ICR Conference

Company Participants

- Laurent Potdevin, CEO
- Stuart Haselden, CFO & EVP, Operations

Presentation

Laurent Potdevin {BIO 18481730 <GO>}

Good morning. I don't know about you guys. But when I saw the final cut of this video a couple days ago on the plane it gave me the chills and it makes me so incredibly proud of everything we've accomplished in 2016. But this is my third ICR and so when I reflect on the past couple of years I remember being in this room two years ago and there were a whole lot of skeptics in the room. It wasn't a fun time.

The brand had been harvested for a couple of years and we set out a pretty ambitious agenda of returning to positive comps, returning to the effortless loyalty that we knew from our guests that we had someone neglected. And then building the men's business, building an international strategy, building a digital ecosystem. And really getting back to a level of performance from a margin and from an earnings standpoint that had deteriorated over a couple of years.

Today we are actually in a position, with the strongest management team that the company has ever had, to deliver on all of those promises. So I am really, really pleased with the progress that we have made and our FY 2016 accomplishments really speak for what we have been able to do.

Oh, forgot about that. I am not going to read it. But you know what that means.

So when you think about FY 2016, first, from a product standpoint, we were very intentional in returning to being a design-led organization that lives really perfectly at the intersection of function and fashion with a very clear mandate that we do not design product if it doesn't solve a problem for the athletes. And as long as we do that, as long as we listen to our ambassadors, we have seen incredible success.

What we have seen with the relaunch of the pant wall, the success of our Nulu fabric, the recent success of our Nulux fabric, which is an evolution of Nulu for higher intensity cardio workouts, really speaks to the fact that when we deliver innovation to our guests they respond incredibly well and we see very little price resistance to the innovation that we bring to market.

As we become design-led we'll also build an overarching design vision between men's and women's. For those of you that have been in our store, you can probably very clearly tell the difference of how the product is coming to life, how much better it's merchandised, how easier it is to put an outfit together. And how both the men's and the women's business live in the same space.

So returning to being design-led, focused on innovation. Three years ago the pipeline, like we said, was very, very dry and today I feel like we have got a pipeline of innovation that is relatively full with a very clear roadmap for the next three to five years and actually a little bit beyond. So very excited about that.

From a guest experience standpoint, we have started playing with a lot of different formats. You have heard us speak about the co-located format. It is really our ability to take markets where we are already very successful and build bigger stores so that the men's have a larger presence and the women's business we can actually show a broader assortment, especially as we get into new categories. So the co-located have been a tremendous tool in allowing us to the stronger in markets where we already have a very strong presence.

Then in markets where we don't have necessarily the market-holding capacity for a full store, we have been playing with locals and the locals are really a very strategic evolution of our showroom model. You think about the local that we have in Tokyo in Harajuku or the one that we have got in Fort Collins. Those are 1,000 square foot locations, really, really well built that allows us to bring the brand to life really powerfully with our ambassadors. And while they are small square footprints, we have amazing digital air cover.

Then when you think about guest experience, I'm really pleased with what we have been able to do with our international expansion. I was in Shanghai right after our earnings call. We opened two stores in Shanghai, one in Beijing.

For those of you that have been in the Asian market, our store in Shanghai, the first store in Shanghai is the IFC Shanghai. Very similar location to what we have got at IFC Hong Kong. Right across from Apple; indoor entrance, outdoor entrance. It is an absolutely fantastic location.

And the second location is at Kerry Center. They are both about 2,200 square feet. And when you think that we took that first trip two years ago to open a showroom to now be in a position to have these two outstanding locations that have since the opening exceeded our expectations, I'm really, really pleased with our focused strategy in China, which is about densification in both Shanghai and Beijing before we go to Tier 2 and Tier 3 cities.

Something that is obviously very clear is that the way the market in China engages from a digital standpoint is very different than how we engage in North America. So we are building a team in China to really have a strategy that is focused on that market.

Then in London -- I mean so we have seen the Asian market grow a little bit faster. We have seen faster growth in Asia than we have in Europe and it doesn't really surprise us. I think the European consumer is a little bit more skeptical of North American brands. But when they are engaged with a brand I think they are actually incredibly loyal and, to some extent, maybe less fickle.

In Q3/Q4 we have actually seen a ramp up in our performance in Europe. I am flying this afternoon to London for the opening of our incredible location on Regent Street, which is obviously one of the most prestigious shopping streets in the world. We have got this amazing 6,200 square foot location right across from Hamleys, the toy store. And so when you combine that with our presence at Harrods, Covent Garden, Marylebone. And King's Road we really feel like we will have London really well under control before we sort of spread our wings beyond the UK.

From a brand and community standpoint I mean we love the way we go to market. We love our ambassadors. We love our educators. We love being focused on grassroots.

What you are going to see us do in 2017 is be a lot louder in how we amplify the message. So don't expect us to have a spread in Vogue magazine or have a Super Bowl ad. I know we have talked about it; I don't think we can afford it. But expect really us to be really intentional in how we take a lot of our local stories put them together and have really powerful global stories.

I think we have an opportunity to do a really, really good job as we grow as a global brand to be very clear and concise about who we are as a brand and what we stand for.

Then from a people standpoint I have mentioned it -- I have mentioned it earlier. I am very, very grateful for our 12,000 educators around the world. They are clearly at the core of our success. They create experiences day in and day out that are second to none. But I also want to recognize the management team that I get to work with every day.

It is the strongest management team that the Company has ever had; certainly the strongest management team that I have ever worked with. And being able to accomplish as much as we have accomplished in a relatively short period of time and be in a position today to have great margin and a return to earnings growth, clearly would not have been able to do any of that without them. So I am very, very grateful for the team that we have got in place.

Then finally operational excellence. Initially, we are focused on returning to positive comp, guest loyalty, being focused on product. Then the last hurdle that we needed to tackle was really sort of building pretty much from scratch an infrastructure and a supply chain that could handle the complexity and the scale of the business, especially as you think about our five-year plan. We are very much on track with that and it shows in our gross margin results.

So a lot of tremendous accomplishment in FY 2016 and I want to be clear; there are all lot of things that we have done well and there are plenty of things that we can do better. You think about our accessory business; we think it is a tremendous opportunity at 7% or 8% of our overall business right now. We think it is a 12% or 15% opportunity.

I mean there is an opportunity for us to be much stronger in jackets and outerwear. And so we have plenty of runway within the current category, within women's and men's. But also as we think down the road with new categories.

So before I let Stuart give you a little bit more detail, we are very much on track with our five-year plan to double revenue and more than double earnings. If you think about the breakdown of the business, I mean the breakdown of men's and women's we think about that as a $3 billion/$1 billion sort of breakdown. The North American continued build out across the men's business, digital. And new categories is a $3 billion opportunity.

We think about building the digital ecosystem as having the potential to be 20%, 25%. And I want to be really clear that we are not stuck with that number. I mean I think it is really, really critical, especially as a vertical brand, that we build channel-agnostic strategies and that we don't get stuck in trying to drive traffic to either channel. The guests really have the choice to engage however, whenever. And wherever they want with the brand and we have to be there for them in a really seamless manner.

So think about as we launch a lot of innovation in the bra category -- you are going to want to go try them. But you might decide to buy the Align pant online. And we are going to see guests engaging in very different ways through different channels. This is how we are qualifying the opportunity right now and I think it could be very different in different parts of the world, especially if you think about China.

Finally, a $1 billion opportunity with 25% penetration for our international expansion.

It has been a long road for the past two years. I'm really proud of what we have been able to do. I'm grateful for the patience that you have had because we have had flat earnings for quite some time and I feel like now we are actually finally in a position where with the team, with the strategy we are finally at that inflection point where we have momentum, effortless loyalty from our guests. And a roadmap that we are very, very excited about tackling.

So thank you so much and I will let Stuart take on from here. Thank you.

Stuart Haselden {BIO 17615686 <GO>}

Thanks, Laurent. We will move on to some details on -- I'm going to skip through. These are some slides that we had just that reiterated the key growth pillars that

Laurent spoke to that we have also highlighted consistently on our earnings calls and it is really the underpinnings of the growth story.

But moving on into the financial update; this is my favorite slide. I always start every presentation with it. It is a nice picture. In all seriousness, I think it is important for us to step back and have some perspective on the momentum and the trajectory that the business has been on.

As you look at the remarkable picture here and you think about what has happened over the last several years, there has been more competition and notably, as you go back to 2013 in particular, some pretty significant self-inflicted issues that even despite all those things the Company has been incredibly resilient in delivering consistent top-line results, which is really the underpinnings of any growth story. And so I think as we now emerge from -- a lot of the new infrastructure investment that Laurent talked about as we -- in the aftermath of 2013 and 2014 and the investment phase that we have been in in 2015 and 2016, we are more confident than ever in this arrow continuing to go up.

And the potential for us to achieve the five-year goals that we set out at the beginning of the year to exceed $4 billion in revenue by 2020, we're more confident than ever in delivering on that. And really it is based on those four growth pillars that Laurent talked to in terms of product innovation, the continued expansion of our North American store and e-commerce business, the investments and the outsized growth in digital and our e-commerce strategies. And international. Really pleased with the progress we have made this year in each of those areas and it shows in our financial results and in particular in the top line.

This is in the backdrop of a pretty tough environment. It is a tough space right now for most retailers and we are pleased with, again, the resilience of our business and the momentum that we have in Q4 that will take us into Q1.

The next slide just gives us some additional details on really the composition of the 2016 results in particular, reaching a new high-water mark in terms of revenue. And the growth here really balanced between stores and e-commerce.

The store business consistently positive across all geographies, across all vintages, every age class seeing expansion in comps and sales per square foot and in four-wall profit. So we are pleased with the health of our store fleet and excited as we see the e-commerce and digital strategies gain momentum. It is an important area of investment as I mentioned.

And also as our business becomes more intertwined in terms of an omnichannel strategy, our stores and our website and our e-commerce strategies are more connected and more intertwined than ever, as we are able to pool inventory and satisfy guest demand across channels wherever they want to shop. And so we are excited to see that element of our strategy accelerating.

The combined comp will become a more and more important indicator of the health of our business as the omnichannel nature of our business accelerates. But nonetheless, we are pleased as we look at the traditional definitions of those channels, how they perform.

Then as we look at -- looking at it from a category standpoint, the men's business incredible momentum. It is an area we feel has incredible potential. We are excited at some of the new leaders that have joined the Company. Ben Stubbington, our new men's designer, is really helping to be a catalyst for forging and developing our new vision for our men's business, among others as well. And so really excited to see the mid-teens consistent growth in men's as that becomes a bigger part of our business.

Women's, remarkable what we were able to accomplish last year with the Pant Wall relaunch and the double-digit comps that we have seen in women's pants all year. We are now comping the launch from last September in Q3 and Q4 in a very healthy way, in a robust way that speaks to just the opportunity that we have and also just the pipeline of innovation that Laurent talked about. Obviously, women's pants is the heart of our business and for us to be able to deliver double-digit comps in our most mature category is remarkable and speaks to that innovation strategy success.

Finally, as we think about square footage expansion, new stores, it really breaks into two buckets: the North American picture and then the international picture. Laurent mentioned a lot of the innovation that the team has developed, particularly in North America, it is really inspiring to see how -- as we think about real estate, it is not an asset conversation; it is a market conversation.

We look at every market and determine and assess the demand that we see in each market. We then assess the retail footprint that we have to determine what the optimal strategy should be for each market and that oftentimes will include expansions, relocations. We are excited to see the success of the new small store format, the local.

And so the innovation that we have been able to bring to the real estate strategy, in North America in particular, has been really inspiring and we are seeing great results. Laurent mentioned some of those even on the Q3 call, where we have seen really remarkable results where we have expanded stores to make room for a more fuller expression of our men's business in particular.

International, exciting momentum, also as Laurent mentioned. In the near term, the balance of our square footage growth will likely be still weighted to North America. But over the next few years that will tip and become more heavily weighted to our international markets. So a lot of exciting developments this year.

Then as we provided some update on holiday results yesterday with our press release, just wanted to have a slide here so that we could speak to and just highlight our thinking around where Q4 is emerging. As we mentioned on the Q3 call, the

Fourth Quarter started out slow. November, for a number of reasons, was a slow start. We saw an acceleration around Black Friday and into Cyber Monday that was exciting.

December was a choppy period. There is some significant calendar shifts year over year, which influenced how we planned the business. But as we step back and we look at December as a whole, we were really pleased. It was a really strong period for us. We saw really strong full-price selling; great execution, both in stores and online. So we were really pleased with how holiday performed and how our team performed.

As we then look to update the guidance, we essentially are seeing the business trending to the high end of the range that we had provided back in December and so we have updated it accordingly. As we think about this range and the mid-single digits being 4%, 5%. And 6%, I would say we are trending to the high end of that range. And so we feel it is a strong performance in a difficult environment and we think this also connects well to the outlook for Q1 that we will talk more about on the Q4 call.

Then lastly, just wanted to highlight some of the drivers for 2017. Obviously, as we discuss the results of the full year in March as we report Q4 we will have more information to offer for 2017. But as I mentioned in my opening remarks, we are really confident that the momentum that we have seen from a top-line standpoint connects well to the targets that we set out for the five-year period. We are also confident that the gross margin recovery that is driven primarily by the product margin recovery puts us well on track to achieve the gross margin levels that will support over the next few years us achieving that operating margin that starts with a two.

So pleased with -- and as we think about just the revenue in particular, again next year will be the continuation of our strategies that we've mentioned, a few of which are noted here on the slide. And as we think about gross margin into next year, specifically we have seen the inflection in our product margins coming into full focus in Q3 of this year. That will extend into Q4, as we have indicated in our guidance.

Would expect to see a step function improvement in product margins and gross margins through the first half of next year, Q1 and Q2. And that will be the culmination of all of the work that we have done over the last two years to improve how we source our products, to include just our own internal processes, as well as logistics and the manner in which we partner with our suppliers.

So all of that will achieve the lion's share of that step function improvement through the first half of next year. Beyond that we will see ongoing improvements in product margin at a more modest pace as we are able to deliver improvements in merchandising, ongoing improvements from a sourcing strategy standpoint as our volumes continue to ramp. And we are excited to get into the work of identifying how we continue to build on the success that we have seen so far.

In addition to that I would expect to see occupancy cost continue to moderate in terms of the degree to which there are headwinds. The international expansion has been part of the big headwind that has accounted for much of the pressure on occupancy as a rate of sales. As that store fleet scales and seasons we will be able to see a moderation in the occupancy pressure that we see there.

And likewise, the portion of gross margin that is related to the costs associated with the product team will also moderate from a degree of deleverage. So all those will be favorable factors for gross margin into next year and beyond. And so as we look into 2017 we see strong potential for gross margin expansion based on all the factors I just mentioned. Beyond that we will see more modest gross margin improvements as we are able to have a continuous improvement strategy to evolve our cost structure.

From an SG&A standpoint, as I mentioned, we have had a couple years of pretty meaningful investment. We are a growth company; we will continue to invest for growth. We believe as we are able to deliver revenues in the mid-teens range we will invest in our business, in our growth strategies, in our infrastructure in a similar level that allow for the opportunity to have a modest level of SG&A leverage.

As we think about the business, we really leverage SG&A on total revenues. So as I mentioned, in the mid-teens range enables us to leverage, have some modest degree of SG&A leverage. Embedded in that assumption is a low double-digit square footage growth and a mid single-digit comp growth. I just wanted to clarify that point in particular.

Again, very excited how the business has performed in the Fourth Quarter, excited for how that connects to, we believe, a very strong outlook into next year and beyond. And really excited to continue into the next chapter of the story. So with that we thank you for your time and look forward to chatting with everyone separately.