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LULU - Q3 2014 Lululemon Athletica Inc Earnings Call

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OVERVIEW:

Co. reported 3Q14 total net revenue of \$419.4m, net income of \$60.5m or \$0.42 per diluted share. Expects FY14 net revenues to be \$1.765-1.780b and diluted EPS to be approx. \$1.53-1.57. Also expects 4Q14 revenues to be \$570-585m and diluted EPS to be \$0.65-0.69.



CORPORATE PARTICIPANTS

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

Laurent Potdevin *lululemon athletica inc. - CEO*

John Currie *lululemon athletica inc. - CFO*

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

CONFERENCE CALL PARTICIPANTS

Matt McClintock *Barclays Capital - Analyst*

Bob Drbul *Nomura Securities - Analyst*

Tom Filandro *Susquehanna Financial Group - Analyst*

Jennifer Black *Jennifer Black and Associates - Analyst*

Tracy Kogan *Wells Fargo Securities - Analyst*

Alex Pham *Mizuho Securities - Analyst*

Oliver Chen *Cowen and Company - Analyst*

Matthew Boss *JPMorgan - Analyst*

Camilo Lyon *Canaccord Genuity - Analyst*

Barbara Wyckoff *CLSA - Analyst*

Kimberly Greenberger *Morgan Stanley - Analyst*

Janet Kloppenburg *JJK Research - Analyst*

Omar Saad *Evercore - Analyst*

Anna Andreeva *Oppenheimer and Company - Analyst*

Ed Yruma *KeyBanc Capital Markets - Analyst*

PRESENTATION

Operator

Good day, ladies and gentlemen. Welcome to the lululemon athletica third quarter 2014 results conference call.

(Operator Instructions)

As a reminder, this conference call may be recorded. I would now like to turn the conference over to Mr. Chris Tham, Senior Vice President of Finance. Sir, you may begin.

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

Good morning, everybody, and thank you for joining us on our third quarter 2014 conference call. A copy of today's press release is available on the Investors section of lululemon's website at www.lululemon.com, or furnished on Form 8-K with the SEC, and available on the Commission's website at SEC.gov.



Shortly after we conclude today's call, a recording will be available for replay for 30 days on the Investors section of the website. Hosting our call today is Laurent Potdevin, the Company's CEO, John Currie, the Company's CFO, along with Tara Poseley, our Chief Product Officer, who will be available during the Q&A portion of the call.

We would like to remind everybody that statements contained on this call which are not historical fact may be deemed to constitute forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Actual results may differ materially from those projected in such statements due to a number of risks and uncertainties, all of which are described in the Company's filings with the SEC.

Today's call is scheduled for one hour, so please limit yourself to one question at a time to give others opportunity to have their questions addressed. With that, I will turn it over to Laurent.

Laurent Potdevin - *lululemon athletica inc. - CEO*

Thank you, Chris. Good morning, everyone, and thank you for joining us today to review our third quarter results. John will discuss the numbers in more detail and speak to our updated guidance in a few minutes. Today, I will summarize the areas where I see positive momentum building within the Company and provide an update on areas where we continue to strengthen our business foundation.

I'm very proud of our team and the solid performance delivered in the third quarter. With a total combined comparable sales growth of 3% that showed improvement over our second quarter, marking a key inflection point with our women's business returning to positive territory. As expected, we delivered better product assortment which was a key driver of improved performance this Fall, compounded with more cohesive brand and product communication in stores, online, and through our PR strategy.

We were pleased to see sequential improvements in each month of the quarter as it progressed, driven by our product flows and new allocations. Overall, I attribute the success of the third quarter to the ongoing foundational work that's been described in the past: building our talent pool, improving our processes, and integrating brand and product. We have turned an important corner, and we'll continue to be relentless about keeping the flywheel turning and accelerating.

Let's take a look, an early look, at Q4. The fourth quarter was kicked off with our annual leadership conference in Vancouver, a gathering of approximately 900 of our key leaders including staff from our Store Support Centre, store and showroom managers, and top educators, representing amazing talent from around the globe. Since joining lululemon back in January, I've been anticipating our most important yearly gathering as a team.

Whether it was a small break-out session, or on my mat side-by-side with 900 colleagues doing yoga together, it was absolutely amazing to witness the passion and the commitment to lululemon and our long-term purpose. It was a tremendous confirmation that our people are second to none and will continue to be a unique competitive advantage as they engage with our guests every day around the world. The whole team left our conference inspired, energized, and ready to deliver on our goals.

We are pleased with our November performance as we sustained October's momentum and delivered on our sales plans with fewer markdowns than November of last year. Black Friday's performance was very strong, led by the special capsule of sequin digital prints which drove guest excitement and traffic to our stores.

Looking ahead to the remainder of the quarter, our team continues to monitor and assess the situation at the West Coast port. Our business is sensitive to this disruption since we schedule a constant replenishment of our inventory, with fluid product drops at our stores.

With the slowdown at the West Coast ports and [units] still on the water, we are actively implementing a number of strategies to mitigate the delivery issues. We have been experiencing delays of 7 to 10 days, and on that basis we estimate that this could impact our fourth quarter and year end revenue guidance by approximately \$10 million. We are continuously assessing the situation, and our entire team is focused on supporting the upcoming key holiday selling weeks and maintaining our positive trajectory into January.



Turning to our product which continues to lead the premium athletic apparel category, the strategic re-balance of our women's product assortment is paying off. Our increased focus on the pant wall, which is an anchor of the lululemon brand, resulted in positive comps. We were also the fall destination for our women's running gear. Our cold-weather layering program resonated exceptionally well with our guests.

In the men's category we expanded both in-store and online assortment, expanding our breadth of styles resulting in a strong performance with an 11% comp this past quarter.

For our younger guests, ivivva broadened its outerwear selection, and created excitement with the launch of additional prints and textures in its seamless assortment, delivering a positive comp of 37%. We are on track to open 10 ivivva stores by the end of 2014.

Innovation will drive the future of our products' success. We continue to invest in R&D dollars in new fabrics, innovative construction, and the expansion of our offering across new categories. I'm very inspired with the pace at which we're making progress and look forward to sharing more details with you as we move into next year.

Next year, we will finish the foundation work in our product engine, go-to-market process, and supply chain so we can see the tangible pay off in 2016 that we have outlined in prior calls. We will begin to shift our investment strategy towards future growth and innovation.

The guest experience that we're known for continues to be a key area of focus, and we continuously strive to improve our online guest experience. Mobile commerce is trending to be approximately one-quarter of our total e-commerce activity.

This past quarter alone, we launched our first mobile shopping app which was downloaded 274,000 times and represents approximately 8% of online sales. Additionally, we launched a redesign of the My Account feature on our website, resulting in a 27% increase in new accounts being captured this past quarter alone.

With the opening of our new distribution center in Columbus, Ohio, we have seen our average transit times for online orders reduced by 46%, now averaging just under two days for the entire United States.

The recent openings of our flagship stores represent a fantastic avenue to building brand awareness both with our local and international guests. This past quarter, our Canadian flagship store opened on Robson Street in Vancouver and almost immediately became one of the top performing stores across our entire portfolio. We now expect Robson's volume to be 50% higher than its original location, and trending to be a \$15 million store.

This month we opened a flagship store in Santa Monica that exceeded all opening sales targets and traffic goals. Its design aesthetic honors the active and social lifestyle of LA's Westside and celebrates its coastal beauty. And, at 5,700 square feet it is the largest lululemon retail store to date.

The space dedicated to men's is second only to our new standalone store in SoHo, which just opened on Black Friday. Our flagship stores have generated brand excitement and will be key assets in our future growth.

Moving now to our international activities, we are proactively building on the pent-up demand for lululemon outside of North America. On our last call, I outlined our goals to have a total of 40 new stores in Europe and Asia by 2017.

Our 2015 international real estate pipeline is very robust, and we are on track to open our first store in the Middle East in the second half of 2015. Our Covent Garden store in London continues to perform well, and our second store in Chelsea is expected to open next month.

Our Singapore store is set to open in a few hours, and we had almost 3,000 people join us at the recent Singapore Yoga Beat event on Orchard Road. We're excited to further connect with our guests in Singapore.



Speaking more specifically to our brand and community efforts, last year our "No Humbug" social media campaign was a tremendous success. This year, we launched our "Give Presence" campaign for the holiday season, which has been getting instant traction from guests through all social channels. Our Give Presence video generated over 1.2 million views within the first week of launch and has now reached 3.5 million views.

We continue to attract incredible talent to our team. I'm really proud to welcome Duke Stump as our new Executive Vice President of Brand and Community. I was inspired by Duke from the minute we met. He shares our vision of creating transformational experiences for people, and his extensive background within the athletic apparel industry, combined with leadership in socially conscious brands, make him a superb fit. I'm confident that under Duke's leadership we will continue to build a bold, audacious, innovative global brand.

We have also built upon our product team with experienced leaders and technical experts. We have hired Lee Holman as Senior Vice President of our Women's Design Division and Mark Baxendale as Senior Vice President of Planning and Allocation. Both bring tremendous strategic and global retail experience, and last but not least, we are in the final stages of our CFO search, and I am confident that we will have a smooth transition.

Before turning this over, I recognize that this is our last earnings call with John by my side. On the behalf of all of us at lululemon, I want to thank John for his enormous contributions since joining the Company in 2007. John's influence and leadership helped take lululemon public, and has continued to shape our success today.

As John embarks on his next phase in his life, I want to personally thank him for his support and wish him much happiness in retirement, with incredible powder there during his ski days, and sunshine on his boating days. With that, I will turn the call over to John who will review the financial details of Q3 and our 2014 guidance. John?

John Currie - lululemon athletica inc. - CFO

Thanks, Laurent. I'll begin by reviewing the details of our third quarter of 2014, and then I'll update you on our outlook for the fourth quarter and the full year of FY14.

Our Q3 total net revenue rose 10.4% to \$419.4 million from \$379.9 million in the third quarter of 2013. The increase in revenue was driven by total comparable store sales growth on a combined basis including e-commerce of 3%, comprised of 27% growth online; and bricks-and-mortar stores sales decline of 3%, all on a constant dollar basis; the addition of 42 net new corporate owned stores since Q3 of 2013, 27 net new stores in the United States, 2 stores in Canada, 2 stores in New Zealand, 1 in the UK, and 10 ivivva stores; and offset with a foreign exchange impact of a weaker Canadian and Australia dollar which had the effect of decreasing reported revenues by \$7.5 million or 1.8%, this was more than we had anticipated as these currencies weakened late in the quarter. This impacted our third quarter relative to our expectations and our outlook for the balance of the year.

During the quarter we opened 19 net new corporate owned stores, 15 in the US, 1 in Canada, and 3 ivivva. We ended the quarter with 289 total stores versus 247 a year ago.

There are now 222 stores in our comp base, 37 of those in Canada, 151 in the United States, 25 in Australia and New Zealand, and 9 ivivva. At the end of Q3, we also have a total of 86 showrooms in operation, 34 lululemon in North America, 16 internationally, and 36 ivivva.

Corporate owned stores represented 73.9% of total revenue, or \$310 million versus 76.5% or \$290.7 million in the third quarter of last year. Revenues from our direct to consumer channel totaled \$77.2 million or 18.4% of total revenue, versus \$62 million or 16.3% of total revenue in the third quarter of last year. Other revenue which includes strategic sales, showrooms, pop-ups, and outlets, totaled \$32.2 million or 7.7% of total revenue for the third quarter, versus \$27.3 million or 7.2% of revenue in the third quarter of last year.

Gross profit for the third quarter was \$211.1 million or 50.3% of net revenue, compared to \$204.6 million or 53.9% of net revenue in Q3 2013. The factors which contributed to this 360 basis point decline in gross margin were product margin decline of 90 basis points, due primarily to a combination of sales mix and input costs, 80 basis points of deleverage from occupancy and depreciation, 150 basis points deleverage from



continued investment in our product engine and supply chain functions, and 40 basis points deleverage from the foreign exchange impact on product costs due to the weakening of the Canadian and Australian dollar.

SG&A expenses were \$129.9 million or 30.9% of net revenue compared to \$112.3 million or 29.6% of net revenue for the same period last year. The 15.7% SG&A dollar increase is due to an increase in operating expenses associated with new stores, showrooms, and outlets, increased variable operating costs associated with the year-over-year growth in our e-commerce business, and increases in expenses at our Store Support Centre, including salaries, administrative expenses, and professional fees, partially offset by a \$3.5 million reduction in management incentive and stock-based compensation accruals, and lastly, the weaker Canadian and Australian dollar which on translation also decreased reported SG&A by \$3.4 million or 2.6%.

As a result, operating income for the first quarter was \$81.2 million or 19.4% of net revenue, compared with \$92.3 million or 24.3% of net revenue in Q3 of 2013. Tax expense for the quarter was \$22.5 million or a tax rate of 27.1% compared to \$27.7 million or a tax rate of 29.5% in the third quarter of 2013. The lower tax rate was a result of truing up our tax expense based on finalized prior-year tax filings. Absent this true-up, our tax rate would've been 30.3%.

Net income for the quarter was \$60.5 million or \$0.42 per diluted share, compared to net income of \$66.1 million or \$0.45 per diluted share for the third quarter of 2013. Our weighted average diluted shares outstanding for the quarter were 143.4 million versus 146 million a year ago.

This takes into account the weighted impact of 1.8 million shares repurchased during this quarter at an average price of \$40.49 per share. The impact of the share buyback on diluted EPS for the quarter compared to our guidance was nominal due to the timing of when these shares were repurchased. Capital expenditures were \$37.3 million for the quarter compared to \$27.9 million for the third quarter last year, with the increase associated with new stores, renovations, IT, and head office capital.

Turning to our balance sheet highlights, we ended the quarter with \$633.6 million in cash and cash equivalents. Inventory at the end of the third quarter was \$229.9 million or 11% higher than at the end of the third quarter of 2013 which is consistent with our expected revenue growth.

This now leads me to our outlook for the fourth quarter and full FY14. We anticipate Q4 revenue in the range of \$570 million to \$585 million.

This is based on a comparable sales percentage increase in the low-single digits on a constant dollar basis compared to the fourth quarter of 2013. It assumes a Canadian dollar at \$0.88 to the US dollar and 13 new store openings, 9 in the US, 1 in Singapore, 1 in the UK, 1 in Australia, and 1 in ivvva.

Now please note that the revenue range for Q4 implied in the guidance I gave last quarter was \$585 million to \$600 million or \$15 million higher. In the first five weeks of this quarter to date, we've been trending consistent with the high end of this range.

However, as Laurent mentioned earlier, we estimate the impact of the West Coast port delays will be approximately \$10 million over the balance of the quarter. The remaining reduction in our revenue expectations comes from two factors, the lower Canadian and Australian dollar, and delayed store openings, notably our second store in London on Kings Road in Chelsea which, due to construction delays, will miss the holiday season and will open in late January.

We expect gross margin to be between 51% and 52%. This is down from a year ago primarily due to product sales mix, deleverage against product and supply chain expenses within cost of goods sold, and store occupancy and depreciation, and lastly the impact of foreign exchange due to the weaker Canadian and Australian dollar compared to last year. We expect SG&A deleverage by 400 basis points as a percentage of revenue compared to the fourth quarter of 2013.

As a reminder, we are annualizing \$11 million in foreign exchange gains and \$9.1 million in bonus reversals incurred in Q4 of 2013 which contributes to 340 basis points of the deleverage to the fourth quarter this year. The remainder is driven primarily from the run rate of investments made last year and some timing of spend that shifted to Q4. Our SG&A outlook also reflects pre-opening costs related to the 13 stores planned to open in Q4 and additional stores planned to open early Q1 of 2015.



Assuming a tax rate of 30.2% and 142.6 million diluted average shares outstanding, we expect diluted earnings per share in the fourth quarter to be in the range of \$0.65 to \$0.69 per share. With the full fiscal year, we expect net revenue for the year to be in the range of \$1.765 billion to \$1.78 billion. We expect to open 48 corporate owned stores, which as Laurent mentioned earlier, now includes our first store in Asia in Singapore, and our second store in London as well as our first men's only store in SoHo, New York.

For the year, we expect gross margin of approximately 51%, down from last year due to the same factors we discussed earlier. We expect SG&A to deleverage as a percent of revenue compared to 2013. This is primarily due to continued strategic investment in areas such as IT, international expansion, brand, and again lapping both the \$17 million in the foreign exchange gains incurred throughout last year and reduced management incentive compensation.

As a result, we expect our overall operating margin to deleverage from 2013, and our fiscal year diluted earnings per share to be approximately \$1.53 to \$1.57, or \$1.74 to \$1.78 when normalized for the nonrecurring tax adjustment we incurred in the first quarter this year. This is based on 144.3 million diluted weighted average shares outstanding.

Our guidance does not reflect an estimate of shares repurchased after Q3, and it assumes an effective overall tax rate of 37.9% which includes the one-time tax adjustment, or 29.4% excluding this tax adjustment. We expect capital expenditures to range between \$115 million and \$120 million for the fiscal year, reflecting new store build-outs, renovation capital for existing stores, IT, and other head office capital including expansion of our existing premises.

With that, I'll turn it over for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Matt McClintock, Barclays.

Matt McClintock - *Barclays Capital - Analyst*

Yes. Hi. Good morning, everyone, and congrats on an excellent quarter.

Laurent Potdevin - *lululemon athletica inc. - CEO*

Thank you, Matt.

Matt McClintock - *Barclays Capital - Analyst*

Since you had talked a little bit about opening stores in Singapore and you're expanding internationally, Laurent, given your comments, your prepared remarks; I was just wondering if you could talk about the showroom performance that you're seeing in varying region. Is there any variances between showroom performance in Europe or in Asia? Anything to call out there specifically? Could you just talk about what you're seeing in some of those regions that gives you some of the confidence that the growth opportunities remain as strong as ever?



Laurent Potdevin - *lululemon athletica inc. - CEO*

Two things to point out about the showrooms. In Europe, we see showroom performance that is very much in line with what we saw earlier when we opened showrooms in the US. In Asia, we see a very strong showroom performance and it's the result of having been there for a longer time. The showroom has been opened in Hong Kong for almost four years now, so that explains the outside performance in Asia compared to Europe. Europe is on track with what we saw in the earlier years in the US.

As far as the outlook, I do have a long-term view on both Europe and Asia as having really large potential and the rest of the world being, we see, larger than North America. The economies are fluctuating, and our showroom strategies are really very powerful and a frugal way to go to market. We're opening markets in regions. We are seeing traction where we have showrooms and that will dictate the rollout. We're still on target to open 40 stores both in Europe and Asia, 20 in each region of by 2017, and that might fluctuate a little bit based on the European or Asian performance. But long-term I see the potential of both regions remaining very large for the organization.

Matt McClintock - *Barclays Capital - Analyst*

If I could have a follow-up to John, just 150 basis points of supply chain pressure on the margin, on gross margin this quarter that you felt. How should we think about that over the next several quarters, given that you should continue to make supply chain investments in 2015, setting yourself up for 2016; just the level of pressure that we should expect going for the next several quarters? Thanks.

John Currie - *lululemon athletica inc. - CFO*

You're right, and as we've said throughout the year 2014 has been a year of investment and shoring up supply chain. I think in this quarter it's a little bit higher than a run rate based on some additional testing costs that came through in the quarter, but generally speaking in 2015, we'll continue to invest with a run rate of a bigger, more capable team, and as you said to deliver the benefits of the product margin and gross margin that we've talked about for 2016.

Matt McClintock - *Barclays Capital - Analyst*

Thank you very much.

Operator

Bob Drbul, Nomura.

Bob Drbul - *Nomura Securities - Analyst*

Hi. Good morning. I just have two questions. Can you talk a little bit about the traffic trends in the stores, I guess, throughout the last quarter and then quarter to date? John, can you give us the new store productivity trends that you're seeing?

John Currie - *lululemon athletica inc. - CFO*

Yes. Okay. The good news within the comp both for Q3 and what we're seeing for Q4 is that, and similar to Q2, traffic continues to build. The traffic component of the comp in Q3 was stronger than even in Q2, and it turned positive. Now that's offset with lower conversion and units per transaction which is understandable, given where I think we're at is definitely improving brand sentiment. The product assortment to match that is still catching up, but better for Q4.



New store productivity continues to be running that 1,100 through 1,200 per square foot area. A little bit higher than more recent openings, so it's very consistent, strong performance on the new stores.

Bob Drbul - *Nomura Securities - Analyst*

Great. Thank you very much.

Operator

Tom Filandro, Susquehanna.

Tom Filandro - *Susquehanna Financial Group - Analyst*

Hi. Thanks, and congratulations on the continued strong execution. First, quick question for John, could you possibly dig a little deeper into the quarter store op margin? I think you contracted about [700]. Does that have anything to do with the store opening delays? How should we think about that contraction if there's similar contraction in the fourth quarter? Then just quickly on the port slowdown, are the goods that are on the water, are they concentrated in any particular categories or classifications? Thank you.

John Currie - *Lululemon athletica inc. - CFO*

Okay. Yes. On the store operating margin in Q3, it's a little bit more contraction than would be the norm. I think that's natural given there's a very heavy new store opening cadence in Q3, and more so than the prior year. That contracted the store operating margin to be a little bit more than you'd expect typically.

The port, to be honest, I couldn't tell you exactly if it's concentrated in any one product category. I think we have to assume it's across the board. The other thing that's important to note is, even though the disruption with the ports is the US ports, it also impacts our Canadian business because a lot of the ships that come from Asia might stop in LA, Seattle, and then make their way up to Vancouver where we unload for Canadian shipments.

Tom Filandro - *Susquehanna Financial Group - Analyst*

Okay. Thank you. Best of luck.

John Currie - *Lululemon athletica inc. - CFO*

Thanks.

Operator

Jennifer Black, Jennifer Black and Associates.

Jennifer Black - *Jennifer Black and Associates - Analyst*

Yes. Let me add my congratulations, and good luck, John, in your new endeavors.



John Currie - *lululemon athletica inc. - CFO*

Thanks.

Jennifer Black - *Jennifer Black and Associates - Analyst*

I think this question is for Tara. You've done some magnificent collections, such as the Sparkle and Exquisite collections. I wondered if you're planning to do a continuous flow of these collections all year long. Are you seeing an increase in units per transactions with the collections based on the coordinated items that lend themselves to outfitting? Thanks so much.

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

Hi Jennifer.

Jennifer Black - *Jennifer Black and Associates - Analyst*

Hi, Tara.

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

I think to really just reframe what we are focused for third and fourth quarter of 2014 was really getting the balance of the inventory right between our core and our seasonal product. Q3 was really about tackling the [pant wall] and really starting to test the new core products as well as adding print and color and texture. Again, I'm going to underscore our continued focus on core.

As we moved into the holiday, obviously, it's such a big gift giving time of year. Really focused with the design teams on making sure we are wherever we could, getting that beauty and functional in our product, because we know that's so incredibly core to our DNA as a brand. Naturally, some of these collections like Sequins and the Exquisite group reinforced that beauty and functional element to our brand. You'll continue to see those as we move into next year, but the place we're spending a lot of time on, is that core. We'll really know that the tank wall is not where it should be quite yet, and that's going to be a big focus of the design team as we move into Q1 and Q2 of next year.

Jennifer Black - *Jennifer Black and Associates - Analyst*

Right. Thank you very much. Good luck.

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

Thanks.

Operator

Paul Lejuez, Wells Fargo.



Tracy Kogan - Wells Fargo Securities - Analyst

Hi. Thanks. It's Tracy Kogan filing in for Paul. You mentioned that product mix hurt your merch margin by 90 bips. I was just wondering what impact markdowns had on your gross margin this quarter. Then I just wanted to confirm that you said you were less promotional in November, and I was wondering if you were planning to hold that online warehouse sale in the fourth quarter? Thanks.

John Currie - lululemon athletica inc. - CFO

Okay. Yes. In Q3, markdowns were actually a little bit less than the prior year. The only reason I didn't call it out was it was fairly minor, maybe 10, 15 basis points. We were less promotional in Q3. Sorry. Your question on November?

Laurent Potdevin - lululemon athletica inc. - CEO

Markdowns. In November.

John Currie - lululemon athletica inc. - CFO

Yes, which as you said in your prepared remarks, were less promotional. The question of an online warehouse sale for Q4, that really depends on how we come through the holiday season. Whether we do an online or a physical warehouse sale, that's yet to be determined or inevitable.

Laurent Potdevin - lululemon athletica inc. - CEO

Continued. Yes.

Tracy Kogan - Wells Fargo Securities - Analyst

Great. Thanks guys.

Operator

Betty Chen, Mizuho Securities.

Alex Pham - Mizuho Securities - Analyst

Hi. It's Alex Pham on for Betty. I was wondering if you could give us a sense of how the seasonal goods and fashion products were trending. Maybe in a mature market like Canada, give us a sense of that penetration versus core, and what it currently looks like in the US. Thanks.

Tara Poseley - lululemon athletica inc. - Chief Product Officer

Hi, Alex. This is Tara. The seasonal goods as we delivered, other deliveries increased, as we got into third quarter. We definitely saw a strong, positive guest response to our seasonal goods. As I said a few minutes ago, the core product both in the pants and in tanks is an area we're going to continue to be focused on as we move into next year, really driving newness in our core product which we know is so important. Speaking to the Canadian market, driving that newness in the core product is really going to benefit our Canadian guests quite tremendously because they're looking for that evolved core from us. They're also responding very well to the seasonal.



Operator

Oliver Chen, Cowen and Company.

Oliver Chen - Cowen and Company - Analyst

Hi. Congrats on all the progress. Regarding the split up between bricks-and-mortar versus online, do you expect that trend to continue in terms of running slightly negative in the stores? Are you feeling like traffic may offset some of those dynamics? Then Tara, as you do continue to focus on the core categories, is the expectation that the materials differ, or you may have SKU breadth? How are you thinking about AUR, and the innovation in terms of the product side? What's ahead with the core? Thanks.

John Currie - lululemon athletica inc. - CFO

In terms of bricks-and-mortar versus e-commerce, we've seen e-commerce has been strong. Bricks-and-mortar has been gaining traction, as I said, primarily benefited by traffic. We do expect conversion to stop being the headwind it's been. My guidance in Q4 actually, we're assuming that the stores will be positive which they have not been for some time.

Oliver Chen - Cowen and Company - Analyst

Thank you.

Tara Poseley - lululemon athletica inc. - Chief Product Officer

Then Oliver, on core, just to remind everybody, development of new fabrics is about an 18-month process. From the standpoint of seeing materials and fabric evolving, we really want to assume that to the back half of next year, and as we get closer to that we can share that. From the AUR perspective, I don't see at this point AUR going up. But as we're developing new innovation, new silhouettes, building more functional beauty into our products, we'll be looking at those products and making sure our price value equation is appropriately set in the marketplace.

Oliver Chen - Cowen and Company - Analyst

Okay. Thanks. As a quick follow-up, could you comment on men's, and how you feel about the positioning now, and where it may have opportunity to evolve over time?

Tara Poseley - lululemon athletica inc. - Chief Product Officer

I'm feeling really good about men's. Early indications of our men's only store have been really great, positive guest response. We see as we are giving men's expanded space both in our Robson store, our standalone store, we're able to expand each one of the categories from our sweat category to the no-sweat, which is really the sweatshirts and things you put on after your workout, and post-sweats, which is really our commute line. We see all three of those categories have opportunity to add breadth within those. As we move into next year, you'll see those categories growing online, which is a great place for us to continue to test and try and learn, as well as expanding what we're doing in our men's only spaces where we have that additional square footage.

Laurent Potdevin - lululemon athletica inc. - CEO

This is Laurent. To add to what John and Tara said, we've a better product assortment, a better flow, and also better predictability. We've been able to work much more closely with our brand and community team, and communicating very strong, cohesive story, as you saw during Black Friday. That's a big part of the confidence that we feel in building trust and returning to positive store comps.



Oliver Chen - Cowen and Company - Analyst

Thanks. Congrats on all the excitement. Best regards for the holidays.

Tara Poseley - lululemon athletica inc. - Chief Product Officer

Thanks, Oliver.

Operator

Matthew Boss, JPMorgan.

Matthew Boss - JPMorgan - Analyst

Hi. Good morning, and nice quarter. With productivity (inaudible) your stores, it sounds unchanged. Any initiatives to kick start some of your mature stores? Have you thought about a remodel program, or can you just talk about performance in some of your stores more than five years old?

Laurent Potdevin - lululemon athletica inc. - CEO

I'm sorry. It's really hard to hear you. Do you mind repeating the question, and maybe getting closer to the phone?

Matthew Boss - JPMorgan - Analyst

Yes. Productivity in your new stores sounds like unchanged. As we think about some of the more mature stores, can you just talk about any initiatives to kick start their performance in your more mature stores, particularly those five years or older?

John Currie - lululemon athletica inc. - CFO

Yes. In general, especially a high volume store, we regularly renovate them every three years, and normal stores, five years. In addition, we got an ongoing program where older stores that were maybe not in the best location within a mall or on the street or were a little bit too small in terms of square footage, every year we're doing relocations or expansions.

Then in a limited number of cases, as we talked about, Robson Street in Vancouver is a good example; we've moved from a very strong 3,400-square foot store, up to more of a flagship store at 4,500 square feet. Flagship's the wrong term because flagships are often characterized as marketing initiatives. In this case, it's a much more profitable store. We're looking for opportunities to make those shifts as well.

Laurent Potdevin - lululemon athletica inc. - CEO

We have an entire group internally very much focused on guest innovation and guest experience, so you've seen [wide] space for products. Think about that group as being the same focus on our guest experience both online and in stores. Longer-term focus on the innovation, but certainly something that will have an impact on those more mature stores.



Matthew Boss - JPMorgan - Analyst

Great. Then just to circle back on the margin front, so it sounds like you continue to buy chain investments. What kind of a comp next year do you need to lever occupancy and rent? Then, if you could just breakdown, as we think about gross margin, should we think about gross margin down next year, and then inflection being in 2016?

John Currie - lululemon athletica inc. - CFO

In terms of leverage on occupancy and depreciation, there's a lot of moving pieces. In general, I'd say it's mid-single digits comp, again, impacted by some of the renovations that we're doing, et cetera, but mid-single digits is about right. I'm sorry. Your second question was what?

Matthew Boss - JPMorgan - Analyst

Gross margin overall in aggregate, should we think about gross margin as down next year, given the supply chain investment? Is that a mid-single digit store comp or all in comp?

John Currie - lululemon athletica inc. - CFO

I'm talking store comp. In terms of supply chain investment gross margin, as I said, 2014 obviously, a build-a-foundation year which is continuing into the early part of 2015. In addition, we're shifting our focus from simply building foundation investments, to investments in supply chain that drive growth, so it'll be that as well. Of course at this point, we're not guiding to gross margin next year. In fact, we're still working through the details of new initiatives in terms of our budgeting for next year. We'll give guidance for next year as we always do when we report Q4.

Matthew Boss - JPMorgan - Analyst

Okay. Great. Thanks. Best of luck.

Operator

Camilo Lyon, Canaccord.

Camilo Lyon - Canaccord Genuity - Analyst

Thanks. Good morning, guys. I had a couple questions. Number one, could you tell us, John, what the impact of the online warehouse sale was to the third quarter? Number two, can you just update us on, what you just said right now to the prior question, the shifting to investments in supply chain that will drive growth? What kind of investments are those? What will we expect to see from the supply chain side that can lead to better growth? Then finally, on gross margin are you at a point where the seasonal component can start to be a margin accretive product category in 2015?

John Currie - lululemon athletica inc. - CFO

Okay. I'll take the online warehouse question. Yes. It was in October. Rather than just have markdowns in our we-made-too-much-site throughout the quarter and really concentrating sales into a limited time period, as opposed to more spread out in our outlets; we decided to do an online warehouse sale. It was like three days. I think we did \$3 million to \$4 million. Again, it was expected in our earlier guidance. That did concentrate that level of sales in online versus what otherwise might have been outlets.

Sorry. Whenever you ask more than one question, I always have to ask what's the second question?



Camilo Lyon - *Canaccord Genuity - Analyst*

Sure. No problem. Just in response to the prior question, you talked about next year being the year in which you shift some of your supply chain investments to investments that will drive growth, if you could just elaborate on what that means? Then maybe for Tara, the seasonal [componentary] of your products, are we at a point that 2015 should have positive gross margin contribution from the seasonal mix?

Laurent Potdevin - *lululemon athletica inc. - CEO*

If you think about the shifting of the investments, think about further investments in R&D, and some of what Tara and her group are working on in fabrics and new silhouettes, as well as continued seamless, authentic guest experiences, both online and in stores as well as our continued international development.

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

Then for the seasonal component, as we move into next year and all the supply chain work we've done on our go-to-market calendar, that we've been talking about, we will start seeing those improvements in seasonal product as we move into the back half of the year.

Camilo Lyon - *Canaccord Genuity - Analyst*

Got it. Best of luck for the holiday. Thank you.

John Currie - *lululemon athletica inc. - CFO*

Thank you.

Operator

Barbara Wyckoff, CLSA.

Barbara Wyckoff - *CLSA - Analyst*

Hi, everybody. Good job. This question is for Tara. Can you talk about initiatives for [sage] basic fabrics so you're better able to respond to reorders on seasonal goods, and quickly? Could you talk a little bit about the testing mechanism and timing on turnaround time, assuming the fabrics are on hand?

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

Okay. I just want to make sure, I'll just talk about what we're working on right now as a team. We've build-out a model to really project out on our raw materials over a five-year period, all of the different key raw materials that we use which is really a stage one to make sure, that on the five-year horizon we're staging the fabrics appropriately. That's going to continue to help us in our process, really being able to build more speed and into our process.

Then as for testing, we've found that Q3 was when we had said we'd have all of our testing protocols in place, up front in the supply chain stream, for raw materials in our factories. We hit that, and that's really where we are with testing. I wasn't quite sure what you're additional question was around testing.



Barbara Wyckoff - CLSA - Analyst

Just of the timing of the turnaround, assuming you have the fabric, how long does it take to, something checks, how fast can you get it back in stock?

Tara Poseley - lululemon athletica inc. - Chief Product Officer

Yes. I'm not ready to talk about that at this moment in time, but just do know that speed is important to us, and we continue to create these improvements in our supply chain in order to take advantage of speed.

Barbara Wyckoff - CLSA - Analyst

Great. Thanks.

Operator

Kimberly Greenberger, Morgan Stanley.

Kimberly Greenberger - Morgan Stanley - Analyst

Great. Thanks. John, I'm wondering if you can just address your long-term gross margin targets. I know you said in the past you expect to be able to get back to that 55% level, but it looks like the majority of the decline in gross margin that you're experiencing is a structurally higher cost base. In the absence of mid-single digit positive store comps, what do you think your long-term gross margin should look like?

John Currie - lululemon athletica inc. - CFO

Yes. If we focus on the core North American business as the base layer, we continue to see the road map to get back to the mid-50% gross margin that we had been at. All the work that Tara and Jennifer's teams are doing, as we've talked about in the past, we continue to believe those will deliver about 300 basis points in improvement in gross margin. As well, there's a lot of other efficiencies beyond that, that I think over time, we'll be able to enjoy.

I've mentioned, it's not built into that 300 basis points, but even being more buttoned down, we'll be able to provide better guidance to our factory partners that will allow them to reduce the contingency that they need to build into our pricing. There's other potential upside in there. We see that road map to 55%. Of course, as you layer on the new markets, that are really Asia and Europe are effectively startups; initially they'll be a lower margin profile, but when they reach a relative level of maturity that (inaudible).

Kimberly Greenberger - Morgan Stanley - Analyst

Okay. John, just one clarification on the cash balance, \$633 million, how much of that is in the US and available for share repurchases?

John Currie - lululemon athletica inc. - CFO

I don't think there's a lot of it actually in the US. Having said that, we've provided already, I guess in Q1, for the tax that we'll incur on moving cash up. I think there's another \$300 million that we can move up where the tax has already been provided for.



Kimberly Greenberger - *Morgan Stanley - Analyst*

Thanks so much.

Operator

Janet Kloppenburg, JJK Research.

Janet Kloppenburg - *JJK Research - Analyst*

Good morning, everyone. Congratulations on the progress, and John, thank you for all the help you've given us over the years, and best of luck. Just a couple of quick questions, I was wondering if the port strike issues could have a tail into the first quarter, or if you see that problem terminating here in the fourth quarter?

Secondly, Tara, if you could just speak to the redesign of the core product? Do you think that's complete in terms of the leggings and the tanks, or do you think there's more work to be done there? Thanks so much.

John Currie - *lululemon athletica inc. - CFO*

In terms of the port situation, we're continuing to monitor it basically every day. Of course, if it turned into a strike then --

Laurent Potdevin - *lululemon athletica inc. - CEO*

It's not a strike right now.

John Currie - *lululemon athletica inc. - CFO*

Yes, it's not a strike right now. That would of course, change things for everyone. But having said that, we've taken steps with respect to our future shipments. Even by the end of December, a lot of them will be rerouted through Vancouver, and get down to the States by rail. That will still likely, give rise to one to three day delay but it won't be the 7 to 10 days that we're seeing right now. I think as you get into Q1, even January, the impact, if it's status quo, should be minimal.

Janet Kloppenburg - *JJK Research - Analyst*

Thank you. Tara?

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

Okay, Janet. How are you?

Janet Kloppenburg - *JJK Research - Analyst*

Good. How are you?



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

I like to call it the evolution of the core product. I look at that, we launched that work in Q3, but as I said, that work is going to be carried into next year. That was just really the start, and I think we've got still a lot of work to do on the tanks. You'll see more of that as we move into Q1 and Q2, as well as continuing to test and try new core styles in the bottoms. But we're progressing, and we are on our way.

Janet Kloppenburg - *JJK Research - Analyst*

Okay. Have a great holiday.

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

Thank you.

Operator

Omar Saad, Evercore.

Omar Saad - *Evercore - Analyst*

Thank you. I wanted to ask a follow-up question on the comment you made about the women's business turning positive. If you think about a year ago, that was all the controversy going on, and the impact it had on your traffic, and you reflect on the last year, have you seen the female customer evolve or change at all? I know in our annual holiday survey, lululemon brand really jumped up with the teen customer. Maybe you're seeing a younger consumer drive some of those positive comps in women's business? Or you're seeing that core female loyalty consumer start to come back and spend more on the brand? Thanks.

Laurent Potdevin - *lululemon athletica inc. - CEO*

We're seeing both. We're seeing much greater brand sentiment, and we're seeing obviously much greater traffic. In a lot of the retail that we've seen when Advent came on board through [Ben and MacKenzie]. We've got a very loyal guest, and she's coming back, and she's coming back more often. I think it's really a combination of gaining that core loyal customer, and giving her a lot more opportunities to engage with us, and buy with us more often, and bringing us new guests as well.

Omar Saad - *Evercore - Analyst*

I appreciate it. Thanks. John, thanks for all your help over the years.

John Currie - *lululemon athletica inc. - CFO*

Thanks, Omar.

Operator

Anna Andreeva, Oppenheimer.



Anna Andreeva - *Oppenheimer and Company - Analyst*

Great. Thanks so much. Good morning, guys, and congratulations on seeing stability in the business.

Laurent Potdevin - *lululemon athletica inc. - CEO*

Thank you.

Anna Andreeva - *Oppenheimer and Company - Analyst*

I was hoping to follow-up. I'm not sure if we missed it. What was the comp in Canada and Australia during the quarter? In Canada, I think you closed a handful of stores. Maybe talk about the margin profile in the region, and what's the ultimate store footprint that you see in Canada? Just as a follow-up to John, I'm not sure if you commented, just the quarter-to-date commentary, did comps continue to sequentially improve along with traffic? Thanks so much.

John Currie - *lululemon athletica inc. - CFO*

Okay. Yes. Canada continued to be slightly negative, but again improving. It was low-single digit negative, versus the US being low-single digit positives. Australia is a little bit higher in terms of a comp. I think there's lots of opportunity there. It comped high-single digits in the quarter. Again, I need you to repeat your second question.

Anna Andreeva - *Oppenheimer and Company - Analyst*

On the store footprint opportunity in Canada, I think you closed a handful of stores. Just a follow-up on the quarter-to-date trends, are you seeing improvement in comps along with traffic?

John Currie - *lululemon athletica inc. - CFO*

Right. Okay. We haven't closed any stores. What you're probably seeing is that we've taken some out of the comp base as we move them, renovated them. Robson, for example, was our second store worldwide, but with the relocation and the increase in size, it's out of the comp base. Other than that, there's no closures in Canada.

Sorry, third question. Can you repeat it again?

Laurent Potdevin - *lululemon athletica inc. - CEO*

(Inaudible)

John Currie - *lululemon athletica inc. - CFO*

The trend into November, I think was your question, traffic and other metrics are continuing to trend up better than what we saw in Q3.

Anna Andreeva - *Oppenheimer and Company - Analyst*

Terrific. Thanks so much. Best of luck.



Operator

Ed Yruma, KeyBanc Capital.

Ed Yruma - *KeyBanc Capital Markets - Analyst*

Hi. Thanks for taking my question, and best of luck, John. Two components, one, given the strong comps and store growth at ivivva, how would you describe the materiality of the business to overall profitability? Two, on in-store inventory, how would you characterize it? I know you're obviously going to see an impact from the port delay, but are you sufficiently in stock to meet demand? Thank you.

John Currie - *lululemon athletica inc. - CFO*

Okay. I think ivivva has got lots of traction. I think this quarter we crossed the thousand dollars a square foot productivity point, but it's still very small. We'll end the year with 20 stores. They're smaller than lululemon women's stores, so not a meaningful component at this point. Again, second question?

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

It's the inventory.

John Currie - *lululemon athletica inc. - CFO*

Yes.

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

Stocked to meet demand.

John Currie - *lululemon athletica inc. - CFO*

Yes. In stocking, we're more of a DC-based model. Again, we started the quarter in pretty comfortable inventory positions, and I think through November the deliveries continued to maintain that position. Of course, with the port disruption that has caused a gap in this next little while, so we have about a million units that are stuck at the ports right now, but there is movement. They're coming through. It's not optimal, and that's why I reflected that in reduced guidance. But we do see breaking that logjam. Then as I said, we've rerouted subsequent shipments through Vancouver so that the impact won't continue.

Ed Yruma - *KeyBanc Capital Markets - Analyst*

Great. Thanks so much.

Laurent Potdevin - *lululemon athletica inc. - CEO*

All right. Thank you very much, everybody. We wish all of you a very happy holiday season, and we'll talk to next quarter.



Operator

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

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