lululemon athletica

Consumer Discretionary
NASDAQ: LULU
Market Outperform | Hold

March 31, 2022
Katie Tu, Portfolio Manager
Emily Chen, Investment Analyst

Return on Investment

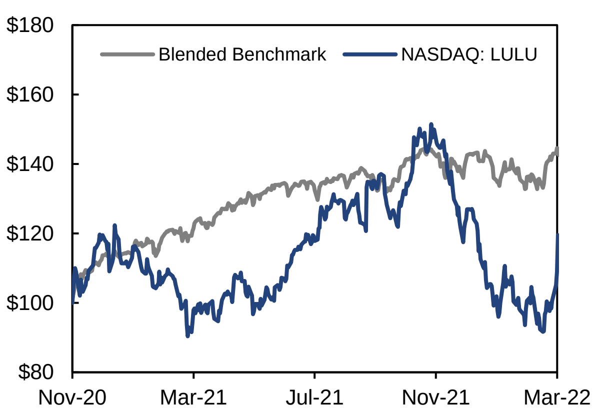
Current Share Price	$365.23
Target Price	$426.00
Dividend Yield	0.00%
Implied Return	17%
Conviction Rating	1

Market Profile

52-Week Range	$278.00 - $485.82
Market Capitalization (US$mm)	$44,818
Net Debt (US$mm)	($1,260)
Enterprise Value (US$mm)	$43,558
Beta (5-Year Monthly)	1.34

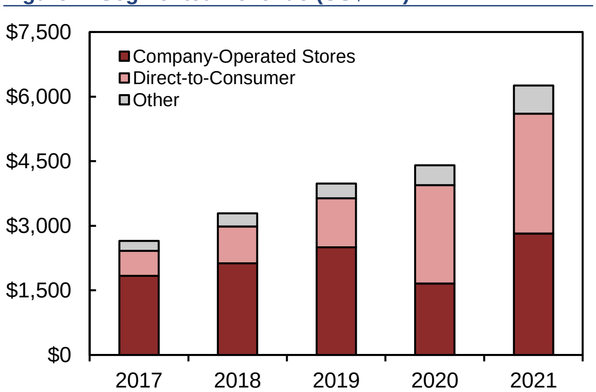
Metrics	2022E	2023E	2024E
Revenue (US$mm)	$7,421	$8,601	$9,577
EBITDA (US$mm)	$1,907	$2,275	$2,605
EPS (US$)	$9.14	$10.73	$12.36
EV/EBITDA	22.8x	19.1x	16.7x

Holding Period Trading Performance (Indexed to $100)



Source: S&P Capital IQ

Figure 1: Segmented Revenue (US$mm)



Source: Company Filings

Business Description

lululemon athletica (NASDAQ: LULU) is a Canadian athletic apparel retailer focused on the design, distribution, and sales of activewear and related accessories. Specifically, LULU positions itself as a premium brand that supports "living the sweatlife" through its stylish, innovative, and high-quality apparel products. The Company reports in three segments: (1) company-operated stores, (2) direct-to-consumer, and (3) other. As of FY2021, the Company operated 574 stores in 17 countries, with the highest percentage of stores found in the U.S. (56%), China (15%), and Canada (11%). LULU's direct-to-consumer segment consists of sales from its e-commerce website and mobile app, both of which enhance the Company's omnichannel strategy. All other revenues are captured in the final segment, which includes sales from outlets, temporary locations, wholesale, and MIRROR (an interactive in-home workout platform acquired by LULU in 2020). The Company was founded in 1998 and is currently headquartered in Vancouver, British Columbia.

Original Investment Thesis

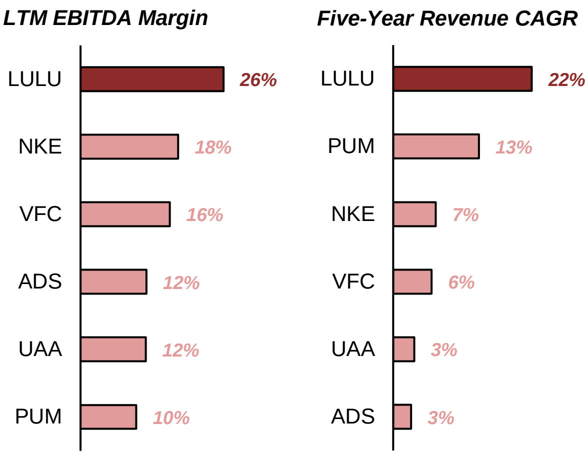
The CPMT entered a position in LULU in November 2020 due to the Company's strong fundamentals, brand presence, and opportunities for market expansion. LULU's unique brand image, diverse product offerings, and emphasis on product innovation was viewed favourably by the CPMT. Furthermore, LULU's e-commerce platform was expected to help the Company adapt to COVID-19 challenges. Overall, the CPMT believed LULU to be a strong operator and an attractive addition to its consumer discretionary holdings.

Industry Overview

The retail apparel industry faces near-term headwinds as a result of economies recovering from the COVID-19 pandemic. With the support of government stimulus and the lifting of restrictions, apparel retailers' top-lines benefitted from increased consumer disposable income and spending. However, as demand rebounded quickly, supply chains struggled to keep up, given that many manufacturing and transport companies laid off workers when uncertainties took hold during the pandemic. As these dynamics played out, inflation emerged, impacting households and leading to a decrease in consumer confidence. However, these effects are unlikely to persist in the long term as inflation will likely normalize when supply chains mitigate temporary shortages and the labour market recovers. Additionally, the circular fashion movement has accelerated as shoppers become more aware of the environmental impact of clothing production. In combination with a reduction in spending power, demand is expected to grow for pre-owned items, thus adversely impacting revenue growth for apparel retailers.

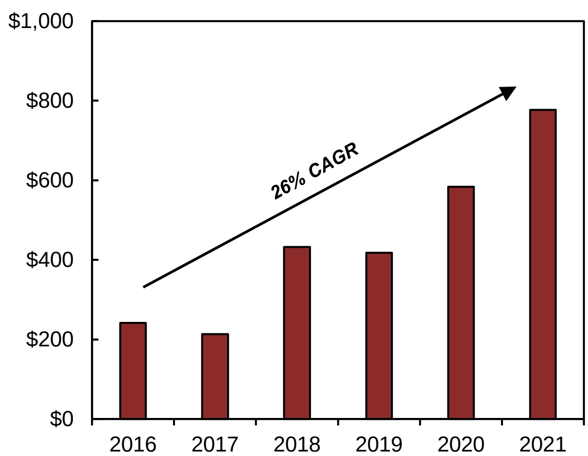
Within the retail apparel industry, LULU competes in the activewear segment with several publicly-traded companies (NYSE: NKE, UAA, VFC; XTRA: ADS, PUM) as well as direct-to-consumer brands, such as Gymshark, Alo Yoga, and Sweaty Betty. This segment continues to benefit from the growing athleisure trend. Since its introduction in 2015, athleisure has defied the typical lifecycle of fashion trends (growth explosion, market saturation, and decline within the span of a few years), and the CPMT expects its sustainability with the growing movement of wellness and pandemic-induced (cont.)

Figure 2: Comparable Analysis



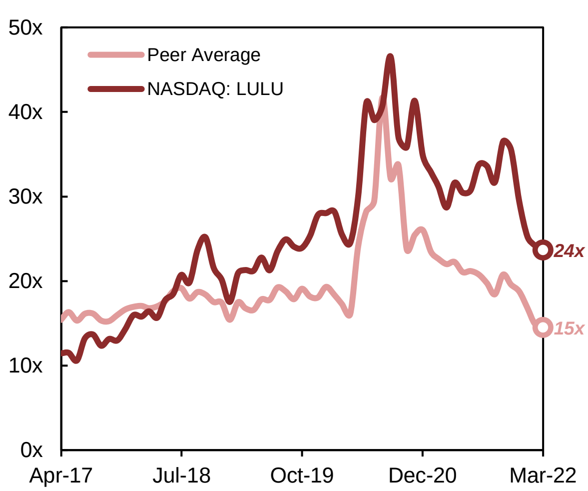
Source: Company Filings

Figure 3: Free Cash Flow (US$mm)



Source: Company Filings

Figure 4: NTM EV/EBITDA vs Peers



Source: S&P Capital IQ

changes in workplace culture. As more work can now be done virtually, companies are increasingly inclined to adopt a more relaxed approach to workwear. Athleisurewear has accommodated this new lifestyle, as it is appropriate for video conferences in the daytime, yet still comfortable enough for relaxation after work.

Mandate Fit

Quality Management: LULU's current CEO, Calvin McDonald, took on the position in 2018 and implemented a five-year plan that included three growth priorities: product innovation, omniguest experiences, and market expansion. Despite challenges with respect to store closures, supplier factory closures, and reduced air freight capacity, management's execution on this strategy has been successful and ahead of schedule. In 2021, the Company achieved several key growth goals, generating a record US$6.0B in net revenues and doubling men's and e-commerce net revenues relative to 2017 levels. LULU is on track with its goal to quadruple its international business by 2023 (from 2018 levels), after seeing a 53% revenue growth in this segment in 2021. Lastly, management has responded well to circular fashion trends, launching the "Like New" initiative where guests can trade-in and buy used gear.

Competitive Advantage: Within the activewear industry, LULU competes on superior product innovation and its ability to grow a loyal customer base. Relative to its peers, LULU continues to outperform operationally through higher margins while maintaining a comparable inventory turnover (3.3x vs peer average of 3.1x).

Strong Balance Sheet: LULU has no debt in its capital structure and has been able to fund its growth strategy with operating cash flows. As of Q4 2021, the Company is in a strong cash position of US$1.5B. Additionally, LULU maintains a high ROIC of ~25% compared to the peer average of ~11%, inclusive of capital leases.

Growing Free Cash Flow: LULU continues to maintain strong FCF generation, with an impressive five-year FCF CAGR of 26%. FCF for 2021 was US$777mm, representing an 86% increase from pre-COVID-19 levels in 2019. The Company's stock repurchase program is a significant use of cash, with LULU approving a new US$1.0B repurchase program on March 23, 2022.

Key Risks

In the current inflationary environment, top-line growth may be jeopardized by lower consumer demand. Additionally, operating costs are expected to increase as supply chain delays extend into 2022. LULU may need to resort to higher-cost air freight as a method of distributing products, thus pressuring margins. Another key risk is the integration of MIRROR, which has already caused 3% - 5% EPS dilution in 2021. Additionally, the level of financial investment and SG&A expense required to scale MIRROR is uncertain. Other risks include decreased mall traffic, COVID-19 store closures, increased competition, and an unsuccessful rollout of LULU's footwear line.

Valuation and Revised Thesis

The target price of $426 was derived using a 50/50 blend of (1) the Gordon Growth method (using a WACC of 7.84% and a 3% terminal growth rate) and (2) applying an EV/EBITDA exit multiple of 22x. LULU trades at a premium to its peers, which the CPMT believe is justified given its operational excellence and runway for growth. Since entering a position, LULU has outperformed operationally despite a challenging macro-environment, and have valuations decreased to more attractive levels. However, the CPMT hesitates to increase conviction in the name due to risks of margin compression, resulting in our Hold recommendation.