VIOLA ADVISORY

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Lululemon Athletica Inc. (LULU): Buy @ $58.00

<u>Buy Thesis:</u> We are Upgrading our Rating on LULU to a Buy with a $58 PT. We believe that Revenue Growth and Market Expectations have Bottomed in 4Q16. Moreover, the steep sell-off in the stock (down 23.4%) post 4Q16 leads us to believe that most of the short-term risks have been fully priced in. Management is now setting the stage for the next leg of its growth plans – international expansion, particularly in China. We believe Asia-Pacific (5-year CAGR ~6.4%) and China (CAGR ~8.0%) give LULU a much better runway for growth. While North America remains saturated amidst an intense promotional environment, <u>our internal analysis shows LULU more than capable of competing and holding market share against the Big 3 – Nike (NKE), Adidas (ADDYY) and Under Armour (UAA).</u> We view 2017 as a consolidation year for LULU with revenue growth and investor sentiment gradually improving as we head into 2018.

TABLE 1: Lululemon 4Q16 Results

4Q16 Results			1Q17 Guidance			4Q16 Results			1Q17 Guidance		
EPS	Cons.	Result	EPS	Cons.	Result	Total Rev.	Cons.	Result	Total Rev.	Cons.	Result
1.00	1.01	miss	0.25-0.27	0.39	miss	789.94M	785.18M	beat	510-515M	555.52M	miss

Source: Lululemon Athletica Inc. and Estimize.com

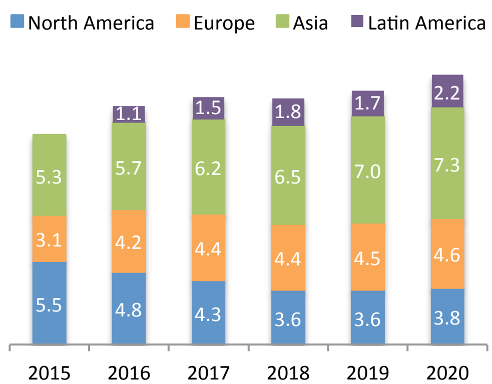
I. *<u>International Expansion in China Could Re-accelerate Top-line Growth</u>*

A. International Expansion Plans Focusing on China in 2017

Lululemon is primarily a North American brand with 287 of 406 stores based in the U.S. and 64 stores in Canada. In addition, they also have 27 stores in Australia, 9 in the United Kingdom and 5 stores in New Zealand. As far as Asia Pacific is concerned, the company has 3 stores each, based in China, Hong Kong and Singapore and 2 stores in South Korea. In the 4Q16 call, management stated that they plan to double revenue to $4B by 2020 with the International segment contributing ~$1B by that time.

The rationale for expanding abroad is simple – with the North American apparel market projected to decline steadily over the 5-year period from 2016 to 2020, the only choice left would be to expand in Asia where the apparel market is expected to grow from $5.7B in 2016 to ~$7.3B in 2020 (see Figure 1, left). On a 5-year CAGR (2016 to 2020), North America is expected to fall by ~6%, Europe is expected to grow by just 2.6% and apparel market growth in Asia is projected at ~6.4% by 2020 (see Figure 1, right).

FIGURE 1: Athletic Apparel Market Size, by Region (US$ Billion) (left) and 5-year CAGR, by Region (%) (right)



5-year CAGR (%)	
N. America	-6.0%
Europe	2.6%
Asia	6.4%
Latin America	18.2%

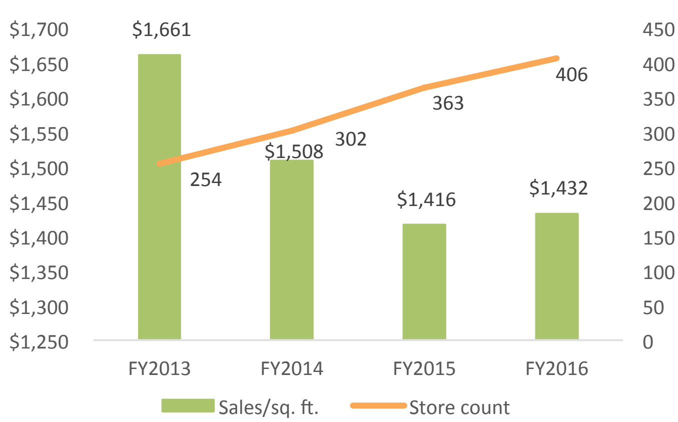
Source: Euromonitor, Morgan Stanley Research Estimates

Management stated that China currently has the world's largest middle class with over 450M millennials living an increasingly active lifestyle. LULU plans to build a distribution infrastructure in Shanghai with the goal of extending their reach and engagement to densely populated Tier 1 cities including Shanghai, Beijing, Guangzhou and Chengdu.

According to *Euromonitor International* ("Sportswear in China," Feb. 2017), the sportswear market in China is expected to grow by a CAGR of 8% with more manufacturers targeting the women's segment, which remains an underdeveloped niche. Nike (China) is currently the sportswear market leader with a 22% market share. Also, former Olympic gold medalist Liu Xuan is planning on introducing her own sportswear brand, *Balanpie* in 2H16, launching the yoga series first, followed by running, fitness and swimming series.

B. Store Profitability Stabilized but DTC Down in 2016

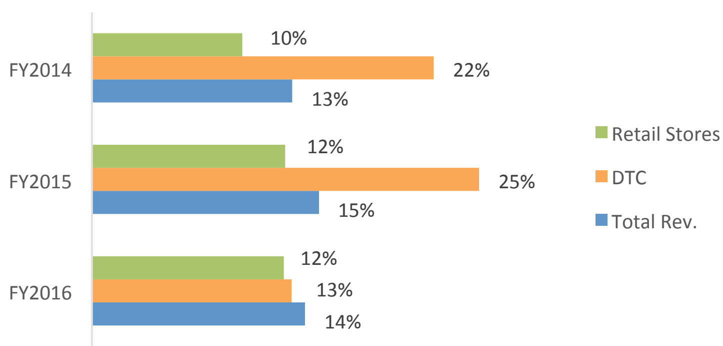
FIGURE 2: Store Count (right axis) vs. Sales Per Square Feet (left axis)



Source: Lululemon Athletica Inc.

A positive takeaway from the 4Q16 earnings is the growth in store profitability. Sales per square feet had declined steadily over the least two years reaching a low of $1,416/sq. ft. (down 6.1%) in FY2015. After opening 43 new stores in FY2016, sales/sq. ft. was up slightly by 1.2% to $1,432/sq. ft. (see Figure 2). For 2017, management is targeting square footage growth of ~10% with up to 28 new stores and 12 store re-models.

FIGURE 3: Revenue Growth by Segment



Source: Lululemon Athletica Inc.

While overperforming over the last two years, Direct-to-consumer (DTC) sales dropped by more than half, from 25% y/y growth in FY2015 to just 13% y/y growth in FY2016 (see Figure 3). While company-operated stores represented ~72.3% of total revenue in 4Q16, revenue from digital channel (DTC) comprised ~20.8% of total revenue for the same period.

Management attributed the underperformance of DTC to lower sales conversion on LULU's E-commerce site. Management said they were taking aggressive steps to improve site performance this year such as the expansion of omni-channel strategies which includes:

1. The ramp-up of their ship-from store program from 85 to 145 stores by the end of 2Q17;
2. The addition of outlet stores to the ship-from store program beginning in 1Q17, and
3. The introduction of the Buy Online Pickup in Store pilot program beginning in 2Q17.

Management noted that the initial signs were positive as these strategies were beginning to gain traction in 1Q17.

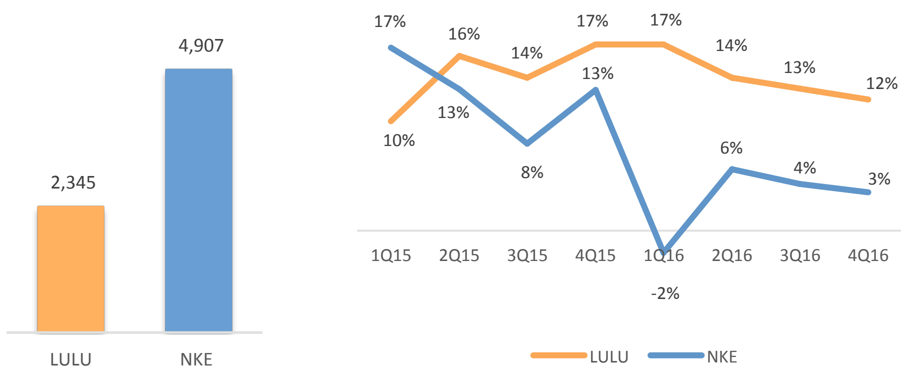
II. *Competition in the North American Sports Apparel Market: LULU vs. The Big 3 – Nike (NKE), Adidas (ADDYY) and Under Armour (UAA)*

To gauge how well Lululemon competes against the Big 3 North American sportswear companies – Nike, Adidas and Under Armour – we isolated just the apparel revenue streams of the Big 3 and compared them with Lululemon. In Nike's case, we were able to break out the company's North American apparel revenue stream, but in the case of Adidas and Under Armour, we were only able to break out the apparel segment revenue stream as both companies did not report segment revenues by Geography.

A. Lululemon vs. Nike North America Apparel Division

Nike North America apparel represented around 14% of Nike's total revenue in 1Q17 (F3Q17). As of FY2016, Lululemon's total revenue was about half the size of Nike's North American apparel revenue (see Figure 4, left). Furthermore, LULU grew its FY2016 revenue by 14% y/y whereas Nike grew its N.A. apparel revenue by 3% y/y during the same period.

FIGURE 4: LULU vs. NKE: 2016 Revenue (US$ Million) (left) and Revenue Growth (Y/Y %) (right)



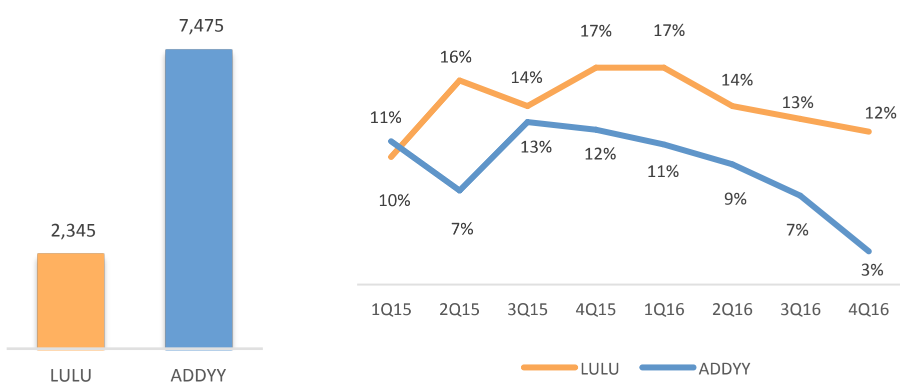
Source: Lululemon Athletica Inc. and Nike, Inc.

Our analysis shows that LULU was able to take share away from Nike and effectively defend its market share position during FY2015 and FY2016. Starting in 2Q15, LULU grew revenue (up 16% y/y) faster than NKE (up 13% y/y) thus effectively taking share from NKE (see Figure 4, right). Since that time, Lululemon has been able to maintain and even grow its market share against Nike. Nike's market share took a severe downturn in 1Q16 when its N.A. apparel revenue declined 2% y/y while LULU's revenue grew 17% y/y. Nike recovered in 2Q16 but N.A. apparel revenue has declined steadily to a low-single digit growth while LULU continues to maintain revenue growth at the low-teens (see Figure 4, right).

B. Lululemon vs. Adidas Apparel Division

Adidas apparel revenue represented around 39% of Adidas' total sales in 2016. As of FY2016, Lululemon's revenue was around one third the size of Adidas' apparel segment (see Figure 5, left). In FY2016, Adidas grew its apparel revenue by 7% y/y while LULU grew its revenue by 14% y/y.

FIGURE 5: LULU vs. ADDYY: 2016 Revenue (US$ Million) (left) and Revenue Growth (Y/Y %) (right)



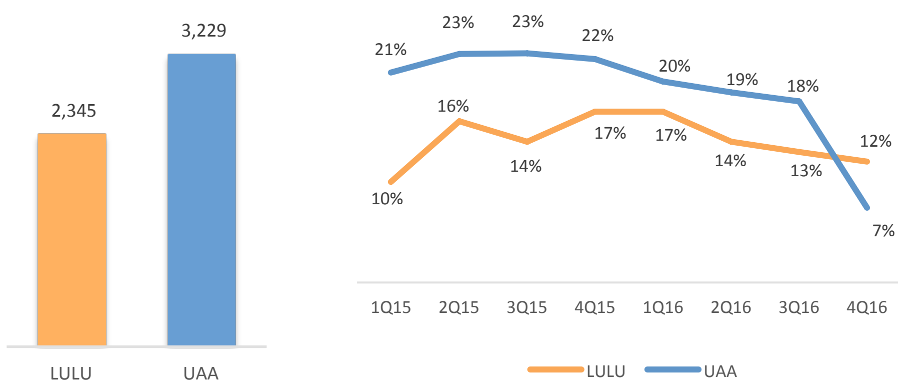
Source: Lululemon Athletica Inc. and Adidas, Inc.

In 1Q15, Adidas had a slight lead over LULU with Adidas growing apparel revenue at 11% y/y vs. Lulu's growth rate of 10% y/y (see Figure 5, right). In 2Q15, Adidas apparel revenue growth fell to 7% y/y while Lulu's revenue growth grew to 16% y/y. Adidas recovered in 3Q15 growing apparel revenue 13% y/y, almost catching up to Lululemon whose revenue growth fell to 14% y/y. However, from 3Q15 to the most recent quarter of 4Q16, Lululemon has been able to gradually take share away from Adidas (see Figure 5, right). Currently, LULU's revenue growth is at 12% y/y vs. Adidas' apparel revenue growth rate of 3% y/y.

C. Lululemon vs. Under Armour Apparel Division

Under Armour's apparel segment represented ~67% of total sales in 2016. As of FY2016, Lululemon's revenue was roughly three fourth the size of Under Armour's apparel segment (see Figure 6, left). In FY2016, UAA grew apparel revenue 15% y/y vs. LULU's revenue growth rate of ~14% y/y.

FIGURE 6: LULU vs. UAA: 2016 Revenue (US$ Million) (left) and Revenue Growth (Y/Y %) (right)



Source: Lululemon Athletica Inc. and Under Armour, Inc.

<u>We believe Under Armour is currently Lululemon's most formidable competitor.</u> Both companies' core products are in the sports apparel segment. For all of FY2015 up to 4Q16, UAA has been able to hold a dominant market share position against LULU. While LULU was able to gradually chip away at UAA's market share from 3Q15 to 1Q16, it could never quite catch up to UAA. It was not until 4Q16, when UAA's apparel revenue took a steep and abrupt fall from 18% y/y to 7% y/y that LULU (revenue growth of 12% y/y) was finally able to catch up and overtake UAA. It remains to be seen whether or not LULU can stay ahead of UAA. Under Armour CEO Kevin Plank has vowed to refresh the company's product offerings, making it more "fashionable" and trendy. We expect market share trends between LULU and UAA to remain volatile in the near term.

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Analyst Certification

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