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Lululemon Athletica Inc. (LULU): Buy @ $67.00

Buy Thesis: We maintain our BUY rating and raise our PT from $58 to $67. We believe the athleisure trend in the U.S. continues to remain strong with Lululemon's premium brand as a prime beneficiary to that trend. While the U.S. retail market is showing some signs of saturation, we believe there is plenty of growth left by expanding abroad, particularly in China and Japan, where LULU remains underpenetrated. Furthermore, the Direct-to-Consumer (DTC) channel (~20% of sales) is still in the early growth phase (possible 20% plus Y/Y growth) with LULU already having made the necessary investments in its digital infrastructure to scale the business globally. Lastly, despite the heavy promotional retail environment, we believe LULU can still grow its gross margin by keeping the product cycle constantly refreshed and by effectively managing its inventory growth.

TABLE 1: Lululemon 1Q17 Results

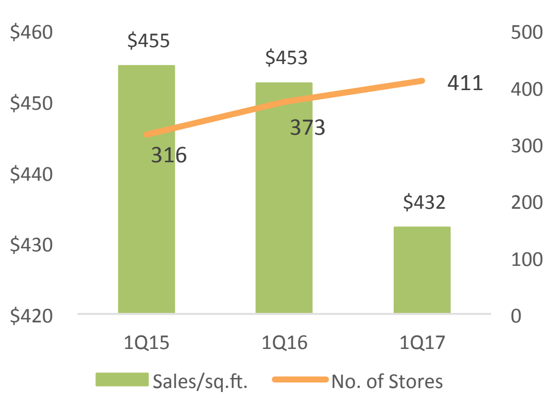
1Q17 Results			2Q17 Guidance			1Q17 Results			2Q17 Guidance		
EPS	Cons.	Result	EPS	Cons.	Result	Total Rev.	Cons.	Result	Total Rev.	Cons.	Result
0.32	0.28	beat	0.34	0.41	miss	520.3M	512.7M	beat	567.5M	563.3M	beat

Source: Lululemon Athletica Inc. and Estimize.com

I. *Slow-down in U.S. Retail Store Productivity*

Over the past two years, Lululemon has seen a marked slowdown in U.S. retail store productivity (see Figure 1). Despite the steady growth in the net number of new stores opened (57 in 2015 and 38 in 2016), sales per square foot has nonetheless declined over the past two years, dropping from $455 in 1Q15 to $453 in 1Q16 and most recently to $432 in 1Q17.

FIGURE 1: Retail Store Productivity: Store Count (right axis) vs. Sales Per Square Foot (left axis)



Source: Lululemon Athletica Inc.

The decline in store productivity may be attributed to an oversaturated U.S. market for athleisure apparel as well as to headwinds in store traffic. Management mentioned headwinds in store traffic in early 1Q17 but also indicated that the new launch of the *Nulux Fast & Free* as well as the "This is Yoga" ad campaign which kicked off on May 15 were helpful in driving both store and online traffic.

In addition, LULU will close all but 8 of their 55 Ivivva stores (by August 20th) and evolve the girls' yoga brand into an e-commerce business. We believe this move should be accretive to store productivity in the short term as well as contribute to top-line growth in 2H17.

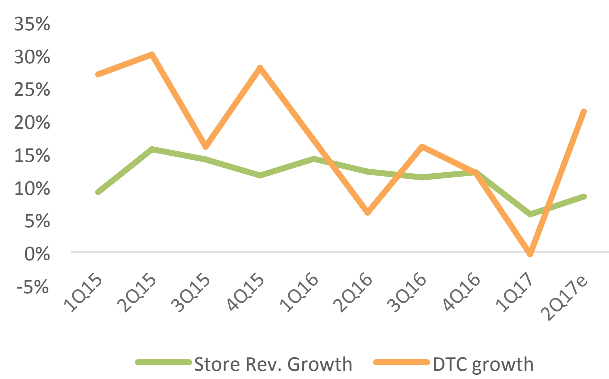
We believe that in order to re-accelerate the pace of store revenue growth, LULU has to focus its new store expansion abroad in both Asia (Japan and China) and Europe where the pace of growth has been faster than the U.S. Management indicated that it was on track to open 50 new stores this year but did not break out specific locations.

As of 1Q17, LULU had a total of 356 stores (ex-Ivivva) of which 247 stores (~70%) were in the U.S. Japan currently has 1 store while China has 4 stores. In addition, Hong Kong has 3 stores while Singapore and South Korea each have 3 and 2 stores respectively.

II. DTC could Revive Top-line Growth

We believe Direct-to-Consumer (DTC or online, e-commerce sales) presents the best way to boost sales growth in the short term. DTC contributes roughly one fifth of total revenue and grew by an average of 19% in both 2015 and 2016. By contrast, store revenue (73% of total sales) grew by an average of 14% in both 2015 and 2016 (see Figure 2).

FIGURE 2: DTC Growth vs. Store Revenue Growth, (% Y/Y)



Source: Lululemon Athletica Inc.

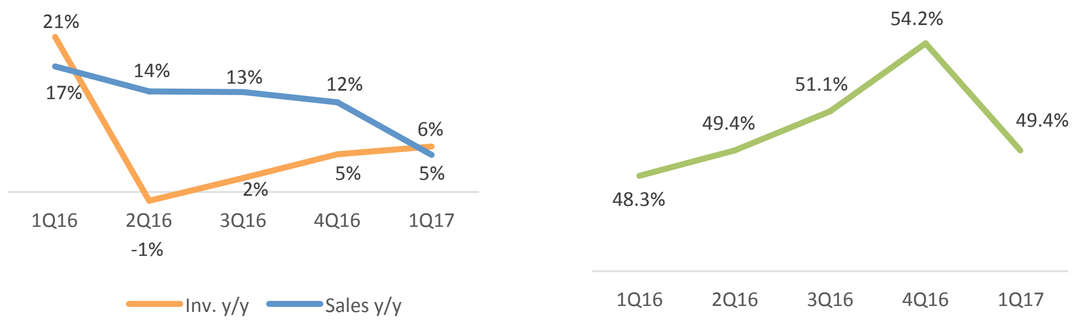
We believe the addition of a new CTO (Julie Averill) to oversee global IT functions and digital marketing as well as a new SVP of Merchandising (Sun Choe) to oversee visual store merchandising and who reports directly to the CEO, should ensure a smooth and satisfactory online shopping experience. DTC growth was flat in 1Q17 largely due to the dull (mostly dark) color choices and to the less than satisfactory online checkout experience.

In addition, LULU made some one-time digital infrastructure investments on their website in 1Q17 as well as hired external agency resources to help with the development of creative content and photography for their website. We believe these investments as well as the direct oversight of digital assets by a CTO could help return DTC growth rate back to a low to mid-20% range.

III. Continued Strength in Gross Margins

Despite the heavy promotional retail environment in the U.S., LULU has been able to grow its gross margins in 2016 (see Figure 3 right chart). This speaks volumes to the premium brand image as well as to the innovative fabric and product designs that LULU is known for among its loyal customers, which are heavily niched in the yoga space.

FIGURE 3: Tight Inventory to Sales Growth (left) Preserves Higher Gross Margins (right)



Source: Lululemon Athletica Inc.

The company has also been able to control the level of inventory growth relative to sales growth (see Figure 3 left chart). By ensuring that inventory growth remains below sales growth, LULU can effectively manage the level of markdowns in stores and online. Moreover, a steady cadence of new product releases keeps the product cycle constantly refreshed which justifies premium pricing and preserves the growth of gross margins.

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Analyst Certification

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