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# EDITED TRANSCRIPT

LULU - Q4 2014 Lululemon Athletica Inc Earnings Call

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## OVERVIEW:

LULU reported FY14 net revenues of \$1.8b and net income of \$239m or \$1.66 per diluted share. 4Q14 net revenues were \$602.5m and net income was \$110.9m or \$0.78 per diluted share. Expects FY15 revenues to be \$1.97-2.02b and diluted EPS to be \$1.85-1.90. Expects 1Q15 revenues to be \$413-418m and diluted EPS to be \$0.31-0.33.



## CORPORATE PARTICIPANTS

**Chris Tham** *lululemon athletica inc. - SVP, Finance*

**Laurent Potdevin** *lululemon atheltica inc. - CEO*

**Stuart Haselden** *lululemon athletica inc. - CFO*

**Tara Poseley** *lululemon athletica inc. - Chief Product Officer*

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**Matt McClintock** *Barclays Capital - Analyst*

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## PRESENTATION

### Operator

Good day, ladies and gentlemen and welcome to lululemon's fourth-quarter and full-year 2014 earnings conference call. At this time, all participants are in a listen-only mode. Later, we will conduct a question-and-answer session and instructions will be given at that time. (Operator Instructions). As a reminder, this conference call is being recorded. At this time, I would like to hand the conference over to Mr. Chris Tham, Senior Vice President of Finance. Sir, you may begin.

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### Chris Tham - *lululemon athletica inc. - SVP, Finance*

Thank you and good morning. Welcome to lululemon's fourth-quarter and full-year 2014 earnings conference call. Joining me today to talk about our results are Laurent Potdevin, CEO and Stuart Haselden, CFO, along with Tara Poseley, our Chief Product Officer, who will be available during the Q&A portion of the call.

Before we get started today, I'd like to take this opportunity to remind you that our remarks today will include forward-looking statements reflecting management's current forecasts of certain aspects of the Company's future. These statements are based on current information, which we have assessed, but which by their nature is dynamic and subject to rapid and even abrupt changes.

Actual results may differ materially from those contained in or implied by these forward-looking statements due to risks and uncertainties associated with the Company's business. Factors that could cause these results to differ materially are set forth in the Company's filings with the SEC, including our Annual Report on Form 10-K and our Quarterly Reports on Form 10-Q. Any forward-looking statements that we make on this call are based on assumptions as of today and we undertake no obligation to update these statements as a result of new information or future events.

During this call, we will present both GAAP and non-GAAP financial measures. A reconciliation of GAAP to non-GAAP measures is included in today's earnings press release. The press release and accompanying Annual Report on Form 10-K are available under the Investors section of our website at [www.lululemon.com](http://www.lululemon.com).



Today's call is scheduled for one hour, so please limit yourself to one question at a time to give others the opportunity to have their questions addressed. And now I would like to turn the call over to Laurent.

**Laurent Potdevin** - *lululemon atheltica inc.* - CEO

Thanks, Chris and good morning, everyone. I am pleased to welcome Stuart on his first earnings call as lululemon's CFO. All of us at lululemon are thrilled to have him on our team and I look forward to working together as we drive long-term sustainable and profitable global growth.

Today, I will provide a brief overview of our fourth quarter and full fiscal year of 2014 results, as well as give you an update on our key initiatives in 2015. Stuart will then walk you through our financials in more detail and outline our guidance. After our remarks, we will open the call to your questions.

I am pleased with our fourth-quarter performance, which concluded a year of solid progress towards our longer-term goals. We continue to see building momentum as reflected by the sequential acceleration of our top-line results. Specifically, we delivered combined comparable sales growth of 8% in the fourth quarter versus 3% in the third quarter. We saw positive global comps for our stores business for the first time this year, along with a double-digit increase in our e-commerce business.

Our women's business momentum continued to build with positive comps in the quarter and most exciting is the high teens comp we delivered in the bottoms category as we capitalized on new silhouettes, along with expanded styles and colors. Additionally, we saw strong results in both our men's and ivivva businesses with 16% and 51% comps respectively.

With men's, we saw continued success with our pant category anchored by the popularity of our core ABC pant and a great guest response to technical tops such as Rulu fabrics and seamless construction. Ivivva's color and texture mix drove sales across multiple styles and categories. And for the 2014 fiscal year, our revenues reached \$1.8 billion, increasing 13% over last year.

So looking to our accomplishments in the fourth quarter and 2014 as a whole, you will recall that we established three key goals at the beginning of the year -- first, to strengthen the business foundation; second, to reignite our product engine; and third, to accelerate our global expansion.

In regards to our foundational investments, we substantially built out our management team with deep experience in critical areas. We strengthened our supply chain with talent, current key technology investments and new processes to improve our ability to consistently deliver high-quality products on time while scaling the business.

We opened a third distribution center in Columbus, Ohio that will extend our distribution capacity for Europe and cut in half the shipping times to our guests and stores in the eastern United States. And we successfully launched our mobile shopping app with over 367 thousand downloads in 2014. And maybe even more relevant, an activation rate of 76%, which ended up representing approximately 8% of our online sales in Q4. In addition, we continued to leverage our backbackroom app to process sales in store from our online inventory, which in Q4 represented approximately 6% of online sales.

We did reignite our product engine through the following actions -- building on our design talent to mobilize us as a truly design-led organization and driving faster leadtimes in our white space innovation pipeline; continuing to leverage our ambassadors who play a very key role in the design, development and testing process to deliver functional performance and innovation; revamping our go-to-market planning calendar to synchronize design, merchandising and sourcing around three distinct product cadences -- one, core; two, seasonal; and three, fast turn. All of them to achieve more compelling assortment with a higher degree of flexibility and higher speed to market. And we leverage this new go-to-market calendar to harmonize with our brand and community implementing strategy as we introduce exciting new products throughout the year. This allows us to better synchronize product education with our store educators and global ambassadors, along with the ability to create compelling stories that inspire and inform our guests.

As an example, we recently had great success with the introduction of the "If You're Lucky" technical yoga collection in Q1. Our guests responded very strongly to our storytelling, as well as the great performing feminine technical product that featured mesh panels, cutouts and beautiful prints.



And our men's business continues to perform extremely well with a continued momentum that supports this key element of our growth strategy driven by our "Sweat" line, which encompasses most of the new fabrics and silhouettes.

And lastly, in regards to our international growth and future goals, we now have two stores open in London, our first Asian store in Singapore and a Middle East partner announced to open our first store in Dubai this fall. As we grow in new markets, we see growing demand for our strong brand. We are on track to expand our global footprint and believe our international business could match and ultimately exceed our overall North American revenues over the long term.

While we continue to see a strengthening of our guest engagement and continued loyalty, there are a couple of discrete external factors that have weighted on results in the early part of the current quarter; thus impacting our 2015 guidance, namely the challenging weather that we've all seen on the East Coast this year and also the extension of the West Coast port delays into Q1.

On the latter point, we are seeing the risk that we identified for Q4 now materializing more than originally anticipated into the initial weeks of Q1. So while these delays proved not to be material in Q4, we are now seeing a more meaningful impact. Stuart will provide more details on these factors in his comments.

We are confident that the fundamentals of our business remain healthy as our momentum continues to build. As we move forward into 2015, we remain true to the core values that have made the lululemon brand unique and powerful, an uncompromised commitment to relentless innovation, best-in-class guest experience, exceptional quality and a vertical model that provides full control. We are also dedicated to managing our business for the long term and as such, 2015 will be a key year of investment reflecting this commitment.

We are a growth company and our vision for growing the business over the long term focuses on extending our brand operating model over genders, categories and geographies to fully unlock the potential for strong and sustainable growth. We've talked about the elements of our brand operating model over the last year, which include our product, our guest experience and our brand and community. This year, as we have said, we plan to strategically invest in these key areas to fuel the accelerated earnings growth in 2016 and beyond.

For product, this investment will include a continued focus on innovation through the expansion of our Whitespace program here at our corporate offices, as well as our regional design labs. Our product pipeline consists of innovative fabrics and technologies that, when married with intelligent striking design, solves a functional problem for the athlete.

Fast Turn is another key capability that allows us to shorten leadtimes in order to bring innovation quickly to market. By leveraging our cross-functional expertise in design, merchandising and sourcing, we expect fast turn will deliver a meaningful portion of our assortment while allowing us to read and capitalize on emerging trends.

More specifically with our women's product, in Q2, you will see a significant evolution of our tanks with an emphasis on support and beauty and in Q3, we are very excited to bring to life our complete new pant reassortment, which will encompass both fabric and silhouette innovation.

Our men's product continues to be focused on function and versatility while expanding the product offering and creating new technical fabric solutions. We remain driven to solve the athlete's training and sport-specific needs in the ongoing development of our "Sweat" assortment.

As far as guest experience, we continue to invest in initiatives that allow us to create a more personalized and integrated experience with our guests. And while we have always done an outstanding job building strong relationships with our guest in stores, we are in the process of seamlessly connecting this across all guest touchpoints.

To create this capability, we will continue to make key omnichannel investments to leveraging state of the art technology, our global website redesign plan for later this year and the completion of our RFID implementation, which was originally successfully piloted in 2014. Collectively, this will allow us to have dramatically improved visibility in our on-hand inventory, a deeper knowledge of our guests, which in turn allows us to build a more intimate experience whenever, wherever and however our guest engages with us.



We continue to see significant demand across all geographies. From a store standpoint, we believe our long-term goal of 350 stores in North America will allow us to have the right footprint without oversaturation. In addition to our established showroom model, we are innovating and investing in different store formats that will vary in size and assortment. It is critical to note that we expect these alternative store formats to achieve a comparable level of four-wall profitability compared to the rest of our fleet after initial ramp-up is completed.

And lastly, in brand and community, we will build programs to foster and extend the culture that has made lululemon so unique. To this end, in Q2, we plan to launch a 17 city tour aimed at engaging with our store and support center teams, as well as our ambassadors through local community-specific experiences in a variety of venues. Building upon the amazing 16 years of history of lululemon, the goal of this tour is to affirm our mission and purpose and declare where our brand is headed.

Adding to my earlier comments, we have seen that the true unlocking of brand value comes from synchronizing innovative products combined with powerful storytelling and relevance to our guests and the local community. These principles will guide all of our brand investment.

Working with our global ambassadors and educators, we aim to inspire, educate, connect and converse with our guests. To emphasize the power of our ambassador community, we recently featured lululemon elite ambassador, Maya Gabeira, big wave surfer, as she explored and surfed in Hawaii. In addition to inspiring footage created for the lululemon website, our team created a mini documentary on Maya delving deeper into her mindful approach to recovering from a massive, life-threatening surf accident. This ambassador-driven campaign launched alongside a new swim capsule illustrates how our brand is most powerful when our stories are inspired and generated by our local communities and our local heroes.

And as I mentioned, our brand operating model comprised of product, guest experience and brand and community will be leveraged in an omnichannel manner across diverse geographies to achieve our growth targets. Specifically, we will continue to build out North America in 2015 with double-digit square footage growth driven by continued store openings. We will also continue to ramp up our international business with new stores planned in the UK, Germany, Hong Kong and Singapore, in addition to our recently announced partnership in the Middle East with MAF. We are on track to have 20 stores in each region, Asia and Europe, by the end of 2017.

2014 was a pivotal year when we turned the corner and started building positive momentum. In 2015, this cadence will continue and will also be an overlap investment year where we substantially complete the foundational work already underway to support our longer term growth. And we are building upon our current momentum and make the shift from playing defense to playing offense. With this game plan, we are setting a clear course to sustainably and profitably grow both within North America and in our global markets.

To the entire lululemon collective, thank you for your continued passion and dedication. We're focused on the opportunities ahead in 2015 and I am confident we can deliver on our promise to strengthen and grow our business as we build a global iconic brand. With that, I'd like to turn things over to Stuart who will outline the financial framework and discipline it will take to meet our near-term and longer term goals. Stuart.

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**Stuart Haselden - lululemon athletica inc. - CFO**

Thank you, Laurent. It's great to be a part of the team and certainly an exciting time to join lululemon. For those of you on the call, I look forward to meeting you and working with our investment community. I'll begin today by reviewing the details of our fourth quarter and 2014 and I'll then update you on our outlook for the first quarter and the full year of fiscal 2015.

For Q4, total net revenue rose 15.6% to \$602.5 million from \$521 million in the fourth quarter of 2013. The increase in revenue was driven by total comparable sales growth on a combined basis, including e-commerce of 8% comprised of a bricks and mortar comp store sales increase of 5% and a 20% growth online, all on a constant dollar basis, the addition of 48 net new corporate owned stores since Q4 of 2013, including 32 net new stores in the United States, one store in Canada, one store in Australia, one store in New Zealand, two in Europe, one in Asia and 10 ivivva stores and offset with the foreign exchange impact of a weaker Canadian and Australian dollar, which had the effect of decreasing the reported revenues by \$13.2 million, or 2.2%.

During the quarter, we opened 13 net new corporate owned stores, nine in the US, one in Australia, one in Asia, one in Europe and one ivivva. We ended the quarter with 302 total stores versus 254 a year ago. There are now 240 stores in our comp base, 39 of those in Canada, 163 in the United

States, 27 in Australia and New Zealand and 11 in the U.S. At the end of Q4, we also had a total of 85 showrooms in operation, 33 Lululemon showrooms in North America, 15 internationally and 37 in the U.S.

Corporate-owned stores represented 75.7% of total revenue, or \$456.1 million versus 75.9%, or \$395.2 million in the fourth quarter of last year. Revenues from our direct-to-consumer channel totaled \$114.5 million, or 19% of total revenues versus \$97.8 million, or 18.8% of total revenue in the fourth quarter of last year. Other revenue, which includes strategic sales, showrooms, pop-ups and outlets, totaled \$31.9 million, or 5.3% of revenue for the fourth quarter versus \$28 million, or 5.4% of revenue in the fourth quarter of last year.

Gross profit for the fourth quarter was \$310 million, or 51.5% of net revenue compared to \$278.8 million, or 53.5% of net revenue in Q4 2013. The factors which contributed to this 200 basis point decline in gross margin were a product margin decline of 50 basis points due to primarily a combination of product sales mix and input costs offset with lower markdowns, 30 basis points due to higher airfreight, 50 basis points due to the foreign exchange impact of a weaker Canadian and Australian dollar, 40 basis points deleveraged from occupancy and depreciation and 30 basis points deleveraged from continued investments in our product and supply chain functions.

SG&A expenses were \$152.9 million, or 25.4% of net revenue compared with \$124.6 million, or 23.9% of net revenue for the same period last year. This 22.6% SG&A dollar increase is due to the following -- an increase in operating expenses associated with new and existing stores, showrooms and outlets, including costs related to our international expansion, increased variable operating costs associated with the growth of our e-commerce business, increases in expenses at our store support center, including salaries, administrative expenses and professional fees tied to growth and foundational investments and the anniversary of management incentive compensation reductions in Q4 last year and foreign exchange gains that on a net basis increased SG&A by \$4.1 million in Q4 this year. These increases were offset with a weaker Canadian and Australian dollar, which on translation also decreased reported SG&A by \$5.3 million, or 3.4%. As a result, operating income for the quarter was \$157.2 million, or 26.1% of net revenue compared with \$154.1 million, or 29.6% of net revenue in Q4 2013.

Tax expense for the quarter was \$48.1 million, or a tax rate of 30.3% compared to \$46 million, or a tax rate of 29.5% in the fourth quarter of 2013. Net income for the quarter was \$110.9 million, or \$0.78 per diluted share compared to net income of \$109.7 million, or \$0.75 per diluted share for the fourth quarter of 2013. Our weighted average diluted shares outstanding for the quarter were 142.3 million versus 146 million a year ago. This takes into account the weighted impact of 400,000 shares repurchased during the quarter at an average price of \$43.30 per share. It is worth noting that we repurchased fewer shares compared to Q3 as we were only active in the market for a small portion of the quarter. Capital expenditures were \$30.4 million for the quarter compared to \$34.5 million in the fourth quarter of last year.

Turning to our balance sheet highlights, we ended the quarter with \$664.5 million in cash and cash equivalents. Inventory at the end of the fourth quarter was \$208.1 million, or 10.2% higher than at the end of the fourth quarter of 2013.

Turning to highlights for our full fiscal year 2014 performance, net revenue rose 12.9% to \$1.8 billion from \$1.6 billion in fiscal 2013, reflecting a 3% comparable sales growth on a constant dollar basis. E-commerce sales totaled \$321.2 million, or 17.9% of total sales. Gross profit was \$914.2 million, or 50.9% of net revenue compared to \$840.1 million, or 52.8% of net revenue in fiscal 2013.

Net income for the year was \$239 million, or \$1.66 per diluted share compared to \$279.6 million, or \$1.91 per diluted share for fiscal 2013. This is based off an effective tax rate of 37.6%, which includes a \$33.7 million tax charge associated with the repatriation of cash from our Canadian subsidiary to our US parent entity to fund our share repurchase program, which had an impact to EPS of \$0.23. Excluding this nonrecurring tax charge, diluted EPS would have been \$1.89 for the year.

This now leads me to our outlook for the first quarter and full fiscal year 2015. I'd like to start by providing some clarity around the impact of foreign exchange on our financials. Approximately a quarter of our business is in Canada and Australia where we saw steep declines in the value of these respective currencies relative to the US dollar during the fourth quarter. This reduces our reported revenue in US dollars and it also compresses our gross margin as our product is purchased in US dollars. These negative factors are then partially offset by lower reported SG&A as the majority of our head office costs are here in Vancouver, Canada.



In addition, as the Canadian dollar weakens, we also incur foreign exchange gains on US-denominated cash and receivables in our Canadian subsidiaries. Assuming currencies remain at their prevailing rates, we expect this to have an approximate impact of \$65 million to revenue for the 2015 fiscal year, a 60 basis point impact to gross margin offset by a \$30 million reduction in SG&A yielding a net impact to earnings of approximately \$0.04 per share when compared to fiscal year 2014.

Moving onto Q1, as Laurent mentioned, we had a challenging start to the year as February was externally impacted by both weather and product delivery delays. First, we estimate that weather had an approximate \$3 million impact to sales in February and early March due to store closures and lower traffic in the areas that were impacted by the storms.

Second, as Laurent also highlighted, while on-time factory handover delivery performance has improved, we have not been able to avoid the delays in ocean shipment times into the West Coast ports. We had previously expected this to impact late Q4, but has shifted into early Q1. We now estimate that the previously identified \$10 million in sales risk for Q4 will materialize now in Q1. We also expect these delays to extend into early Q2.

We are otherwise seeing that sellthroughs remain strong and underlying demand for our product is consistent with what we saw over the holiday period. As a result of these factors discussed, we expect Q1 revenue to be in the range of \$413 million to \$418 million. This is based on a comparable sales percentage increase in the low single digits on a constant dollar basis compared to the first quarter of 2014 and assumes a Canadian dollar at \$0.79 to the US dollar and 14 new store openings, eight lululemon stores in North America and six ivivva.

We anticipate our gross margin in the first quarter to be between 49% to 50%. While we expect merchandise margins to stabilize from last year as we begin to see initial results of our supply chain investments, this will be more than offset by several factors, including the impact of FX from the decline in the Canadian and Australian dollar, higher air freight in part due to mitigating the West Coast port delays, deleverage from continued investments in our product engine and in occupancy and depreciation.

Specifically with regard to occupancy and depreciation, we expect deleverage in 2015 due to the following -- higher lease costs associated with new larger store formats creating a temporary lag on profitability until these locations ramp up and a more run rate level of sales productivity is achieved; an increase in major renovations and relocations as we reposition and expand certain stores to accommodate our product strategy such as men's and new categories; international expansion and amortization of the capital invested in our Columbus DC, which went live last August 2014.

We expect SG&A to delever slightly from Q1 2014, a portion due to a higher number of new store openings and strategic investments. Assuming a tax rate of 30.2% and 142.3 million diluted weighted average shares outstanding, we expect diluted earnings per share in the first quarter to be in the range of \$0.31 to \$0.33 per share. For the full-year 2015, we expect revenue to be in the range of \$1.97 billion to \$2.02 billion, which represents an annual combined comp in the mid-single digits.

We expect to open 60 corporate-owned stores, which includes up to eight new stores in Asia and Europe and also 20 ivivva stores. We expect gross margin for the year to delever from 2014 with merchandise margins stabilizing but more than offset by the factors mentioned in regards to Q1. We also expect some deleverage in SG&A versus 2014. As Laurent noted, 2015 will reflect the continuation of key investments central to our growth strategies. These include substantially completing foundational systems and process changes while also ramping investments into areas of guest experience, product innovation, brand and international expansion. It is critical to make these investments now to drive accelerated growth in 2016 and beyond.

As a result, we expect operating margin to deleverage from 2014 and our fiscal year 2015 diluted earnings per share to be in the range of \$1.85 to \$1.90. We estimate that the impact of foreign exchange, weather and port delays will have a collective impact of approximately \$0.09 in earnings per share for the fiscal year of 2015. This is based off of 142.6 million diluted weighted average shares outstanding, which does not reflect an estimate of shares repurchased after Q4 2014 and also assumes an effective tax rate of 30.2%.

We expect capital expenditures to range between \$130 million and \$135 million for the fiscal year 2015, reflecting a higher number of new store openings, renovations and relocation capital and also strategic IT and supply chain capital investments.

In closing, I would like to provide some additional color around our longer-term growth plans. In terms of our revenue, we are targeting long-term comp growth in the mid-single digits, along with annual new unit growth that is in line with our 2015 opening plans. In terms of gross margin, we are targeting a recovery to the low to mid 50% range for the total Company with North America at the high end of this range and international below this range as this business continues to scale.

Our planning assumes modest leverage in SG&A over the long term and operating margin to begin to leverage in 2016 with projected long-term recovery to the low to mid 20%. Our target for North America is to return to the mid-20% with international below this as this business ramps up. The momentum we are currently seeing in the business results, along with the guest response to our early assortment improvements, reaffirms our confidence in our ability to deliver this accelerated growth over the next several years. With that, I will turn the call back to Laurent.

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**Laurent Potdevin** - *lululemon atheltica inc. - CEO*

Thank you, Stuart. Before we begin our Q&A session, we would be remiss not to acknowledge the immense contribution of our founder, Chip Wilson, who stepped down from our Board last month. It goes without saying that we would not be here today discussing this tremendous business were it not for his vision back in 1998. With that, I will open up for questions. Operator.

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## QUESTIONS AND ANSWERS

### Operator

(Operator Instructions). Paul Lejuez, Wells Fargo.

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**Paul Lejuez** - *Wells Fargo Securities - Analyst*

Stuart, welcome. Any initial thoughts, Stuart, on just what you have seen thus far being part of the organization for just a couple months, positive, negative, areas of potential improvement and also if you could give us maybe a little bit of color around US versus Canada in the quarter. Thanks.

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**Stuart Haselden** - *lululemon athletica inc. - CFO*

So it's exciting to be here. I think that the business has incredible momentum. The investments that the Company has been making over the last year seem to be putting the Company on track for some explosive growth into the future. The foundation investments we expect will be completed this year and Tara and her team have done remarkable work. So I think there's a lot of exciting things in the future for lululemon.

To your second question in regards to US versus Canada, what we have seen is sequential improvement clearly into Q4 in all regions. We saw improvements in all of our geographies in the fourth quarter. The US was still clearly stronger than the other geographies that we operate in, but we did see improvements in Canada. In Canada specifically, we saw stronger business in the West versus the East in the fourth quarter. That seems to be continuing into the first quarter and that's likely related to certain macro factors that are influencing those different areas.

But as we focus on our Canadian business and look for ways to continue to drive that business, we have seen some exciting initiatives and specifically I'd call out the work that we've done in our Robson Street store. We did a remodel there last year where we increased the size of the store about 50%. And in the six months since the remodel was complete, we have seen traffic and sales increase over 50% in that store and we've seen our men's business specifically increase over 90%. So we view that as an example and a template for how we might look to pursue similar strategies in other stores in Canada and elsewhere in our chain, for that matter. We actually did a similar project at our Santa Monica store in California and have seen a similar outcome in terms of the increase in sales and sales productivity. So we are excited to see those projects and we are excited to see that as another way we can continue to drive our business.



So I think we are seeing the sequential improvements. Certainly what has happened in the first quarter in regards to weather and the port delays are impacting both the US and our Canadian businesses, but we are encouraged by the momentum that we are seeing.

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**Paul Lejuez** - *Wells Fargo Securities - Analyst*

Thanks. Good luck.

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**Operator**

Matt McClintock, Barclays.

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**Matt McClintock** - *Barclays Capital - Analyst*

Good morning, everyone and welcome, Stuart, as well. I was wondering if we could focus on gross margin just in terms of input costs. You called out 50 basis points, I think, of pressure this quarter from mix, as well as input costs. It seems as commodity costs go lower, your input costs would follow. At what point in the year or potentially going forward should we see relief from input costs in margin? Thanks.

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**Stuart Haselden** - *Lululemon Athletica Inc. - CFO*

So the product margin guidance that we gave -- or I should say the gross margin guidance that we gave -- does reflect that our expectation -- and we are seeing this in the early part of Q1 -- that our product margins will stabilize and what I mean by that is that they should be at least flat and we are in fact seeing that. So that reflects a sequential improvement in those input costs from Q4 into Q1.

The pressure that we are seeing in the guidance that we gave around gross margin is really related to the occupancy and depreciation primarily. There are some other factors -- FX, and also some continued investments in the team and the foundational product engine -- but the lion's share of that pressure this year is related to that occupancy and depreciation that we called out and the discrete factors that we had mentioned in the prepared remarks and specifically the larger format stores, some of the major renovations and relocations that are connected to what I just described with our Robson and Santa Monica stores, but it comes with some increase in occupancy and depreciation related to that. We see that as temporary until those stores reach their run rate productivity and a net benefit to the P&L over the long term. And the last thing that was pressuring that occupancy and depreciation was just the Columbus DC investment that we made as that now is complete.

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**Matt McClintock** - *Barclays Capital - Analyst*

Thanks a lot, Stuart.

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**Operator**

Oliver Chen, Cowen and Company.

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**Oliver Chen** - *Cowen and Company - Analyst*

Thanks a lot. Congrats on really solid momentum here. Regarding the slowdown, could you just help us understand the nature of the inventory most impacted? And it sounds like you are encouraged for stabilizing or flattish merch margins, so is there any implication there in terms of the slowdown in relation to that? And also as you engage in the variety of the store sizes, which classifications are you going to see more of in the larger format and which ones might you see less of in the smaller formats? Thank you.



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**Stuart Haselden** - *Lululemon athletica inc. - CFO*

So the inventory impact from the port delays, it's across the board in the inventory flows planned in the early part of Q1. And so what we're seeing is a meaningful portion of the inventory for the quarter has been delayed up to three weeks and there is a smaller portion that has been delayed beyond that timeframe. So it is affecting the spring flows that we had planned and even some of the late winter flows. So we are working hard with -- our merchant teams are working hard to optimize the inventory that we have and get ready for those flows that we expected to come earlier when they do hit the stores so that we can be well-positioned from a marketing and an educator standpoint so that we are able to make the most of it.

To your other question, in terms of the merch margin impact, it certainly affects the merch margin. I feel at this point we are not backing away from the guidance that we gave. We feel we will be able to work through these issues and still deliver that stabilized merch margin for the year. That picture is benefiting from a lot of the work that Tara and her team have done over the last year and we are starting to see the fruits of that work.

And then for your last question in regards to the store sizes and format, so we continue to test and experiment new formats. We are seeing the potential for expanded store footprints, particularly as we have a growing men's business that we are now working to ensure that we are presenting that in the strongest manner and making sure we have enough space to accommodate the experiences in a high-quality way. So it's going to be market by market. We will look for flagship type locations where it makes sense; otherwise we will test expanded formats where we see the potential demand. And again it's really a trade area and market-driven exercise. And then we will also continue to roll out the ivivva stores as we mentioned.

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**Laurent Potdevin** - *Lululemon atheltica inc. - CEO*

As far as the multistore format, we will play with larger format. In areas where it makes sense, we might also play with smaller store formats if you think about resorts, whether it's at the beach or in the mountains and with our enhanced ability to look at localized assortments and really leverage omnichannel, we will look at different formats around the world. But what's really important is that we look at the same level of profitability four-wall contribution from all of the formats.

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**Oliver Chen** - *Cowen and Company - Analyst*

Thank you so much and we have been pretty thrilled with what we've been seeing in stores. On your comments, Laurent, on the tanks, just broadly speaking, what is the degree of newness, or the nature of the real innovation opportunity for the Q2 tanks story?

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**Laurent Potdevin** - *Lululemon atheltica inc. - CEO*

I'll let Tara talk about tanks. I think it's a lot more appropriate.

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**Tara Poseley** - *Lululemon athletica inc. - Chief Product Officer*

So for Q2, stepping back to 2014, our goal was to stabilize the business and as we are moving into 2015, you've heard me talk about this a few times, really making sure function and beauty is consistently across the assortment. Quarter by quarter, you will continue to see improvement in that.

In Q2, we have really focused on the tank wall. That was our second -- last year we started tackling the (inaudible) wall. Q2 is about tackling the tank wall. You are going to see a better balance of support options in the tank, which has really been lacking. So we are adding four new styles with medium support and then by Q3, we will be adding a full support tank. So also not only addressing the technical piece of the tank, we're going to be addressing the beauty and we have always owned exquisite designs in our tank wall and we are aggressively returning to those roots. From an innovation standpoint, you will see more innovation in tanks as we move into 2016.



**Oliver Chen** - Cowen and Company - Analyst

That's great. Very helpful. Thank you and congrats on all the excitement. The product looks outstanding.

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**Operator**

Bob Drbul, Nomura Securities.

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**Kevin Heanan** - Nomura Securities - Analyst

This is Kevin Heanan on for Bob. I was just wondering if you could give us a little more color on showroom performance internationally.

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**Laurent Potdevin** - lululemon atheltica inc. - CEO

The showrooms have continued to perform incredibly well and we've actually seen an acceleration of our performance in Germany and we continue to perform really well in Asia and we are opening a couple showrooms soon in Sweden. So it's still a very, very powerful and nimble way for us to enter the market and to meet the communities and we see the performance continuing to increase as we reengineer the assortment given the higher level of brand awareness that we see in the new regions or the new markets that we are entering.

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**Kevin Heanan** - Nomura Securities - Analyst

Great. Thanks very much.

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**Operator**

Matthew Boss, JPMorgan.

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**Matthew Boss** - JPMorgan - Analyst

So traffic was positive in the fourth quarter. You spoke to the continued momentum that you are seeing. Can you just talk a little bit about the underlying traffic thus far in the first quarter in maybe less weather-impacted areas, but more so also your comfort with inventory on hand today and when you think the store will be fully set to capture the conversion opportunity?

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**Stuart Haselden** - lululemon atheltica inc. - CFO

So on your traffic question, so we have continued to see strong traffic into Q1. So the traffic acceleration that we saw late in 2014 has continued into Q1. Conversion has improved sequentially. It has still been a headwind for us. We have seen some slight improvement in AUR as well, so we are encouraged by the traffic and we look to that as an indicator of that. The momentum that we had in the fourth quarter is in fact extending into Q1 and we are working through the inventory issues, as you mentioned, which is really the bigger headwind for us currently. We feel the inventory will begin to rebalance likely in Q2 and will more normalize -- the flows will hopefully more normalize into the second half of the year.

But nonetheless, we are responding to our new expectations for when we expect to receive inventory so that we are well-positioned to make the most of it. So in terms of the amount of inventory we have, we are comfortable with both the increase, the level of increase and the composition, the health of that inventory, so we are comfortable with that. I'm going to pause there and ask you to repeat your last question.



**Matthew Boss** - *JPMorgan - Analyst*

More so just how we should think about inventory versus sales as the year progresses in order to really capture that conversion opportunity.

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**Stuart Haselden** - *lululemon athletica inc. - CFO*

Sure, I think over the long term we expect to maintain a very disciplined posture in terms of our inventory investments versus our top line, our revenue. But given some of the disruptions that we've seen this year with regard to the supply chain, you may see some point-in-time anomalies where that relationship may become disconnected, but again we are confident that as we plan the business for this year and into next year, we will ensure that we maintain that discipline and the relationship between the inventory position and our sales momentum.

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**Matthew Boss** - *JPMorgan - Analyst*

Great. Best of luck.

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**Operator**

Ed Yruma, KeyBanc.

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**Ed Yruma** - *KeyBanc Capital Markets - Analyst*

I know you mentioned markdowns were down in the fourth quarter. I guess embedded in your guidance for gross, how should we think about markdowns? And I guess just as a bigger picture question, any thoughts, Stuart, on kind of clearance philosophies? I know you guys have used warehouse sales, you've done some select broken size run sales in stores. How can you best optimize your markdown strategy? Thanks.

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**Stuart Haselden** - *lululemon athletica inc. - CFO*

Yes, so the markdowns into Q1 versus Q4 and versus last year rather, we see it as a similar level of markdowns. We may opportunistically run some markdown activities to take advantage of our inventory position and more recently, we actually ran an event earlier this week that was really an opportunistic chance for us to drive some traffic to the store, to get clean on some of the late winter inventory flows that were reaching our stores now so that we are ensuring we are in a clean place for the spring flows that are in the pipeline. And so it really should not put us measurably different year-over-year from a markdown standpoint. It was really small in terms of the overall percentage of sales and inventory for the quarter and really not a departure from things we've done in the past. We have been doing similar programs for several years, so no concerns with regard to markdowns. Overall similar posture to last year and we will continue to leverage that.

In terms of your other question around the clearance philosophy, I can tell you, versus other places I've worked, this is a remarkably full-price business. It is a very powerful brand. We do not drive our business with markdowns and it is remarkably healthy in that regard. So I think where we choose to do markdown activity, it's really purely aimed at liquidation and getting the inventory in the position we want it to be.

The warehouse sales, as you mentioned, have been wildly successful, I think, because of that strong full-price position of the brand. And so we will continue to evaluate where and when to do those, but it's not part of the business model in terms of driving sales with markdowns and we don't have plans to introduce that go forward.

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**Laurent Potdevin** - *lululemon atheltica inc. - CEO*

You have heard us speak for over a year now about our scarcity strategy and obviously we have been more scarce this past year than we would like to be, but we are very focused on continuing to be scarce and driving business with very high sellthrough at full retail. And there might be categories in a very narrow selection of the product where we are going to go deeper to really understand the full potential of our opportunity especially as it relates to men's.

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**Ed Yruma** - *KeyBanc Capital Markets - Analyst*

Great. Thanks so much.

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**Operator**

Adrienne Yih, Janney Capital Markets.

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**Adrienne Yih** - *Janney Capital Markets - Analyst*

Good morning and congratulations on the progress throughout 2014. Welcome, Stuart. Tara, my question is for you. Are you at the targeted level of seasonal versus core basic? How much of the product would you say is in those two buckets and then were you pleased with the in-stock positions for holiday in that seasonal product? Quickly for Stuart, you did give the comp sales per square foot, \$1678. Could you give it for total? And then would you break down comps by US and Canada? Thank you so much.

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**Tara Poseley** - *lululemon athletica inc. - Chief Product Officer*

As for the question about core versus seasonal, really our focus is on filling the gap with beautiful assortment, whether it be from seasonal or from core. So there's work going against all of those areas of the business. We talk about our efforts against the pant wall, as well as the tank wall and bringing beauty and function back to all of our product assortment. And those strategies hit all buckets of our inventory, whether it be core or seasonal. So our in-stock positions around seasonal in Q4, we were fine with that. Of course, we had some areas that were runaway successes, but again referring to Laurent's comments about the scarcity model, it is a really important part of this brand and we will continue to go forward making sure that we are coveting that because it is really something that makes us special.

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**Laurent Potdevin** - *lululemon atheltica inc. - CEO*

And as you recall, some of our discussions at ICR, we've had some of the same successes with some of our core assortment, so really it's not about core or seasonal. That discussion needs to go away. It is really going to be driven by the guest and in different parts of the world, we're going to be seeing different mix with different maturity of the brand, but we are going to be equally as strong and as profitable in both categories.

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**Adrienne Yih** - *Janney Capital Markets - Analyst*

Great. And Stuart?

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**Stuart Haselden** - *lululemon athletica inc. - CFO*

Sure, I think you have what we disclosed around the sales per square foot and where we landed for Q4. The comps were strong across the business in the fourth quarter. We saw stronger comps in the US versus Canada, but we saw sequential improvements in both geographies. So we're not going to break down the specifics by region, but suffice it to say we are encouraged by the results that we saw in all of our geographies, Canada and the US included.

**Adrienne Yih** - *Janney Capital Markets - Analyst*

Great. Thank you. Best of luck for spring.

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**Chris Tham** - *lululemon athletica inc. - SVP, Finance*

Operator, we have time for one more question.

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**Operator**

Howard Tubin, Guggenheim.

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**Howard Tubin** - *Guggenheim Securities - Analyst*

Maybe, Laurent, can you just update us on your thoughts on the overall competitive environment and whether you think it has changed recently and if so has it impacted or not your business?

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**Laurent Potdevin** - *lululemon athletica inc. - CEO*

I've answered that question many, many times. I think that we've got -- the overall market globally is growing and the strength and the number of competitors really validates the long-term growth and size of the market, but we either compete against everybody or we compete against nobody. We own the market that we created and we have second to none products and guest experience and our vertical model really allows us to create experiences that are unique. So we look at ourselves as being in a very unique position and we are going to continue to lead at the premium segment of the market in distribution that we control. So I feel very good that, with the investments that we are making in innovation, in product, in guest experience, as well as in brand and community, we are going to continue to lead the market and the competitors will come as the market gets healthier.

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**Operator**

Thank you. Now I would like to hand the conference back over to management for closing remarks.

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**Laurent Potdevin** - *lululemon athletica inc. - CEO*

Thank you very much and we look forward to speaking with you again in three months.

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**Operator**

Ladies and gentlemen, thank you for participating in today's conference. This concludes our program. You may all disconnect and have a wonderful day.

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