

Lululemon Athletica, Inc. (LULU)

James Luessman & Joe Ziolkowski

Ticker: LULU	Current Price: \$123.76 *11/26 Closing Price	Stock Exchange: NASDAQ
Sector: Consumer Discretionary A	Industry: Apparel Retailer	Headquarters: Vancouver, Canada

Introduction:

Lululemon Athletica, Inc. engages in the design, distribution, and retail of high quality, premier athletic apparel and accessories. Lululemon Athletica places a high focus on quality, product performance and customer experience which makes them an extremely popular and booming apparel brand. 2017 revenues reached \$259 million and are projected to reach over \$400 in the current year resulting in an increase of 86%. Revenue stems from three main segments: Company-Operated Stores (69%), Direct to Consumer (22%), and Other (9%). The Company-Operated Stores segment comprises of Lululemon which specialized in adult athletic wear and the lululemon brand that specializes in athletic wear for youth. The Direct to Consumer segment is involved in e-commerce business. The Other segment consists of outlet and warehouse sales; temporary locations; wholesale; showrooms; and license and supply arrangements. It offers pants, shorts, tops, and jackets; and bags, socks, underwear, yoga mats, equipment, and water bottles. Lululemon strives for superior customer service which is evident through their customer centered in store experience.

Price (\$):	123.76	Beta:	.74		2016A	2017A	2018A	2019E
Price Target (\$):	175.87	WACC:	9.3	Revenue (M)	266	303.4	258.7	349.6
52 WK H-L (\$):	64.38-164.79	Current Ratio:	5.6	% Growth	11.30	14.03	-14.74	22.95
Market Cap:	17,808	PEG Ratio:	1.5	EBITDA	430.5	517.1	604.1	803
Float:	85.3	Asset Turn:	1.5	EBITDA Margin %	20.9	22.1	22.8	24.9
FCF	331	Quick Ratio:	4.3	EPS	1.89	2.21	2.10	1.96
Avg Daily Vol:	2.02 (M)	ROA (%)	14.1	Locations	365	410	409	448
Div Yield (%):	0%	ROE (%)	17.5	Same Store Sales	5%	6%	7%	15%

Net Debt	-\$990.5	ROIC (%)	17.5	Price Increase (5 YR)	14.1%			
----------	----------	----------	------	-----------------------	-------	--	--	--

Recommendation:

We recommend a buy for Lululemon Athletica (LULU) based on the following attractive factors: Expanding growth margin, growth markets such as Europe and Asia, leading apparel retailers in sales per square foot and inventory turnover, and the overall growing of the athletic apparel industry. Based on our valuation models, we estimate a 42% upside for Lululemon. Over the past 5 years, Lululemon has seen a CAGR for revenue and net margin of 18.9% and 15.3% respectively. Furthermore, this company has ranked within the top five retailers in terms of sales per retail square foot over the last several years, averaging \$1,738. Lululemon is also committed to growing their business by opening new stores in strategic locations globally and they have been averaging a year over year growth rate for new store openings of 18.75%. We see this growth continuing for many reasons, the main one being that the fitness clothing industry is expected to reach \$232 billion by year 2024. That is a 38% increase from current global sales of around \$170 billion. Besides overall fitness apparel growth, Lululemon still has many new customers to reach and many new growth markets to expand into. For example, in China, they currently have 24 stores with plans to open many more. Year over year, this region has seen 50% comparable sales growth and it is expected to increase as the Chinese government is enacting new policies designed to encourage its citizens to be more active and involved in sports. Lululemon also saw a 40% comparable sales growth in their European market as well and have plans to further expand in this market as well as Korea and Japan in 2019. We also see the growth of this company continuing because they have been able to keep up with the trend of retail shifting online. They have shown a 24.18% year over year sales growth of their online sector and it currently equates to 27.8% of their total sales. Lululemon is continuously building their competitive advantage by differentiating themselves from competitors, superior product quality, customer loyalty, patented materials, efficiency, innovation, and responsiveness to customers. For these reasons, at a current market price of \$139.52, we feel Lululemon is undervalued, making it a strong “buy”.

Investment Thesis:

Reaching New Customers: One aspect of Lululemon we find exceptionally attractive is their potential to reach new customers. Essentially, the entire world is a growth market for Lululemon as they are a relatively new company. In the United States, there are still many markets that Lululemon has not reached. Moreover, they are starting to focus on growing men's apparel, which is largely untapped into. Over 2018, men made up 30% of new customers, which is significantly up from last year. Lululemon will continue to focus on growing its men apparel by expanding into outside gym clothing and focusing on ad campaigns like Father's Day to capture more market share.

International Sales are another pillar to Lululemon's growth strategy, especially in the Asian market. Currently they have 24 locations in the Asian market and comparable sales grew over 50% from last year. This also included a 200% sales growth in their e-commerce segment in this region from 2017 as well. While this market still only makes up about 5% of their revenue, Lululemon is strategically planning on growing this segment to capitalize on one of the hottest markets in the world.

Financial Strength: When comparing financial statements of companies in the retail apparel industry, Lululemon is one of the best. In the coming years, this company is unlikely to fall into financial distressed situations. Currently this company has no debt and its debt to income ratio is 0.14. Furthermore, Lululemon has a current Altman's Z score of 23.52 meaning this company is very financially sound. Another great aspect of this company is its ability to turnover inventory better than its closest competitors. By introducing exclusive collections of clothing, Lululemon is essentially turning its premium styles into "collector's" items, creating a must-buy-now mentality among its customers. Currently their inventory turnover is at 8.074 and the industry average is currently sitting around 3.94. While Lululemon does have a higher P/E than its competitors at 41.62, its PEG ratio is lower than its closest competitor, Nike, at 2.02. This is only slightly above the industry average of 1.85. As talked about above, Lululemon also has very strong sales growth and net income growth of 18.9% and 15.3% respectively over the past five years. The financial strengths of Lululemon are one of the reasons we feel this company will continue to strive into the future. Even if the economy turns, this company is prepared financially to weather the storm.

Fitness Apparel Industry – Overall Growth: Across the globe, athletic apparel has become one of the most popular fashion trends. Athletic wear is becoming a fixture in mainstream fashion and apparel and it's more than just a fad. This trend has started to take hold for a variety of factors including social and demographic trends. The U.S. and Europe has seen an explosion of health-conscious people attuned to their physical well-being. Popularity is also growing in developing countries as their expanding middle class is signing up for gym memberships and sports activities at an increasing rate. This is all contributing to the athleisure movement as athletic apparel is increasingly versatile and worn in everyday settings. Along with this athletic fashion trend, companies like Lululemon can capitalize on high barriers to entry in this apparel segment. Athletic apparel such as sportswear and shoes require extensive research and development, making it difficult for lower-priced knock-offs to gain traction in this industry. This is one of the reasons Lululemon charges a premium for its products, they are simply of the highest quality and that is what their customers want. Lululemon is far better positioned than traditional apparel retailers in this fitness industry explosion because they can sell direct to consumers over the internet and through their specialty stores where profit margins are much higher. Over the long run, fitness apparel will only become more prevalent in consumer wardrobes. Among other social and demographic trends, millennials are driving this industry forward with a clear preference of casual fitness apparel for everyday use.

New Innovative Products: One of the reasons Lululemon has been so successful is because of their innovative fabrics and products. Through market research, Lululemon has learned they need to combine comfort, performance, and aesthetics into their clothing to create long-term sustainability. There is a specific department within Lululemon that is continuously committed to researching and developing innovative materials to use within its products. Currently they have over 45 patents on their athletic gear and they have created specific product lines based on these innovative materials. Some of these product lines include the luon family (Lululemon's original, signature yoga fabric), luxtreme (Lululemon's fastest wicking running fabric), swift (extreme lightweight material made for superior breathability and running) and so much more. Lululemon is constantly adding more innovative product lines to continue growth into the future. Lululemon also offers a lifetime warranty on every product in order to ensure its top of the line quality.

Store Growth: Store growth is another area Lululemon is currently seeing exponential growth. With the emergence of e-commerce, Lululemon has found a way to combat this shift and pull customers into stores as can be seen with their exponentially high average sales per square foot. Currently they are among the top retail companies in this aspect with sales of \$1500 per square foot. However, if you look at their older, more mature locations in Canada, they have an average of \$2800 in sales per square foot. Compared to their newer stores in the U.S. that are averaging \$1100 in sales per square foot in their first year, shows potential for further gains in the U.S. as they build a loyal customer base. Over the past six quarters, LULU has on average opened six new stores as they continue to grow. It is important to note that Lululemon targets upscale shopping centers and malls and has a long, tedious research and prospecting process in order to determine exactly where to place the new stores. Combined with an aggressive approach to international store growth of 25 stores this coming year, Lululemon will continue to profit from expansion.

Unique In-Store Experience: One particular way Lululemon has found their niche and continued to succeed can be attributed to their unique store experience. Within seconds of entering a store, customers are immediately greeted by an “Ambassador,” which Lululemon refers to as their sales associates. As the front line of the company, Ambassadors are trained to be experts within every facet of the brand, so they can assist customers with any question. Another unique aspect of Lululemon stores is that it’s not uncommon to find a yoga or workout class in action. Lululemon’s partner with local yoga instructors and trainers to provide customers with free classes offered inside stores. With the domination of e-commerce, customers value experiences that drive them into brick and mortar stores. This paramount customer service and in store experience is something that sets them apart from other athletic wear retailers and drives sales.

Valuation:

Two separate models were used in the valuation of Lululemon. The first was a discounted cash flow model. The cash flows for the first five years were calculated separately, the second stage used a conservative growth rate of 8% for five years, and a terminal growth rate of 3%. This led to a one-year price estimate of \$171.98 which gives Lululemon an upside of \$48.22. Our next valuation model was an EV/EBITDA multiples model. We used a peer group of five different companies that can closely be related. Using the multiples approach we came to a price estimate of \$179.76. We then split these two valuations 50/50. This is because we believe both methods of valuation may be accurate in their own ways and should be valued fairly. Our final one-year price estimate is \$175.87 with an upside of 42.11% from the closing price on November 26th of \$123.76. This leads us to believe that Lululemon has a target price range between \$170-\$180 per share.

Risks

Economic downturn: Lululemon is a high-end specialty brand and they charge a premium for their clothing. Even though they have great financials, allowing them to survive an economic downturn, their sales would inevitably drop. With less sales, this would certainly hurt the stock price of this company. However, Lululemon showed in the last recession they can turn bad times into an opportunity to sharpen their business. By carefully researching target markets, in 2008, Lululemon opened 35 new locations, showing they can still expand during a recession. Other lesson Lululemon learned during the last recession is they need to hoard their cash, stay off the TV, and offer free incentives to gain traction.

Supplier Power: Another risk Lululemon faces is supplier power. In order to simplify their business and cut costs, Lululemon depends heavily on five key suppliers in the Asian-Pacific region. If anything were to happen with these partnerships or if political relationships changed, Lululemon would be forced to find new suppliers, possibly in North America, which would cause margins to deteriorate. While there isn't much Lululemon can do with political relationships, they are continually building and strengthening their relationships with these suppliers to continue growth into the future.

Threat of Entrants: As stated above, it is very hard for cheap, knock-off competitors to enter the athletic apparel industry because of the cost and extensive research and development required. However, several large, well-known companies like Nike, Gap, Adidas, and Under Armour have the resources to create an athletic apparel line that directly competes with Lululemon and they have. Lululemon knows it cannot compete with some of these competitors in terms of pricing, so they are focusing on the high-end part of the market by offering the highest quality and most innovative fabrics/designs. By differentiating themselves from competitors through superior product quality, patented materials, innovation, and efficiency Lululemon can have a competitive advantage over their rivals.

Over Valued Share Price: Lululemon is currently trading at 43 times its forward earnings while the average of its competitors is around 25 times. Many people would view this as overvalued, however, we believe LULU is still a strong buy and their rally has just begun. Lululemon's ability to grow sales organically through a direct to consumer approach will help drive this stock forward. Furthermore, Lululemon has a gross margin of 54% and it has only been growing year over year, indicating competitors are not affecting this company. We believe Lululemon has created a perfect niche that it will continue to dominate.

Management:

In August of 2018, Calvin McDonald was appointed the new CEO of Lululemon. He was previously the CEO of Sephora in the United States where he was voted the top beauty CEO of 2017 and he was also the CEO of Sears Canada for two years. McDonald has an impressive track record for leading companies through significant portions of growth and innovation and he is prepared to continue this through Lululemon. The board believes McDonald is a perfect fit for Lululemon because of his strong consumer mindset, performance-driven approach, and his success for developing people. McDonald has a base salary of \$1.25 million with an annual target performance bonus of 150% base salary. We believe that having well over half of his salary being performance based will help align his goals and decisions with the overall company. Overall, there are 22 members of Lululemon's management, nine on the board and 13 in management. The average age of the C-suite level is 52 years old, while the average tenure is 3 years. Therefore, we feel Lululemon possesses well qualified individuals that will continue to lead and push this company forward.

Stock Chart of Performance:



Peer Analysis:

Name	Tick.	Market Cap	Sales	EBITD A	P/E	ROE	Gross Margin	Net Margin	PEG Ratio	Sales Per SF
Lululemon Athletica	LULU	17.9B	2,650	604.1	43.45	28.67	55.67	12.94	2.02	1,554
NIKE	NKE	119B	36,363	5,247	25.56	17.40	44.03	5.32	2.51	469
GAP	GPS	9.88B	15,855	2,063	11.53	26.8	38.26	4.36	1.13	347
Adidas	ADS	46.5B	21,218	2,328	28.33	20.91	48.47	3.37	1.65	523
Under Armour	UAA	9.52B	4,977	325.2	--	(2.38)	44.81	(0.97)	6.69	640
Puma	PUM	6.73B	4,136	299	34.67	8.15	45.55	3.28	3.09	367
Peer Average		38.9B	16,509	2,052	25.0	14.42	44.22	3.072	3.014	469

Ownership of Shares

Insider vs Institutional

% of Shares Held by all Insider Groups	14.75%
% of Shares Held by all Institutional and Fund Owners	77.55%
% of Shares Held by Unknown Investors	7.7%

Top 5 Shareholders

Holder	Shares	% Outstanding
<i>Fidelity Management & Research Co.</i>	18,805	15.34%
<i>Advent International Corp.</i>	10,105	8.24%
<i>The Vanguard Group, Inc</i>	8,421	6.87%
<i>Dennis Wilson</i>	7,583	6.19%
<i>BlackRock Fund Advisors</i>	4,675	3.81%