Lululemon Athletica (Nasdaq: LULU) – Long

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VALUATION UPDATED FOR MOST RECENT QUARTERLY PERFORMANCE

NOTE PRICE TARGET IS FOR YEAR END 2015

Investment Thesis:
I believe Lululemon Athletica is undervalued at its current price most likely due to lack of confidence in the company after several mishaps in 2013. It's been about a year since 15-20% of the company's trademark yoga pants were recalled due to the product being too sheer. The company is also several months past a PR nightmare in which the chairman and founder Chip Wilson made some negative comments. With the company now moving through these "growing pains" combined with a new CEO and other executive management, LULU shares could trade up significantly over the next 24 months and beyond.

Company Description:
Lululemon Athletica is a designer and retailer of high-end athletic apparel. The company is best known for its yoga-inspired apparel, especially yoga pants, but they also sell athletic shirts and shorts, jackets, and other outerwear for activities such as yoga, running, general fitness, and dance amongst others. Adult women represent a large majority of the customer base of the company, although LULU continues to broaden its portfolio of products to appeal to male athletes and athletic female youths. As of December 12, 2013 the company operated 247 stores located primarily in the US, Canada, Australia and New Zealand. The company has 63 showrooms in the same countries along with five in Asia and seven in Europe. The company also has a direct to consumer channel through www.lululemon.com. The company is based in Vancouver, British Columbia and the fiscal year ends on the Sunday closest to January 31 of the following year.

Strengths:
Premium active brand - The company is associated with high-quality premium athletic apparel as some items such as yoga pants and men's athletic shorts sell for $98 and $72 respectively.

Distinctive retail experience - Stores are located in specific locations as to position them to be an integral part of their communities. Each store is unique as the layout is designed by the employees that work at that location.

Innovative design process - High-quality premium apparel is a function of a feedback-based design process which seeks input from customers and local fitness practitioners. The company is also working more closely than ever with its third-party suppliers after the sheer pants mishap of 2013. Products usually take eight to ten months to go from design to market, but the company's vertical retail strategy allows select products to be brought to market in two months.

Community-based marketing approach - The company differentiates itself by building brand awareness and customer loyalty through a community-based marketing approach. Not only does the company have a large social media presence, but it also hosts community events and creates in-store community boards that provide customers with local activities to participate in.

Solid fundamentals - Despite mishaps in 2013, the company continues to grow revenues, albeit a slower pace than previous years. The company's balance sheet is also stronger than ever with tons of cash to reinvest back into the business.

Weaknesses:
Despite sales that continue to grow, gross margins and ebitda margins peaked in 2012.
Although it's been a year since sheer pants were recalled, customers will now think twice before they drop $100 on yoga pants.

The stock price is down some 34.5% since 12/31/2012 while the market is up some 33.1%. This could leave a sour taste in some investors' mouths, which will make them reluctant to get back into the stock until progress is seen.

The company recently reduced 4Q13 guidance at the beginning of January citing a slowdown in traffic. If one looks at a map of store locations they will see that a significant number of stores are in the Midwest, East, and North East. I believe this slowdown was due more to inclement weather than a loss in interest in the LULU brand.

Opportunities:
International expansion - The company continues to open new stores in Canada, Australia and New Zealand. Showrooms continue to be built in Europe and Asia to build brand awareness with new stores to follow.

Brand development - The company has been around since 1998, but the brand has really only gained steam since 2006-2007. I would still call this a relatively young company, with much to gain and not much more to lose. The company will continue to increase brand awareness through its grassroots marketing efforts, social media, and store expansion.

North America expansion - The company's long term goal is to have some 350 stores in North America and at the end of fiscal 2012 the company operated 186 stores in North America. Most of the near-term store growth will remain in North America.

Develop DTC Channel - E-commerce platform went live in 1Q09, so this is also a relatively new channel for the company. As they grow over time this will become a larger chunk of sales which will help margins grow as well.

New and more appealing products - The company continues to focus on new technologies and expanding product categories to increase the size of their target markets. I view LULU today as UA 5-6 years ago.

Negative stock sentiment - Street estimates and price targets continue to come down before earnings this Thursday. Combined with the fact that short interest as a percentage of total float is some 20-21%, I believe the worst is priced into the stock. If it gets much worse, I believe the company will become an attractive buyout candidate.

Threats:
Obviously as an athletic apparel company LULU faces significant competition. On top of that, the company is a premium retailer so a lot of competitive products are being offered at much lower price points. Finally, the company is up against far bigger companies with much more operational experience and deeper pockets such as NKE, UA, Adidas, amongst others.

As the company expands internationally earnings could become more volatile as FX rates change.

Since the company is geared toward a higher-end consumer any stock price or house price volatility could affect consumer net worth, which could lead to less discretionary spending and would be a risk to LULU.

Valuation (Updated 3/27/14):
LULU currently trades at roughly 23.6x my forecasted 2015 deps and roughly 12.94x my forecasted 2015 ebitda. On the company's 4Q13 and fiscal 2013 conference call management noted that 2014 will be an investment year where the company will invest in its supply chain and expand internationally. My new estimates reflect increased spending due to these comments and I have also updated my model to accompany 2014 guidance. While I realize there is only some 21-22% upside between current prices and my 2015 YE estimate I believe my estimates are conservative as I derived my price target from an average of my P/E estimate and my EV/EBITDA estimate (25x 2016 deps of $2.55 and 17x 2016 ebitda). If the company executes on its supply chain and international initiatives and/or sales are better than expected the stock could be rewarded with higher multiples. I believe there is a strong likelihood of this happening as I am impressed with new management's prior successful endeavors. Simply put, if you don't believe in the brand and the growth of the brand over the next several years then this stock is not for you.

Catalysts:
New management - Laurent Potdevin took over as the company's new CEO on January 20, 2014. Previously Mr. Potdevin worked as the President of Toms Shoes, was the CEO of Burton Snowboards, and was also an executive at LVMH. Along with a new CEO, the company hired a new Chief Product Officer in Tara Poseley. Prior to joining LULU, Ms. Poseley held positions at Kmart Apparel, Bebe Sport, The Disney Store, Design Within Research and Gap Inc. Finally, the company also recently hired Felix Del Toro as SVP and head of Men's and Jennifer Battersby as SVP of Sourcing, Quality, and Communications.

The company will announce 4Q13 earnings BMO on March 27, 2014. Current consensus (estimize) sees Revenues of $516.15MM (up 6.3% yoy) and Earnings of $0.72 (down 4% yoy).

Analyst Day is April 17, 2014. This will be the first analyst day with the company's new management team. I believe the company will reaffirm its targets of 55% gross margins and 25% operating margins.

I believe if the stock trades significantly lower ($40 or below) over the coming year, the company will be bought out by a larger brand developer such as VF Corporation.

Closing Thoughts:
It's obviously not going to be easy for the company to turn around in a quarter or two, but with previously successful new management, solid fundamentals and the worst being priced into the stock with a short interest of some 20-21%, I believe LULU represents a solid opportunity for anyone that wants to take advantage of a young and growing athletic-lifestyle brand. Unless one thinks the company is absolutely going to fall apart I would recommend buying the stock ahead of earnings. I recognize the multiple could remain compressed relative to history and peers, but as the company executes over time I believe they will be rewarded with a higher valuation.

****FEEDBACK IS ENCOURAGED****

Sources: Company Annual Reports, lululemon.com, proprietary research