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### Love<sup>i</sup>

Rachael Fowler ran cross-country and played tennis in high school. In college, she successfully completed two full marathons. After college, she remained active and health conscious. Now a 37-year-old mother of two boys, Rachael maintains her physical fitness through gym sessions with a personal trainer and by attending yoga classes twice a week. At the end of one yoga session, a friend of hers suggested she purchase some yoga apparel from lululemon. Overhearing the two women talk, the class instructor added that she was a lululemon ambassador and began to rave about the quality and style of lululemon's products.

"This is how 80 percent of our guests come to know lululemon, through word-of-mouth. Guests are so pleased with the clothes we offer that they can't help but tell all their friends about it," explains Laci Levisay, a lululemon associate from a store in Austin, Texas.<sup>1</sup> Levisay continues, "For the other 20 percent who walk into lululemon stores with no previous knowledge, store employees look to find out as much as possible about the guests' lifestyle and then educate them on what products would best suit their needs."

### Choose a Positive Thought

Based in Vancouver, Canada, lululemon athletica provides premium quality athletic apparel at a premium price. One of lululemon's signature items is its yoga pants, typically sold by competitors for between \$25 and \$50.<sup>2</sup> Yoga pants available in lululemon stores and

online range between \$78 and \$128 with its most popular pair priced recently at \$98 – two to three times rivals' prices.<sup>3</sup> However, lululemon's products sell and they sell fast. Demand for lululemon clothing is so high that stores have trouble keeping new lines in stock. Sheree Waterson, Lulu's chief product officer conveyed this example, saying, "A hot-pink color named 'Paris Pink' that launched in December (of 2011) was supposed to have a two-month lifecycle but sold out its first week."<sup>4</sup> The question then arises as to why customers, or "guests" as lululemon refers to them, are willing to pay high prices for high fashion items that are destined to be soaked in sweat!

It seems the answer to this question resides in lululemon's ability to connect with its guests on a deeper level than just the typical sales associate–customer relationship. After all, other companies such as Nike, Adidas, and Under Armour not only produce high-tech clothing with the same soft cotton feel, four-way stretch, and moisture-wicking technology that lululemon touts, but do so much less expensively for their end consumers. Ultimately, what competitors cannot duplicate is lululemon's culture. It is lululemon's deep understanding of its target market, close relationships with its communities, and an inimitable culture that transforms customers/guests into diehard loyalists.

This is not to say that lululemon does not uphold the highest quality standards in its products. Levisay states, "People will save up if they need to in order to afford our clothing because of the benefits they provide." She goes on to explain, "It's silly to spend that much on yoga

i. The majority of headers used in this case are quotes from the lululemon athletica manifesto.

pants if they're not going to live up to their promise."<sup>5</sup> Jennifer Black, president of an investment research firm confirms this sentiment saying, "lululemon won't put stuff in its store just to sell it. They don't compromise on quality."<sup>6</sup>

### Friends Are More Important than Money

lululemon athletica's in-depth knowledge of its target audience is an important, firm-specific asset. "Rooted in yoga but expanded into any sweaty pursuit you may have, lululemon creates technical fabrics that work with you instead of against you. Plus, they look cute!" explains Levisay. The stores' "...guests comprise anyone living a physically active life that strives to achieve balance,"<sup>7</sup> although the majority of shoppers are female, have disposable income, and are in the 15- to 65-year-old range.<sup>8</sup> Fitness blogs confirm that lululemon "...recognizes this niche market and combines high performance material with attractive product design to create a committed brand following."<sup>9</sup>

One of the strongest examples of lululemon's focus on culture is the company manifesto, which appears on multiple lululemon products, from bags to water bottles. Explaining the company's perpetuation of its manifesto, Whitney, a store employee and lululemon blogger writes,

*We are sharing a piece of our culture and inspiration as a company. We have traditionally printed our [bags] with the lululemon manifesto, which is a series of statements that embodies our company's vision, culture and beliefs... [as] a constant reminder of our vision to create components for people to live longer, healthier and more fun lives.<sup>10</sup>*

### Observe a Plant Before and After Watering

Each and every store employee at lululemon is considered a steward of the company's culture. From the beginning of the hiring process, throughout training, and continuing throughout employment, each employee is expected to reflect the company's mission and vision. lululemon athletica's "...success is reflected in everything within the store experience. The people who work there believe strongly in the lifestyle and what it represents."<sup>11</sup> A focus on employee development is a crucial component of the company's strategy. In general, a lot of money and effort is put into training store employees. Levisay comments,

*Employees don't exist just to fold clothes or set up displays. They share their knowledge of the clothing and culture with every guest that walks through the door. They have the ability to explain functions of the clothing you would not necessarily recognize; items such as hidden pockets,*

*body support, material that protects against harmful UV rays, and special woven silver that makes the material antibacterial.<sup>12</sup>*

Another employee, Samantha Baldwin, clarifies the link between employee and guest. "If your employees are happy and feel supported in their goals, your genuine nature comes across and this allows consumers to buy the experience, buy the product." This "caring-and-sharing" culture bolsters the high-quality products. Baldwin continues, "It wasn't just about selling stretchy pants. It was about connecting with people on an authentic level and finding out their story."<sup>13</sup>

### This Is Not Your Practice Life

lululemon athletica was founded in 1998 by Dennis "Chip" Wilson in response to increased female participation in sports and in accordance with his belief in yoga as the optimal way to maintain athletic excellence into an advanced age. Wilson, an avid surfer and snowboarder, had previously parlayed his passions for these sports into building a successful company – Westbeach – that sold snowboarding and skateboarding apparel. After taking a yoga class, Chip fell in love with the practice. Once again melding his athletic passions with his acumen for producing high-end performance apparel, Chip saw the opportunity to produce higher-quality yoga attire.<sup>14</sup>

Wilson noticed that the cotton materials used in yoga apparel were inefficient for the demands placed upon them. He applied his knowledge of materials to design highly technical fabrics that would move and breathe better. Chip opened a design studio and retail store that doubled as a yoga studio at night to pay the rent. Yoga instructors at the studio became product testers, wearing Chip's designs while teaching, and providing feedback about the product.<sup>15</sup>

The first official lululemon store was opened in 2000 in Kitsilano, a beach neighborhood in Vancouver. The first store served as a community hub for multiple aspects of healthy living including nutrition, running, biking, and of course yoga. Realizing the potential for female-centric, high-quality athletic apparel, lululemon began to grow; expanding across Canada for the next couple of years and entering the U.S. market in 2003.

lululemon athletica continued to expand both in North America and overseas and announced its initial public offering in May 2007. In 2009, lululemon expanded its offerings by launching an e-commerce channel and ivivva, a subsidiary specializing in athletic gear for girls 4 to 14 years old.<sup>16</sup>

### **Dennis “Chip” Wilson**

The success of lululemon is attributable to the vision of Dennis “Chip” Wilson. After taking the company public in 2007 and serving as Chief Innovation and Branding Officer, Chip officially turned over the reins in January 2012.<sup>17</sup> During his time with lululemon, he helped the company grow to 147 stores, transformed the brand into a cult following, and provided company focus by developing the lululemon manifesto.<sup>18</sup> He remains chairman of the board and continues to represent lululemon at investor meetings. His successor, Christine Day, has renewed the company’s goals and assembled an exemplary “management team with a complementary mix of retail, design, operations, product sourcing, marketing and information technology experience from leading apparel and retail companies such as Abercrombie & Fitch Co., The Gap, Inc., Nike, Inc., and Speedo International Limited.”<sup>19</sup>

### **Christine Day**

Christine Day joined lululemon as Executive VP of Retail Operations in January 2008 and was promoted to CEO in June 2008.<sup>20</sup> Day was with Starbucks for 20 years, most recently serving as President of the Asia Pacific Group of Starbucks Coffee International.<sup>21</sup> Starbucks and lululemon are very similar in that both are high-growth, international companies focused on cultivating their culture and brand loyalty. Day will focus on brand expansion and developing long-term corporate- and business-level strategies.

### **John Currie**

lululemon athletica’s current Chief Financial Officer (CFO) joined the strategic leadership team in January 2007.<sup>22</sup> Currie has a long history as a financial leader within several companies including CFO of Intrawest Corporate and senior financial positions at a telecommunications service provider.<sup>23</sup> He helped Chip take lululemon public in July 2007 and actively communicates with investors every quarter.

### **Ten to Fifteen Friends Allows for Real Relationships**

Of the nine individuals serving as members of lululemon’s board of directors, seven are independent. These independent directors contribute a vast array of knowledge, including experience in retail markets, finance, and corporate structure. Several have worked with very high-growth companies and companies with strong corporate cultures. The combined skills and knowledge of this board will help guide lululemon through its growth and

changes in its strategies. See Exhibit 1 for background information on additional leaders and board members.

### **Don’t Trust that an Old Age Pension Will Be Sufficient**

In terms of financial strength, lululemon athletica (“LULU”) is positioned to weather declines in the economic environment. The company has a significant amount of cash, over 50 percent of assets and, although the company has a line of credit should it face an immediate liquidity need, lululemon holds no debt. Companies such as Adidas, Nike, and Under Armour all carry some debt and it is certainly noteworthy to see lululemon operate with none. lululemon athletica has experienced tremendous growth in both revenue and profitability over the last couple of years. As seen in its income statement, revenue grew by a compound annual growth rate of 41.47 percent from fiscal year (FY) 2009 to FY 2012. lululemon’s net profit margin improved from 12.87 percent in 2010 to 18.39 percent in 2012, driven mainly by improvements in the gross margin and control over the growth in sales, general, and administration expenses. As expected by the growth in sales and profitability, both return on equity and return on assets also increased (Exhibit 2).

As seen in Exhibit 3, lululemon compares very favorably to some very well-known companies within the performance apparel clothing industry. Because lululemon operates primarily in a niche product market, it is able to compete against the likes of Adidas, Nike, and Under Armour and still generate above-average returns, principally by offering customers what it believes are higher-quality products. Historically, Adidas, Nike, and Under Armour did not offer separate apparel lines for yoga activities; however, all three have recently entered this particular market. Even so, lululemon is the only publicly traded company focused solely on the yoga apparel market. While lululemon does face competition from other companies with yoga apparel lines, none of these competitors can demand the premium that lululemon has on its products.

### **The Pursuit of Happiness Is the Source of All Unhappiness**

At the beginning of FY 2013, lululemon was forecasting that its revenue and profit would continue to grow, albeit at a slower pace compared to the firm’s recent growth rates. Management was forecasting that same-store sales would increase around 20 percent in FY 2013 and that earnings per share (EPS) would be between \$1.50

**Exhibit 1 Other lululemon Leaders****Delaney Schweitzer: Executive VP, Retail Operations North America**

Delaney Schweitzer began her career at lululemon in 2002. Since her days as a lululemon educator then manager, Schweitzer has served in various capacities within lululemon, including Director of Training and Culture and Director of Original Intent. Prior to joining lululemon, Schweitzer spent 10 years in the hospitality industry as a general manager. She is a graduate of the Executive Advanced Management Program at Harvard Business School. (Source: *Forbes.com*. <http://people.forbes.com/profile/schweitzer-delaney/142021>. Apr 2012)

**Sheree Waterson: Executive VP, Chief Product Officer**

Sheree Waterson has served as Executive VP, General Merchandise Management and Sourcing since June 2008. Prior to joining lululemon, she served as President of Speedo North American, a Warnaco, Inc. brand, from January 2005 to June 2007. She was VP of Merchandising, Women's, for Levi Strauss & Co. from January 2002 to August 2004. From 1997 to August 2001, she served as CEO of Enfashion.com. She graduated from the University of California, Berkeley with a BA in Psychology. (Source: *Forbes.com*. <http://people.forbes.com/profile/sheree-waterson/127405>. Apr 2012)

**Michael Casey: Director**

Michael Casey has been a member of the Board since October 2007. He retired from Starbucks in October 2007, where he had served as Senior VP and CFO from August 1995 to September 1997, and Executive VP, CFO, and Chief Administrative Officer from September 1997 to October 2007. Subsequent to retirement, he served as a Senior Advisor to Starbucks from October 2007 to May 2008 and from November 2008 to present. Prior to joining Starbucks, Casey was Executive VP and CFO for Family Restaurant, Inc., and President and CEO of El Torito Restaurants, Inc. He is also a member of the board of directors of The NASDAQ OMX Group, Inc. Casey graduated from Harvard University with an AB degree in Economics and Harvard Business School with an MBA.

**RoAnn Costin: Director**

RoAnn Costin has been a member of the Board since March 2007. She has served as the President of Wilderness Point Investments, a financial investment firm, since 2005. From 1992 until 2005, she served as the President of Reservoir Capital Management, Inc., an investment advisory firm. Costin was a director and member of the audit committee of Toys "R" Us from 1995 to 2005. Costin received a BA in Government from Harvard University and an MBA from the Stanford University Graduate School of Business.

**Brad Martin: Director**

R. Brad Martin has been a member of the Board since March 2007. He served as the CEO of Saks Inc., a retail department store company, from 1989 until January 2006. He is a member of the board of directors of First Horizon National Corporation, a banking company, Dillard's, Inc., and FedEx Corporation. He also served on the board of directors of Gaylord Entertainment Company from November 2006 to May 2009, and on the board of directors of Ruby Tuesday, Inc. from April 2008 to June 2011. Martin received his BS in Political Science from the University of Memphis and an MBA from Vanderbilt University.

**Marti Morfitt: Director**

Martha A.M. (Marti) Morfitt has been a member of the Board since December 2008. She has served as the CEO of Airborne, Inc. since October 2009 and as a principal of River Rock Partners, Inc., a business and cultural transformational consulting firm, since 2008. She served as the President and CEO of CNS, Inc., a manufacturer and marketer of consumer healthcare products from 2001 through March 2007. From 1998 to 2001, she was COO of CNS, Inc. Morfitt currently serves on the boards of Graco, Inc., a fluid handling systems and components company of Life Time Fitness, Inc. She received her HBA (Honors Business Administration) from the Richard Ivey School of Business at the University of Western Ontario and an MBA from the Schulich School of Business at York University.

**Rhoda M. Pitcher: Director**

Rhoda M. Pitcher has been a member of the Board since December 2005. For the past 14 years, she has been the Founder and CEO of Rhoda M Pitcher Inc., a management consulting firm providing services in organizational strategy and the building of executive capability to *Fortune* 500 corporations, institutions, start-ups, and non-profits. From 1978 to 1997, Pitcher co-founded, built, and sold two international consulting firms. Pitcher holds a Master's degree in Organizational Development from University Associates.

**Thomas G. Stemberg: Director**

Thomas G. Stemberg has been a member of the Board since December 2005. Since March 2007, he has been the managing partner of Highland Consumer Fund, a venture capital firm. From February 2005 until March 2007, he was a venture partner with Highland Capital Partners. Stemberg co-founded Staples, Inc., an office supplies retailer, serving as its Chairman from 1988 to 2005, and as its CEO from 1986 until 2002. He serves on the board of directors of CarMax, Inc., PETSMART, Inc., and Guitar Center. He received an AB in Physical Science from Harvard University and an MBA from the Harvard Business School.

**Emily White: Director**

Since September 2010, White has been Senior Director of Local and now Mobile Partnerships at Facebook Inc. Prior to joining Facebook, White was at Google Inc., running the North America Online Sales and Operations channel from 2001 to 2007 and the Asia Pacific and Latin America business from 2007 to 2009. From 2009 through 2010, White ran the Local and Commerce monetization businesses. She serves on the boards of the National Centre for Women in I.T., a non-profit coalition working to increase the participation of girls and women in computing and I.T. She received a BA in Art History from Vanderbilt University.

**Exhibit 2** Financial Metrics

	FY 2012	FY 2011	FY 2010
Revenue Growth	40.63%	57.14%	28.12%
Net Profit Margin	18.39%	17.12%	12.87%
Return on Equity	37.12%	39.09%	16.89%
Return on Assets	29.83%	30.21%	18.97%

Source: lululemon athletica inc: Competitors. Finance. *Yahoo.com*. Accessed 20 April 2012.

and \$1.57. The EPS expectation translates into a 16 to 22 percent growth range for net profit in 2013, which is substantial given the economic condition of the United States.<sup>24</sup> Even so, these forecasts disappointed stock analysts that had expected the company would maintain its breakneck pace of growth at least throughout 2013.<sup>25</sup>

As the first – and sole – potential sign of trouble for the company, YE 2012 inventory increased nearly 85 percent from \$57 million to \$104 million. This growth in inventory combined with a lower sales growth forecast may reflect pressure from the economic environment, pressure that lululemon has historically weathered unscathed. Additionally, with the increased popularity of yoga and sustained above-average returns, new competitors are beginning to enter the market. For instance, in late 2011, Nike, Gap, and Nordstrom launched their own lines of yoga clothing to capture part of the growing market. The increased competition from these major apparel retailers will pressure lululemon and test its ability to continue generating desirable returns for shareholders as well as for other stakeholders such as employees.

Financial information regarding lululemon appears in Exhibits 4, 5, and 6.

## Life Is Full of Setbacks

lululemon athletica has four primary competitors that operate in the same sphere of yoga apparel: Nike, Adidas, Under Armour, and VF Corp. Up to this point, lululemon has been able to successfully expand its business through focused and targeted marketing – but the firm's competitive environment is rife with potential threats and challenges.

### Nike

Nike began with a handshake between two visionary Oregonians: Bill Bowerman and Phil Knight. This pair grew the company from a U.S.-based footwear distributor to a global marketer of athletic footwear, apparel, and equipment that is unrivaled in the world.<sup>26</sup> Headquartered near Beaverton, Oregon, a suburb of Portland, Nike now operates in more than 160 countries around the globe. Through its suppliers, shippers, retailers, and other service providers, Nike directly or indirectly employs nearly one million people. This includes more than 35,000 Nike employees across six continents, each of whom contributes to fulfilling Nike's mission statement: "To bring inspiration and innovation to every athlete in the world."<sup>27</sup>

The Nike brand is world-renowned and the company is characterized by strong operational and financial performance. For FY 2011, the company recorded \$20.8 billion in revenues and \$2.8 billion in income before taxes. Nike's balance sheet is strong and the company has

**Exhibit 3** Direct Competitor Comparison

	lululemon	Adidas	Nike	Under Armour	Industry Average
Market Capitalization	\$10.58B	\$16.39B	\$50.77B	\$5.26B	\$416.10M
Employees	5,807	40,637	38,000	1,800	2.59K
Quarterly Revenue Growth	51.4%	11.3%	15.1%	33.9%	14.7%
Revenue	\$1.00B	\$17.64B	\$23.42B	\$1.47B	\$812.37M
Gross Margin	56.9%	47.5%	43.8%	48.4%	35.5%
EBITDA	\$317.22M	\$1.67B	\$3.46B	\$199.07M	\$60.60M
Operating Margin	28.67%	7.57%	12.98%	11.05%	5.80%
Net Income	\$184.06M	\$887.06M	\$2.27B	\$96.34M	N/A
Earnings Per Share	\$1.27	\$2.12	\$4.79	\$1.85	\$0.17
Price to Earnings	\$58.03	\$18.52	\$23.11	\$54.88	\$13.88
Price to Earnings Growth	\$1.56	\$2.89	\$1.72	\$2.11	\$1.01
Price to Sales	\$10.47	\$0.93	\$2.14	\$3.39	\$0.51

Source: Lululemon Athletica, Inc: Competitors. Finance. *Yahoo.com*. Accessed 20 April 2012.

Exhibit 4 Consolidated Statements of Operations

(Dollars in Thousands)	Jan 29, 2012	Jan 30, 2011	Jan 31, 2010
Net revenue	\$1,000,839	\$711,704	\$452,898
Cost of goods sold	431,569	316,757	229,812
Gross profit	569,270	394,947	223,086
Operating Expenses:			
Selling, general and administrative expenses	282,312	212,784	136,161
Provision for impairment and lease exit costs	–	1,772	379
Income from operations	286,958	180,391	86,546
Other income (expense), net	2,500	2,886	164
Income before provision for income taxes	289,458	183,277	86,710
Provision for income taxes	104,494	61,080	28,429
Net income	184,964	122,197	58,281
Net income attributable to non-controlling interest	901	350	
Net income attributable to lululemon athletica inc.	\$184,063	\$121,847	\$58,281
Net basic earnings per share	\$ 1.29	\$ 0.86	\$ 0.41
Diluted earnings (loss) per share	\$ 1.27	\$ 0.85	\$ 0.41
Basic weighted-avg number of shares outstanding	143,196	70,860	70,251
Diluted weighted-avg number of shares outstanding	145,278	71,929	70,949

Source: lululemon athletica, Inc. Form 10-K for 2011. Accessed 14 Apr 2012.

approximately \$4.6 billion in cash and short-term investments, representing over 30 percent of assets. Nike holds under \$0.5 billion in debt, a minimal amount compared to its liquidity. In terms of financial strength, Nike has a substantial capacity to invest in new markets and ventures.

Nike recently launched its own line of yoga apparel to capture part of the growing market. Nike yoga products are typically part of Nike's Dri-Fit line and are priced less than lululemon's products. Nike tops are priced from \$20 to \$40 while its pants are priced from \$40 to \$70. The line was launched in late 2011 and it has yet to be seen whether its products will be attractive to lululemon's customers.

## Adidas

Adolf ("Adi") Dassler was inspired by a single idea when he made his first shoes in 1920 at just twenty years of age: to provide every athlete with the best footwear for their respective discipline. This principle guided him and his company until his death in 1978. His first shoe, made from the few materials available in the difficult post-war period, was constructed using canvas. From the very beginning, Dassler, a passionate athlete himself, was in close contact with sporting event participants, and personally attended many important sporting events.<sup>28</sup>

On January 31, 2006, Adidas acquired Reebok International Ltd., providing the new Adidas Group

with a footprint of around €9.5 billion (\$11.8 billion) in the global athletic footwear, apparel, and sports hardware markets. Today, the Adidas product range extends from footwear and apparel to accessories for all kinds of sports. Its key priority sports are running, soccer, basketball, and training.<sup>29</sup>

Similar to Nike, Adidas is a world-renowned brand and is characterized by solid operational and financial performance. For FY 2011, the company recorded €3.3 billion in revenues and €0.9 billion in income before taxes. Adidas' balance sheet is moderately strong; the company has approximately €1.3 billion in cash and short-term investments, representing over 12 percent of assets. Adidas holds under €1.3 billion in debt, a moderate amount compared to its liquidity. Based on these metrics, Adidas has the capacity to invest in new markets and ventures.

Though Adidas does have yoga apparel, its line is very limited. The firm's styling is significantly different from lululemon's, suggesting that Adidas is targeting a different market compared to lululemon.

## Under Armour

Founded in 1996 by former University of Maryland football player Kevin Plank, Under Armour started with the simple plan to make a superior tee shirt; one that

## Exhibit 5 Consolidated Balance Sheets

(Dollars in Thousands)	Jan 29, 2012	Jan 30, 2011	Jan 31, 2010
<b>ASSETS</b>			
Current assets			
Cash and cash equivalents	\$409,437	\$316,286	\$159,573
Accounts receivable	5,202	9,116	8,238
Inventories	104,097	57,469	44,070
Prepaid expenses and other current assets	8,357	6,408	4,529
	527,093	389,279	216,410
Property and equipment, net	162,941	70,954	61,591
Goodwill and intangible assets, net	31,872	27,112	8,050
Deferred income taxes	8,587	7,894	15,102
Other non-current assets	4,141	4,063	6,105
	\$734,634	\$499,302	\$307,258
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>			
Current liabilities			
Accounts payable	\$14,536	\$6,659	\$11,028
Accrued liabilities	34,535	25,266	17,583
Accrued compensation & related expenses	22,875	16,872	10,626
Income taxes payable	8,720	18,399	7,742
Unredeemed gift card liability	22,773	18,168	11,699
	103,439	85,364	58,678
Other non-current liabilities	25,014	19,645	15,472
	128,453	105,009	74,150
Stockholders' equity			
Undesignated preferred stock	-	-	-
Exchangeable stock	-	-	-
Special voting stock	-	-	-
Common stock	551	534	511
Additional paid-in capital	205,557	179,870	158,921
Retained earnings	373,719	189,656	67,809
Accumulated other comprehensive income	21,549	20,329	5,867
	601,376	390,389	233,108
Non-controlling interest	4,805	3,904	-
	\$734,634	\$499,302	\$307,258

Source: lululemon athletica inc. Form 10-K for 2011. Accessed 14 Apr 2012.

provided compression, wicked perspiration off your skin rather than absorbing it, and worked with your body to regulate temperature and enhance performance.<sup>30</sup> Under Armour's mission is to "Make all athletes better through passion, design, and the relentless pursuit of innovation."<sup>31</sup>

For FY 2011, the company recorded \$1.47 billion in revenues and \$0.16 billion in income before taxes. Under

Armour's balance sheet is strong and the company has approximately \$175 million in cash and short-term investments, representing over 19 percent of assets. The company holds approximately \$78 million in debt, a relatively minimal amount compared to its liquidity. Under Armour has the capacity required to invest in new markets and ventures, but not to the degree that Nike and Adidas

Exhibit 6 Consolidated Statements of Cash Flows

(Dollars in Thousands)	Jan 29, 2012	Jan 30, 2011	Jan 31, 2010
<b>Cash flows from operating activities</b>			
Net income attributable to lululemon athletica inc	\$184,063	\$121,847	\$58,281
Net income attributable to non-controlling interest	901	350	-
Net income	184,964	122,197	58,281
<b>Items not affecting cash</b>			
Depreciation and amortization	30,259	24,614	20,832
Stock-based compensation	10,340	7,273	5,616
Provision for impairment and lease exit costs	-	1,772	379
Derecognition of unredeemed gift card liability	(1,775)	(1,406)	(2,183)
Deferred income taxes	(693)	11,234	387
Excess tax benefits from stock-based compensation	(5,750)	(7,863)	3,858
Gain on investment	-	(1,792)	-
Other, including net changes in other non-cash balances	(13,730)	23,966	30,790
Net cash provided by operating activities	203,615	179,995	117,960
<b>Cash flows from investing activities</b>			
Purchase of property and equipment	(116,657)	(30,357)	(15,497)
Investment in and advances to franchise	-	-	(810)
Acquisition of franchises	(5,654)	(12,482)	-
Net cash used in investing activities	(122,311)	(42,839)	(16,307)
<b>Cash flows from financing activities</b>			
Proceeds from exercise of stock options	9,614	5,836	1,209
Excess tax benefits from stock-based compensation	5,750	7,863	(3,858)
Net cash provided by (used in) financing activities	15,364	13,699	(2,649)
Effect of exchange rate changes on cash	(3,517)	5,858	3,772
Increase in cash and cash equivalents	93,151	156,713	102,776
Cash and cash equivalents, beginning of year	\$316,286	\$159,573	\$56,797
Cash and cash equivalents, end of year	\$409,437	\$316,286	\$159,573

Source: lululemon athletica inc. Form 10-K for 2011. Accessed 14 Apr 2012.

possess. The company has grown rapidly over the years, but remains significantly smaller than Nike and Adidas.

The Under Armour brand is strong in the United States; however, it lacks the worldwide awareness that Nike and Adidas possess. Nevertheless, the company has strong operations and financial performance and has marketed its products very aggressively in the United States. Under Armour recently launched its own line of yoga apparel to capture part of this expanding, growing market. Under Armour's yoga products are priced from \$40 to \$100 and its pants are priced from \$70 to \$100. The Under Armour yoga line has styling similar to lululemon yet has a limited selection as, to date, the company has focused on other apparel lines.

### VF Corp.

VF Corporation, organized in 1899, is a worldwide leader in branded lifestyle apparel, footwear, and related products. VF is a highly diversified apparel company with multiple brands, product categories, channels of distribution, and geographies. Included in the VF Corp. portfolio are brands such as The North Face, Vans, Timberland, Jansport, Wrangler, 7 For All Mankind, and Nautica. It markets its products to consumers shopping in specialty stores, upscale and traditional department stores, national chains, and mass merchants located in different parts of the world.<sup>32</sup>

Among its brands, VF Corp. is the owner of Lucy, a women's active wear brand that most closely compares

to lululemon's dedicated yoga apparel brand. *lucy* is a relatively young company, founded only a year after lululemon. "The styles are designed and developed by women who do the activities we design for: yoga, running, training, exploring the outdoors, and traveling to your favorite destination."<sup>33</sup>

For FY 2011, VF Corp. recorded \$9.4 billion in revenues and \$1.2 billion in income before taxes. Of the lululemon competitors, VF Corp.'s balance sheet is the weakest. The company has approximately \$341 million in cash and short-term investments, representing just over 3 percent of assets. VF Corp. holds over \$2.1 billion in debt, a relatively large amount compared to its liquidity. Based on these metrics, VF Corp. has a very limited capacity to invest in new markets and ventures.

VF's *lucy* is not well known within the United States and represents only a small portion of the VF Corp. brand portfolio. *lucy* yoga products are typically priced less than lululemon's products with a similar styling. *lucy* tops tend to be priced from \$35 to \$80 while its pants are priced from \$35 to \$90. *lucy* is the closest brand to lululemon in terms of product and customer focus, but the brand is one of the smallest in a large portfolio of the parent firm's brands.

### **That Which Matters the Most Should Never Give Way to that Which Matters the Least**

The general environment is particularly interesting for lululemon due to the niche nature of its product offerings (yoga, and more recently, running gear). Although lululemon offers products for males and even for children as young as four years old,<sup>34</sup> its target is females between the ages of 15 and 65. Given this broad, targeted band of the female population, the potential market for lululemon's products is over 105 million women in the U.S. alone,<sup>35</sup> representing over two-thirds of the U.S. female population. Not even considering men, children, and international customers, it is evident that the potential customer base for lululemon is substantial. Of course, other factors, such as the medium to high price of its products and the fact that not all potential customers need or want yoga apparel, cull from this potential customer base.

The geographic footprint of lululemon is growing every day. The company currently has 47 stores in Canada, 108 in the United States, 18 in Australia, and 1 in New Zealand.<sup>36</sup> Through distribution centers in the United States and Canada, and the 2009 addition of its e-commerce business, the company has been able to

serve an increasing number of international markets.<sup>37</sup> Since its customer base encompasses such a large number of people, the ethnic mix of its customers is quite diverse. Based on its product pricing, lululemon targets higher income clientele.

Given the global economic downturn, consumers worldwide have cut their discretionary spending. The company's bottom line would be expected to decrease due to the high priced, "discretionary" nature of its products; surprisingly, lululemon's sales have continued to grow for the past twelve quarters.<sup>38</sup> At this point however, it is unknown how the long-term effects of the changing global economy will affect the firm's profitability.

Uncertainties in political and legal areas also affect lululemon. The company has manufacturing facilities in the United States and Canada, but it also relies heavily on its factories in China, Taiwan, South Korea, Peru, Israel, Cambodia, Thailand, and Vietnam.<sup>39</sup> International and country-specific rules and regulations play a significant role in getting the company's products to market in a timely manner. Ensuring compliance with lululemon's internal, international, and country-specific policies is a time- and capital-intensive effort.

Recently, the company has had to deal with the California Transparency in Supply Chains Act of 2010. This law requires retailers and manufacturers doing business in California to disclose their efforts to eliminate human trafficking and slavery from their direct supply chains.<sup>40</sup> This is just one example of the many legal hurdles that lululemon must address to operate effectively both domestically and globally while relying on foreign production facilities. Any potential changes in international trade laws could have a detrimental effect on lululemon's operations. Additionally, changes in international tax regulations and country-specific tax laws play a large role in the variability of the company's earnings and are an area that the company must continue to carefully evaluate.

Technology has played a surprisingly important role in lululemon's operations. Many of its product features are technology driven, including its use of silver thread in select products.<sup>41</sup> Technology has also played a key role in lululemon's expansion. The introduction of e-commerce in April 2009 has made it possible for the company to reach customers outside of its traditional bricks-and-mortar locations.<sup>42, 43</sup>

Virtually all of the company's employees, ambassadors, and guests participate in yoga and/or running. Collectively, they provide a considerable amount of valuable feedback on how to improve existing products and create potential product line extensions. Guests are given

the opportunity to provide feedback in stores and online. Ambassadors are local athletes and yoga instructors recruited by lululemon to help promote the brand and apparel. They are the focal point of the company's unique "grassroots marketing" campaign, but are not paid by the company. Ambassadors are given products to test so they can provide crucial feedback for the company. In turn, they become fans of lululemon's products and encourage potential customers to visit a store.<sup>44</sup>

Finally, lululemon's physical environment is taken into consideration in the company's operations. Whether it is reducing paper use or packaging waste at its corporate offices or gathing fabric remnants at its factories, lululemon is constantly striving to reduce its environmental footprint.<sup>45</sup>

### **Creativity IS Maximized When You Are Living in the Moment**

lululemon athletica constantly scans its external environment to identify potential key issues, including new trends that the firm might be able to serve by developing product line extensions and/or entering new markets. Scanning keeps lululemon alert with respect to identifying new potential competitors.

After a thorough environmental scanning, lululemon continues to monitor the environment and attempts to filter out the "noise" in an effort to identify what is actually important. Upon identifying potential issues, lululemon develops projections of anticipated outcomes should a potential issue become a real problem.<sup>46</sup> Finally, lululemon conducts an assessment of the timing and importance of environmental changes and trends it observes.<sup>47</sup>

The implementation of this comprehensive analysis process led the company to introduce its running apparel segment and develop the *ivivva* brand for children. It also contributed to lululemon adding its e-commerce option to serve its global customer base. This process also keeps the company aware of potential competition, including the multiple entrants into its product field since the company's founding in 1998.<sup>48</sup>

### **Jealousy Works the Opposite Way You Want It to**

The threat of new entrants within the yoga apparel industry is very high, and this poses a threat to lululemon's continuous efforts to succeed. Virtually every company that has any semblance of active wear in its product lines and manufacturing capabilities is an actual or potential competitor. As noted previously, leading global companies, such as Nike and Adidas, and regional powerhouses such as Under Armour, have joined the market.<sup>49</sup> The ease of

market entry has also opened the door for retailers such as GAP, Nordstrom, Eddie Bauer, Macy's, and many others in recent years. These new entrants bring additional capacity that, theoretically, should reduce lululemon's profits, especially in an industry where switching costs are very low. As a testament to the power of its brand and culture, this has yet to become a reality for lululemon.

The company has high standards for its suppliers and this requires a large investment of lululemon's time to ensure they are up to standards. In a retail setting, timing is very important. Because lululemon champions product exclusivity as a main component of its popularity, having an adequate and timely supply of product is crucial. In addition, lululemon does not own any of its manufacturing facilities. In fact, more than 36 percent of its product offerings are produced by 5 of its 45 manufacturers. If something were to happen to any one of these five manufacturers, it would have devastating effects on lululemon's supply chain. Additionally, 90 percent of its products are produced in Asia, with 49 percent produced solely in China.<sup>50</sup> Any global political or environmental events that affect this part of the globe would have material ramifications on lululemon's product supply.

The vast number of similar products available from many different brands means that buyers have multiple choices available to them. Additionally, lululemon's products are on the high end of the price spectrum. A change in buying habits or a large decrease in discretionary spending could affect lululemon's ability to operate as profitably as the company desires. Surprisingly, lululemon has continued to grow at an admirable pace in spite of the global economic downturn and decline in discretionary spending. Not only is it charging more than some, if not most, of its competitors, but it is selling more than it ever has. Its brand equity combined with extremely loyal customers and a highly successful grassroots marketing campaign have made lululemon a force in the industry.

### **Dance, Sing, Floss, and Travel**

lululemon athletica uses a clear set of strategies to achieve the company's vision - "To be a community hub to provide our guests with knowledge, tools and the components for people to live longer, healthier and more fun lives."<sup>51</sup>

### **Listen, Listen, Listen**

The company relies on its ability to maintain the value and reputation of its brand by successfully anticipating and adjusting to customer preferences and changing needs.<sup>52</sup> lululemon concentrates on providing an active

and comfortable communication relationship with its customers. One example is the fact that executives go into the stores and observe customer behavior. Further examples include yoga instructors providing frequent and detailed inputs to the firm's research and development process, sales staff treating their customers as guests rather than buyers, and apparel folding stations located near the dressing rooms so employees can overhear and respond to comments and complaints.<sup>53</sup>

By building relationships with its customers, lululemon is better able to design and produce products that satisfy their needs. For instance, the design team "identifies trends based on market intelligence and research, proactively seeks the input of our guests and our ambassadors" to develop products in conjunction with suppliers.<sup>54</sup> This process ensures that its products are of the highest quality and able to perform according to customer preference.

### **Goal Setting Triggers Your Subconscious Computer**

The company concentrates on creating value through its grassroots marketing, superior service, and communication with customers. Supply-chain activities also play an interesting role in lululemon's strategy. The company creates artificial scarcity through limited production runs and purposely seeks to maintain low levels of inventory. This strategy keeps the already sought-after clothing at a demand level that exceeds supply. As a result, lululemon rarely has leftover inventories, which serves as an advantage in the ever-changing retail industry. When new lines are released to the public, excitement is generated, and these lines typically sell out before their anticipated expiration date. According to the *Wall Street Journal*, this creates a "feeling of scarcity that increases the psychological need to purchase the products."<sup>55</sup>

### **Your Outlook on Life Is a Direct Reflection of How Much You Like Yourself**

The company relies on its unique capability to design and create technologically advanced products and market those unique products to a particular/targeted group of individuals. The company indicates that it may expand its product variety and target new market segments that

share the same interests as the target market: healthy lifestyles and stylish performance wear.<sup>56</sup>

### **Sweat Once a Day**

The vast majority of lululemon's revenues come from product sales in its stores located throughout the world; but a small portion comes from sales at the five ivivva branded stores. The company notes that ivivva's clothes are for very seriously active girls. The products are designed with inputs from several parties including ice skaters, gymnasts, and dancers. At least in the near term, if not the mid-term as well, revenue growth is expected to come from newly established lululemon locations, increases in ivivva's sales, and from additional online sales activity. Finally, two percent of total revenues come from wholesale operations. Revenue from wholesale operations – originating in premium yoga studios, health clubs, and fitness centers – are not expected to grow dramatically. Wholesale operations are viewed as offering "an alternative distribution channel that is convenient for our core consumer and enhances the image of our brand."<sup>57</sup>

### **Do It Now, Do It Now, Do It Now**

The company's success has been built on lululemon's ability to deliver quality products that are carefully and successfully tailored to address customers' preferences. The company has been able to create these products through input received from customers and through its grassroots marketing that utilizes ambassadors, such as local athletes and yoga instructors. As the company grows in size and continues to expand globally, can it maintain the community-centered and symbiotic relationships it has historically relied on for success?

International growth is another issue for lululemon to consider. To date, lululemon has expanded internationally into various countries such as the United States, Australia and New Zealand. These developed countries share common languages and have similar cultures, meaning that the barriers to expansion in these countries are lower than the barriers in emerging markets such as China and India. With further expansion, will the company be able to replicate its success in countries with significantly different cultures?

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