Stifel Consumer Conference

Company Participants

- Jim Duffy, Analyst
- Stuart Haselden, CFO

Other Participants

- Unidentified Participant, Analyst, Unknown

Presentation

Jim Duffy {BIO 6065587 <GO>}

Lifestyle analyst for Stifel. Pleased to be joined today by lululemon. With us from lululemon, Stuart Haselden, CFO; Chris Tham, SVP of Finance. The agenda for today is Stuart is going to kick off with a handful of slides. And then we'll get into Q&A thereafter. So thanks for being here, guys.

Stuart Haselden {BIO 17615686 <GO>}

Thanks, Jim, good to be here. So before we get into the Q2 margin and inventory discussion, I thought we'd start with a few slides on just our strategic priorities and how we are progressing against those.

So first off -- forward-looking statements. We'll have some.

We'll start on this third slide, strategy overview. This framework should look familiar to those of you who have followed us in the earnings calls over the last several quarters. The brand operating model that you see listed here at the top: product, guest experience, branded community -- key tenants of how we run the business. Certainly international, as well, a major focus for us. And operational excellence here really speaks to the investments we've been making in our supply chain over the last 1.5 years.

So really what we're focused on internally. And we've included on this slide just a few comments here to give some indication of how we are thinking about how these strategies will take shape into the next several years. So product -- really, this speaks to our investments in innovation, our Whitespace labs, our regional design labs. And how that will feed product innovation into our product pipeline for the next several years. We mentioned on the call we expect our men's business to grow to $1 billion in revenues over the next five years. We expect women's to reach $3 billion.

The store and website experience related to our guest experience -- really, how we engage our guests. We see Web penetration exceeding 25% over the next five years and the continuation of double-digit square footage growth on an annual basis for our store business. Omnichannel and CRM -- really huge opportunities for the business in areas where we are focused on.

Branded community: part of what's really innovative about the lululemon model and how we grow our collective, which speaks to our guests, our educators, our ambassadors -- and this is a key strategy we'll continue to evolve. And international, certainly a focus that we've talked about; on track for 40 store openings, 20 each in Asia-Pacific and in Europe -- and that's by 2017, ramping above that, ramping faster annually beyond that.

Then on the supply chain -- and a big focus for the margin improvement goals that we have into next year -- continue to invest in the supply chain, not only to support those goals. But also to enable the strategic growth internationally and domestically that we've identified.

So the next slide here just highlights some of the things that we've accomplished in the first half of the year. Starting with product, you see the -- we've listed here the women's Pant Wall launch, certainly a major milestone for us, our women's business comping double-digit in the Third Quarter. The work that went into this really was accomplished in the first half. The Pant Wall, as you know, launched in September.

Exciting momentum in our men's business. 25% comps in the first half of the year with, I think, a 31% comp in the Second Quarter. Guest experience, 33% e-commerce comp year to date. Exciting momentum in that channel. Positive store comps -- in Q2 we saw all regions post positive store comps.

And store expansion: so this is been an exciting part of the business model. We see a growing opportunity there across the store fleet to expand selected stores to capture additional market share.

Branded community: a couple of examples in the first half, certainly the Get Quiet. Live Loud. city tour that Laurent talked about, critical to helping drive the culture, which enables the store model and the store experience. The SeaWheeze Half Marathon, a great event that helps us continue to build our brand awareness. Then international -- four new stores opened in three countries and 17 showrooms in operation in the first half in nine countries. Then, again, operational excellence: the continued investments in our systems and management team.

So we've just got a few slides here on -- with some highlights, again, of things that we have in the works this year. So the Pant Wall launch -- the largest coordinated product launch, I would assert, in the history of the Company. This is the fruit of the investments that we have made in our Whitespace labs, our regional design labs. This is emblematic of how we will build innovation into our product pipeline for the years to come. Certainly at the heart of our business. And all indications initially a very positive response from our guests.

Robson -- this is getting at the relocation strategy that we have been pursuing. Three stores, major relocations in last year. 10 teed up for this year. Just a couple of stats on the store, which continues to really exceed expectations. We increased square footage around 40%. And we're seeing a 75% increase in sales.

We have a few big relocations teed up for this year, second-half in particular. We're relocating our West Edmonton store, the most productive store in the Company. We're doubling the square footage of that store.

Our Union Square store here in New York -- relocating that to the Flatiron area, doubling the size of that store as well. Very productive stores that we've identified opportunities in these key markets to capture meaningful upside.

Branded community: we mentioned the SeaWheeze. This is a shot from that event -- again, over 10,000 participants from over 17 countries. A creative way for us to extend brand awareness in a manner that is consistent with our brand and our culture.

And international growth: so the Hong Kong IFC Mall store. So really exciting. This is a shot of the store. It's about 1,100 square feet. It's across the way from the Apple Store in this mall. We are on track to put up $8 million annually out of that store, $6,000 per square foot. We don't expect every store to be that productive. But it's exciting to see that kind of response.

Okay. Enough of that stuff -- let's get into the numbers. So this next slide, Q2 financial results: we just included this for reference. These are the numbers that you heard us report on the call last week. So I'm not going to plow through these.

Q2 gross margin: let's drill down here on what happened with gross margin in the Second Quarter. I'm going to start with sort of the bottom part of the slide here where you see markdowns, air freight, FX, buying costs. And occupancy and depreciation listed. All of these items more or less came in with where we expected they would when we gave guidance.

The element that was not in line with our guidance was the product margin. We mentioned these factors on the earnings call. There are really three sources of that miss. I'll start from the bottom. First, the about 20 basis points related to selling mix. So we put up a 31% comp in men's, as we mentioned.

Men's comes at a little lower gross margin than women's. That's a situation we expect will -- that gap will narrow over time as our men's business grows in volume. But nonetheless, don't feel terrible about that amount of pressure related to that outstanding result from our men's business.

About 35 basis points related to raw material liability actions. Every quarter we look at our fabric positions. We look at our development plans. And we identify the Second Quarter opportunity to clean up that relationship and identify it. It was appropriate to increase the accrual in the Second Quarter. I would not expect to see that increase in the accrual to occur normally going forward. So essentially that delta was what I would describe a one-time change related to where we saw our fabric positions in the Second Quarter -- again, more of a one-time item.

The cost variances and the port disruptions, the 55 basis points here -- this is a more frustrating part of the miss. In the First Quarter, as we were taking steps to mitigate the impact of the port slowdown, we were redirecting freight from one port to another, diverting freight from Los Angeles, to Seattle, to Vancouver, incurring additional costs to do that -- freight surcharges from our logistics providers. We also incurred costs to move freight between our distribution centers -- all as we were scrambling to get inventory to our stores to flow inventory to our guests.

So what happened was these are not typical surcharges that we typically incur in a given quarter. It was related to those actions that we took in response to the port slowdown. We did not appropriately estimate those in our landed costs. And so that was a miss in our forecasting efforts. That inventory that carries those related costs will be sold down for the most part into Q3. So will see this type of pressure that happened in Q2 related to the cost variances extend into the Third Quarter. We believe it will be immaterial by the Fourth Quarter. Those are the three areas that gave rise to the product margin miss.

We next want to give some time here just to walk through the guidance and how the third and Fourth Quarters connect to the Second Quarter results. And as we look at that product margin. And just as I mentioned, we expect a similar outcome as -- if we continue to outperform in men's, the selling mix will be with us, as well as what I mentioned with regard to the cost variances. So we are at this point expecting the product margin to delever similar to Q2 before we get past those cost variances. Into the Fourth Quarter we start to see a sequential improvement in product margins in that period.

Going down the page here: markdowns -- we expect to be similar in the Third Quarter and Fourth Quarter to what we saw in Q2.

Air freight: an important point here -- air freight will be an area of deleverage in the Third Quarter, although we expect it to improve sequentially. And by the Fourth Quarter we expect air freight to be an area that delivers leverage to our gross margins. This is the result of the work that we are in with regard to our supply chain planning, our go-to-market calendar. And just greater discipline in our supply chain processes.

Buying costs were flat in the Second Quarter. We expect that to be the case in Q3 and Q4.

FX, 70 basis points in the Second Quarter. We expect this to be an area of deleverage in Q3 and Q4. We expect it to be -- and this is based on the assumptions that we articulated on earnings call, where were rates are currently, assuming rates remain in that area, we'd be sequentially worse in the Third Quarter before improving in the Fourth Quarter.

Occupancy depreciation: so a big area of deleverage in the Second Quarter. We see that looking similar in the Third Quarter before having some sequential improvement in the Fourth Quarter. And in particular, the Fourth Quarter is just a function of a higher revenue base. We are better able to leverage our fixed costs in the Fourth Quarter in that area.

Margin outlook for 2016: and so we talked about the opportunities we have for margin inflection in 2016 -- an important part of the work we are in this year, extension of the efforts and investments last year. There's really four areas we expect to see improvements in the product margin.

And we've listed these in order of magnitude. Air freight, finished and raw material -- this is air freight to expedite raw materials into the production process and air freight to expedite finished goods out of the production process to our DCs. We have new disciplines, new controls, and a better synchronized calendar to enable that.

Improved costing: as we become a better partner to our vendors and have a more disciplined planning calendar, we'll be able to better commit to production schedules and be able to deliver improved costing. Raw material efficiencies: as we become more disciplined in how we -- in the development ratios that we have, we should be able to deliver the same development outcomes with less fabric required.

Then, lastly, logistics and distribution. So even within ocean and air freight, there are meaningful opportunities to optimize mode within those logistics channels. And then distribution within our own networks. So those were the elements of that product margin improvement -- the 300 basis points we've talked about.

In addition to that, it's important to understand that -- the other factors of gross margin and how we expect them to perform into next year. Foreign-exchange: a continued point of deleverage; again, just based on the assumption around where the rates are now continuing forward. Occupancy and depreciation: deleverage. But to a materially lower degree. So sequentially better picture from an occupancy and depreciation standpoint into next year. Then buying costs -- we expect to leverage our buying costs into next year.

Okay, inventory: so inventory at the end of Q2, up 55%. And that reflected the overhang that we had from the port slowdown, net of what we were able to clear in the Second Quarter; as well as early receipts, early Q3 receipts in the Second Quarter. And as we look forward into Q3 and Q4, we would expect inventories at the end of the Third Quarter to remain elevated. And I would expect that what you're seeing in the Second Quarter will be more or less the levels that we will expect to see at the end of the Third Quarter, before where able to work those down and have inventories better aligned with our sales trend at the end of the Fourth Quarter.

Markdowns as a % of sales: 30 basis points in the Second Quarter. We expect that to be similar as we, again, work through the exit strategies for the overhang that we had coming out of Q1 through the balance of the year.

Excess clearance movements: this just is intended to give you some details around the third of the 1.1 million of excess at the end of Q1 -- the 400,000 units. How are we moving through that over the course of the year? We cleared 170,000 units in Q2. We have 100,000 units planned for Q3 and 130,000 planned for Q4.

We did an online warehouse sale in Q2. And we have physical warehouse sales planned -- one in Q3 and one in Q4. This is not a change in our strategy for how we leverage warehouse sales. We have done two physical warehouse sales in a year previously. And we've obviously done online warehouse sales as well. So it's not unusual to see this combination of strategies with regard to our exit channels.

Then we've included the quarterly -- the Third Quarter guidance and the updated annual guidance here just for reference. No new news here; this is what we had disclosed on the call last week. And those are the prepared remarks.

Jim Duffy {BIO 6065587 <GO>}

Great. Thanks for that. I think that was a good idea to address some of the concerns head-on deliberately in the slides.

One question that didn't come out of the slides from my perspective, however -- and recognizing you've got some moving parts -- what's the net effect to the gross margin of each of the different variables that you itemized in 2016, assuming FX rates stay the same? Is it your expectation you can make forward progress on the gross margins in 2016?

Stuart Haselden {BIO 17615686 <GO>}

Absolutely. So the benefits that I outlined -- those four buckets are the manner in which we will deliver the 300 basis points of improvement in product margin versus 2014; important to note that is pre-FX. So we'll look at what the FX offset to that is as we set our plans for 2016. We gave an indication of where we saw that being a continued point of deleverage or a continued area of deleverage.

Then you'll have leverage on buying costs; you'll have a moderation in the degree of deleverage from buying and occupancy. And FX was the other -- the key element.

Jim Duffy {BIO 6065587 <GO>}

Okay. And obviously, one of the key variables in deleverage of buying. And occupancy and depreciation. And so forth is comp. What type of comp would you need to see leverage of those line items in 2016?

Stuart Haselden {BIO 17615686 <GO>}

I think on a store comp basis, we'd look at high single digits into next year to be able to leverage that amount of occupancy and depreciation.

Jim Duffy {BIO 6065587 <GO>}

One more question for me. And then I'll turn it over to the audience. Generally speaking with lululemon, demand has not been an issue. But there have been challenges matching what's in supply with what's in demand. As the business becomes more global, men's grows as a component of the mix; what should give us confidence that you can better address that challenge?

Stuart Haselden {BIO 17615686 <GO>}

You're talking just in terms of the consistency in the sales results?

Jim Duffy {BIO 6065587 <GO>}

Not so much consistency of the sales results. But matching what you have in inventory with what's actually in demand. And comp store levels with inventory per square foot levels?

Stuart Haselden {BIO 17615686 <GO>}

Right. You know, Q2 was the first point in probably two years that the Company had seasonally appropriate inventory in an adequate degree -- obviously, more than adequate Second Quarter. And what you saw was an acceleration in our revenues across all our channels, stores and e-commerce.

If you look historically, when the Company has had builds in inventory, it's been correlated pretty strongly with improvements in sales trends. So what that tells me is the products that we are developing and bringing to market are in demand. And our merchants are working to have the right assortments that brings to life the work that our design team is doing in bringing that innovation to market.

So when we have the right inventory in the stores, our guests are telling us that they like it. And they are responding. And that was reflected in our top-line results.

Jim Duffy {BIO 6065587 <GO>}

Great. Any questions from the audience? Yes. In the back?

Questions And Answers

Q - Unidentified Participant

(inaudible – audience question)

A - Jim Duffy {BIO 6065587 <GO>}

For the benefit of people on the webcast, the question relates to raw material supply and ability to secure adequate quantities.

A - Stuart Haselden {BIO 17615686 <GO>}

I believe we have strong vendor relations, particularly in Taiwan, to support our fabric needs. What we've been talking about with regard to efficiencies in fabric relates more to us and a more disciplined process, where we can have improved development ratios, where we will be able to eliminate waste in the degree of fabric that we have historically required to deliver X amount of product.

So those are the efficiencies that we're in the work of. That's a different question from, I think, what you are getting at in terms of are we confident in our vendor base from a raw material standpoint. I would tell you we are. I think our relationships with those fabric producers are stronger than they ever have been. And we enjoy, I think, a position, given the scale of our business, that -- we don't have concerns, I guess, to be more direct, around the availability of those raw materials. It's more about our process becoming more disciplined.

Q - Unidentified Participant

(inaudible – audience question)

A - Stuart Haselden {BIO 17615686 <GO>}

You know, there's -- the efficiencies are more as we have grown as a company from what was a very entrepreneurial company that grew very rapidly. We have reached a point where if we were to accomplish that $4 billion revenue mark that we talked about in the beginning, we need a different supply chain. We need a more sophisticated, resilient, capable supply chain that can support that level of growth. Along with that investment in building that capability should come greater efficiencies from where we had been up to this point.

Q - Unidentified Participant

Just a clarifying question. You said you needed a high single-digit store comp to lever occupancy next year. And you're guiding to deleverage. So in terms of getting the 300 basis points, do you need something less than high single digits. Correct?

A - Stuart Haselden {BIO 17615686 <GO>}

Right. So I think the guidance we've given is for this year. So we're talking about next year.

And so the occupancy picture moderates into next year. And so the sales levels needed to accomplish that are different. And I was speaking to store comp specifically; it would be a different equation when you layer in the e-commerce to get to total revenues and non-comp volumes.

Q - Unidentified Participant

Great. So I think you said -- in answer just to Jim's question -- was a high single-digit comp for next year.

A - Stuart Haselden {BIO 17615686 <GO>}

We're talking about occupancy into next year -- where do we leverage in 2016. And my response --.

Q - Unidentified Participant

I guess the question is simply to get the 300 basis points is -- you assumed what comped back up?

A - Stuart Haselden {BIO 17615686 <GO>}

It's a mid to single -- mid single-digit comp assumption for next year.

Q - Unidentified Participant

I had a question; you may have covered this before. And I apologize. Just in terms of the inventories being up 50%, if I remember, they were -- how did they get that high? Is it a systems breakdown? Is it a procedural breakdown? How does that happen? And maybe you have addressed the guidance conflict. But it just -- for a company that's been around this long, it seems strange.

A - Jim Duffy {BIO 6065587 <GO>}

The question relates to the Q2 ending inventory balances.

A - Stuart Haselden {BIO 17615686 <GO>}

Right. So if you look at where we ended inventories in Q2, we entered Q2 from Q1 with about $30 million of excess inventory related to the port issues. We sold down $4 million to $5 million of that in exit activities in the Second Quarter. Additionally, we had about $18 million of early Q3 receipts that landed in Q2.

So you have got to net those elements down to get to what was the underlying trend in inventory. It was high -- higher than our forward sales trend. But closer. And you also have to look at the fact that -- and we have mentioned this previously -- the build in inventories in 2014 was essentially zero. So you have to look at a two-year relationship of sales to inventory growth to see the underlying trend of that inventory to sales relationship in 2015. So when you do that, it normalizes that picture.

A - Jim Duffy {BIO 6065587 <GO>}

Maybe time for one more question. Nancy?

Q - Unidentified Participant

Thanks, Jim. Certainly over the last year you've talked a lot about a litany of investments the Company wants to make across product, supply chain. And store base, what have you. In terms of the store base internationally, can you give us a little bit more of a sense on the strategy that you're taking in really high-cost markets like Europe? Clustering of stores versus big flagships? Because generally speaking, as you focus a lot more of your investment and you look for growth for the Company to come from those markets, elaborate on that and balance that against the risk/reward of the strategy you've chosen against a potential more moderate creating of same-store sales growth here in the US and in Canada.

A - Jim Duffy {BIO 6065587 <GO>}

So the best way to paraphrase that I think is a risk/reward assessment in terms of capital allocation for growth, particularly in international markets.

A - Stuart Haselden {BIO 17615686 <GO>}

Sure. So as we look at the strategy for international, it's focused on two geographies: Western Europe and Asia, with an owned strategy. What I mean by that -- we're going to enter those markets owning and operating each of those store locations. We believe that will ensure the greatest likelihood of success in terms of how the brand will be introduced to those markets. It will also offer us the strongest economics in terms of our control in ownership and not splitting profits with a third-party partner, for example.

So those are key elements of the strategy. Then as you get into which markets do we enter, in what sequence and what approach, it's essentially a capital city strategy, where we are looking to build stores that, again, will are % the brand; be beacons for the brand in those key markets; that will drive brand awareness in a way that fits with our brands.

So in Asia we're talking about, obviously, Singapore, Hong Kong, Seoul, Tokyo, Shanghai, Taipei, Kuala Lumpur. Those are those capital cities that -- we'll have a collection of stores in each of those. And the number of stores in each market will be determined by the demand that we measure and the potential that we measure in each of those markets.

We've been very encouraged by the initial stores that we've opened. Same strategy for Europe. Similar or a different set of capital cities, obviously. But again, it's looking to reach some level of density within those key cities, where we will build stores that will be emblematic of the brand and drive brand awareness regionally.

And from there we'll determine the timing and sequence of how to penetrate beyond those capital cities over a longer time frame. So as we've mentioned, we believe this strategy should deliver breakeven economics in 2017 so that we can drive earnings growth for the overall -- in the years 2018/2019 and beyond.

So we're making investments in the management teams, in the marketing and supply chains to enable the entry into these markets. We'll need to reach a certain scale. We estimate that will happen in 2017 to be able to fully leverage those investments.

Q - Unidentified Participant

How many showrooms do you have in those capital cities in the world?

A - Stuart Haselden {BIO 17615686 <GO>}

We have 17 total showrooms internationally. And I think they are broken out in the remarks that we had in our earnings call.

A - Jim Duffy {BIO 6065587 <GO>}

So that's all the time we have for today. My thanks to lululemon, Chris and Stuart, for being with us. Thanks for the clarification and thanks for your perspective, guys.

A - Stuart Haselden {BIO 17615686 <GO>}

Thanks, Jim.

A - Jim Duffy {BIO 6065587 <GO>}

Thank you.