



Porter's 5 forces (scores are out of 100)



Valuation	
Period	Revenue growth
Base Year	14.2%
11/1/2016	13.7%
11/1/2017	14.5%
11/1/2018	18.4%
11/1/2019	15.4%
11/1/2020	13.5%
11/1/2021	11.7%
11/1/2022	9.9%
11/1/2023	8.0%
11/1/2024	6.2%
11/1/2025	4.3%
Continuing Period	2.5%
Invested Capital	
Base Year	\$420.61
11/1/2016	\$595.93
11/1/2017	\$814.63
11/1/2018	\$1,026.33
11/1/2019	\$1,146.18
11/1/2020	\$1,459.35
11/1/2021	\$1,586.66
11/1/2022	\$1,812.15
11/1/2023	\$2,121.62
11/1/2024	\$2,470.27
11/1/2025	\$2,823.67
Continuing Period	
Net Claims	
Base Year	\$278.79
11/1/2016	-\$25.86
11/1/2017	-\$307.19
11/1/2018	-\$618.21
11/1/2019	-\$982.98
11/1/2020	-\$1,410.46
11/1/2021	-\$1,859.03
11/1/2022	-\$2,347.61
11/1/2023	-\$2,874.33
11/1/2024	-\$3,435.74
11/1/2025	-\$4,026.70
Continuing Period	
ROIC/WACC	
Base Year	16.29
11/1/2016	9.20
11/1/2017	7.67
11/1/2018	6.87
11/1/2019	5.82
11/1/2020	4.72
11/1/2021	3.91
11/1/2022	3.28
11/1/2023	2.78
11/1/2024	2.38
11/1/2025	2.04
Continuing Period	1.76
Price per share	
Base Year	\$50.11
11/1/2016	\$52.06
11/1/2017	\$54.48
11/1/2018	\$57.36
11/1/2019	\$60.66
11/1/2020	\$64.49
11/1/2021	\$68.59
11/1/2022	\$73.08
11/1/2023	\$77.97
11/1/2024	\$83.27
11/1/2025	\$89.00
Continuing Period	