William Blair Growth Stock Conference

Company Participants

- Patrick J. Guido, CFO
- Stuart C. Haselden, COO

Other Participants

- Sharon Zackfia, Partner & Group Head of Consumer, William Blair & Company L.L.C., Research Division

Presentation

Sharon Zackfia {BIO 4804954 <GO>}

Pleased to have with us today from lululemon, Stuart Haselden, COO; and PJ Guido, CFO.

With a limited number of highly productive stores across the globe generating sales of roughly $1,550 per square foot, a rapidly growing e-commerce business and nearly 100% proprietary products, we believe lululemon is a retailer built for the 21st century with full control over its product line and little potential disintermediation from channel disruption.

This control over its own destiny is apparent in management's 5-year plan to double revenue and more than double earnings by 2020 as well as its phenomenal sales momentum. For those of you who weren't paying attention, they just comped 19% in the First Quarter.

There will be a video. And then, Stuart will come up to the podium. But before the video plays, I need to tell you, there is a complete list of research disclosures and potential conflicts of interest at williamblair.com.

(presentation)

Stuart C. Haselden {BIO 17615686 <GO>}

Okay. Thank you, Sharon. It's good to be here. All right, now ready. And it's good to be here, in particular, with our new CFO, PJ Guido. So you'll hear from PJ here in a few minutes. But I thought we'd start with just a discussion of our strategies. And an update on the progress we've made in the First Quarter. So forward-looking statement, nice job, Howard.

2020 vision. So in the beginning of 2016, we set out a bold plan, as Sharon mentioned, to double our revenues and more than double our earnings. So we're very pleased with the progress we made against that plan. You see here listed the 4 primary growth drivers that are helping us achieve the trajectory that we'll deliver, about $4 billion in revenue. While there is still a lot of work to be done across these areas, we're very pleased with the progress that we're making in each of them.

I'm going to drill into each of these areas a little bit today. Starting with North America. Very strong First Quarter, 6% store comp in the quarter, really driven by strong store traffic. We've seen an accelerating trend in store traffic over the last several quarters. This is the Second Quarter where we had positive store traffic overall. And we're excited to see this trend continuing into the Second Quarter and even accelerating.

So this is, I think, a reflection of the health of our business and our guest engagement strategies in general. And again, really pleased with the success we're seeing here.

As we step back from just the results in the First Quarter and look more broadly at our store strategy in North America, really happy and really inspired by the innovation that our North American team has delivered. And so we now have a number of store formats that didn't exist several years ago. And so the co-located format that you heard us talk about, if you follow the company, is an important growth driver for square footage in our most productive stores.

We've also had success with a small format concept that we call the local, that is enabling us to enter markets that we wouldn't otherwise look to open our normal format store. And most recently, the exciting innovation with regard to our seasonal store. So we opened 24 seasonal stores in the Fourth Quarter. They accounted for $20 million of revenue in the Fourth Quarter. We kept 9 of them open into the First Quarter based on the strength in their performance and we're looking to convert those now to permanent stores. So a great new way that the team has developed to derisk market entry and capture demand that we otherwise wouldn't. So really pleased with the trajectory and the punchline on those. The innovation is that we're able to now extend the square footage growth runway in North America for our store business from where we had contemplated just a few years ago. And that's part of the double-digit square footage growth outlook that we have for next several years within our store business. You see here a couple of photos, 2 of our experiential stores, Queen Street in Toronto and our new store in New York on 5th Avenue.

There's some exciting innovation the team's also developing in this regard. I would encourage you the next time you're in Toronto, to visit the Queen Street store. It now incorporates a community space as well as dedicated studio space. And this is helping us change the trajectory in a very dramatic way of traffic and engagement in that community as a result of those aspects of the store. So very exciting.

Digital. So this has been a big part of the story over the last few quarters, going back to last year. So First Quarter, we posted a 60% increase in digital sales, really driven by strong traffic and conversion. We are having success with our digital marketing efforts in driving higher levels of engagement and traffic to our site. And as the guests are arriving at our site, they're having a better experience. And we're converting at a higher rate.

This is -- this reflects also the -- all the work that went on last year into the -- into improving the website that culminated in the relaunch of the website at the end of the Third Quarter. We saw the 40% comp in the Fourth Quarter accelerate into the First Quarter, as you see here. The work is not done. There are still a number of things that we're working on for this year. The 3 that you see listed here, checkout, search and personalization, are areas that we're working on, driving further improvements in conversion this year. We will have our efforts in these areas completed largely by the Third Quarter of this year.

So moving on to men. So this has been an exciting part of the product story. It's -- we've seen a higher growth rate in men's. We have set a target for 2020 to have a $1 billion men's business. And we're pleased to be ahead of schedule in achieving that level of growth. The men's business is a deep opportunity strategically for us to grow our business. I'm very happy with the performance and the progress we made in the First Quarter. A few stats you see here, or a few headlines. 26% growth in men's comp in the First Quarter. And it really came in a very balanced way across the entire portfolio. So we saw double-digit comp increases in every major category within men's.

You see a couple of the major -- the hits, if you will, from a products standpoint, listed. I would add to this, our ABC franchise continues to perform really well and be an important entry point for a lot of new guests.

The -- this -- the new styles that we introduced last year in the Third Quarter continue to perform well. We won't comp those -- that introduction of those new styles until later in the Third Quarter this year.

The -- I would say, also a headline for us, as we look into the second half of the year, is outerwear. We're very excited about new styles, broader assortment, solving new functional problems from an outerwear standpoint. So that will be something to watch for.

We've also had a big focus within men's on just driving awareness and consideration. We still see our men's business as a bit of a secret, broadly speaking, with our guests -- with our target guests. So we've had a big focus on driving increased levels of engagement and leveraging new strategies from a brand marketing standpoint. You see here a couple of screenshots from a film that we did with Mark Healey, one of our Elite ambassadors. This was particularly successful in the First Quarter. We had over 5.3 million views of this film across our social media outlets against the plan of 4 million. So again, just an example of how we're innovating our business model.

International. So really exciting to see the growth, both in Asia and Europe. As I mentioned on our earnings call, if you'd listened to that, while we're excited about the growth in our international markets. This is an area that will likely take us a little bit longer to achieve the original goals that we've put out for 2020. Nonetheless, we're seeing very robust growth, particularly in Asia. You see a couple of stats listed here for the First Quarter, 53% overall international growth and over 100% growth in China -- I'm sorry, in Asia and the -- with the majority of the growth, as we look forward, in Asia coming from China.

So while we're excited about international and we're seeing very exciting growth rates in Asia, we're still pleased with the progress that we're making in Europe, even though slower than the original schedule that we had drawn up. We did comment on the call that we saw double-digit comps in Europe in the First Quarter ahead of budget. And so that's just another indication of the health of that business and the progress that we're making to take it forward. So look forward to seeing that momentum continue into the balance of the year.

Then finally, supply chain. This has been a big enabler for our business over the last three years, as we emerge from some of the problems that we had a few years ago. We now have a much more stable infrastructure on which to grow our business globally. These were important investments that we made, that not only enabled our growth. But also enabled the margin recovery -- the product margin recovery specifically that we have seen and continue to enjoy. As we have accomplished a lot with our supply chain, the next chapters of that story will focus on speed and improving the flexibility within our supply chain to deliver goods faster to market. So that -- there's a number of strategies that we're pursuing now to -- along those lines and those goals that we'll talk more about in the coming quarters.

Segmented supply chain is really the essence of how we have been able to drive efficiencies in our cost structure. So there you'll see continued success in driving down AUCs and product margin improvements as we've talked about into the future. Connected to both of those is a new partnership with Mas, one of our largest and most important suppliers from Sri Lanka, Mas have built a factory in Haiti, that now produces a meaningful amount of our seamless styles. And so that does a number of things for us in terms of shortening shipping times as well as improving our cost structure. So that's an important innovation, if you will, in the footprint -- the geographic footprint of our production network.

Then lastly, from a -- further down the supply chain into our distribution network in North America, we have an exciting project that we've launched to improve delivery times and cost, primarily for our e-commerce business. We'll be building a new DC in the Toronto area that will help us achieve those improvements for our East Coast guests. And that will be benefits that we'll begin to realize into next year and the following years. So those are just some of the headlines of the progress that we made against our key strategies so far in 2018. We're excited in terms of what's in front of us for the balance of the year and even beyond that, as we look to 2020 in achieving the goals that we've spoken about and moving beyond that.

So with that, I'm going to turn it over to PJ to take us through some of the financial headlines of the quarter.

Patrick J. Guido {BIO 20577804 <GO>}

All right. Thank you, Stuart. So I'd like to start by doing a quick financial diagnostic on the health of the lulu brand. For all (inaudible), if we're going to promote healthy lifestyle for our guests, we should be promoting and protecting the health of our own brand.

So these are -- look at these key financial metrics. These are metrics that you all track. It really supports the case for lulu as one of the healthier and stronger brands in retail today.

So Stuart mentioned the comp, 19%. I'd like to just quickly drill into the deep -- the brick-and-mortar comp of 6%. So our stores are our window to the world and still represent 75% of our revenue. So the fact that we did a 6% comp shows that our guests are willing to bypass convenience in order to physically interact with the brand. And that's meaningful. And as you know, our approach is based on community, where our guest educators, our ambassadors, our guests are all interconnected in the community. And it's a hard thing to replicate and something that we view as a competitive advantage.

So in regards to traffic, we see a brand that is inviting and relevant. In regards to conversion and new guest acquisition, that tells us that we are true to our mission of solving problems for our guests. And we also have very low return rates, which, again, speaks to the quality of the product and us, again, giving our guests what they want.

Lastly, I'll -- I would just focus on the gross margin, which is a great story. On both sides of the gross margin, on one hand, we are improving -- we -- our mix is favorable, which drives up the gross margin. But also lower markdowns are driving an improvement in gross margin.

On the other side of gross margin, we are seeing leverage on fixed costs but as well as product cost. So I'll just quickly go through this.

The top line was up 25% in Q1. We improved the gross margin by 270 basis points. The SG&A rate was leveraged by 130 basis points.

Operating margin plus 400 basis points. And EPS up 72% at $0.55. So strong results there.

As the new CFO, I've got to be honest. It's comforting to know that we have a very strong financial position. We have -- with operating margins approaching 20% and cash flow surpassing $0.5 billion, we have the financial resources to support our pillars of growth that Stuart talked about.

Our inventory is well balanced. We're very low-aged inventory with the right mix of core and seasonal product to meet robust demands. We have minimal debt on the balance sheet, which gives us additional financial resources and access to capital. As the retail consumer evolves, we need to evolve with the consumer. And many retailers will be faced with buy versus build versus partner decisions over the coming years. And it's comforting to know that we have the resources to evaluate and engage on all of those things.

And lastly, I would just mention that we are active. For right now, we do find ourselves in a position where we have excess cash. And we are actively returning it to shareholders. We recently upped our share authorization to $600 million. One of our largest shareholders, Advent, did monetize part of their position. We participated in that trade, repurchasing $400 million of stock or 3.3 million shares. So we are -- and we still have a remaining $200 million of authorization there.

So I'll close by just reiterating our guidance. We're calling for high single-digit comps in Q2, EPS of $0.46 or $0.48. And for the year, again, high single-digit comps with $3.10 to $3.18 EPS. This does not include the recent share repurchase, which we forecast to be approximately $0.03 accretive as well for the year.

And with that, thank you for attending. And we appreciate your interest in the lulu brand.

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