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Lululemon Goals a Stretch as Analysts See Growth Slowing

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Lululemon Inc. (LULU) says it can double its size in the U.S., build an international unit almost from scratch and get men hooked on $88 yoga pants. More and more analysts are saying those plans are a stretch.

As the company looks for a new chief executive officer to succeed the retiring Christine Day, there's growing evidence the yoga-wear powerhouse can't sustain its current growth. Lululemon is running out of room to expand in North America, and sales gains at established stores are slowing as brands such as Gap Inc. and Nike Inc. encroach on its turf.

"It's unlikely that it's going to stay on this double-digit trajectory," Jahnia Sandford, a Columbus, Ohio-based analyst for Kantar Retail, said in an interview. "It's a very small company, and the goals that they have are very, very big for what they may or may not be able to pull off in the next three years."

Lululemon has been a retailing phenomenon since its founding in 1998 as it used free yoga classes and local brand "ambassadors" to help amass a cult-like following in the U.S. and Canada. Those customers have proven willing to shell out about $60 for tank tops and $90 for stretchy pants that are meant to be as fashionable on the street as they are comfortable in the yoga studio.

Still, while the shares have climbed more than fivefold since their initial offering in 2007, sentiment is starting to shift. About 35 percent of the analysts covering Lululemon recommend buying the shares, down from 50 percent a year earlier, according to data compiled by Bloomberg. The shares closed yesterday at a 41 percent premium to the Standard & Poor's 500 Retailing Index on a price-to-earnings basis, the smallest premium in more than three years. Lululemon rose 0.2 percent to $65.55 at 9:31 a.m. in New York.

Slowing Gains

The gain in sales at stores open for at least a year, excluding the effect of foreign-currency translation swings, peaked at 35 percent in the first quarter of the company's fiscal 2010, according to a June 10 report from Buckingham Research Group. And while new locations helped boost total revenue 37 percent last year, that growth may not be sustainable as Lululemon runs out of prime sites in affluent neighborhoods, Sandford said. The Vancouver-based company says the U.S. can support 300 of its stores, more than twice its current total.

Lululemon's "price point is very high for them to double their footprint," Sandford said in an interview. "There's not a ton of SoHos or San Franciscos out there."

Alecia Pulman, a Lululemon spokeswoman who works for Integrated Corporate Relations, declined to comment beyond information provided in the company's last earnings call.

International Expansion

Expanding overseas is not necessarily a panacea, either. Nike, the world's largest sporting-goods company, shows the troubles Lululemon's high-priced products may face abroad. The Beaverton, Oregon-based shoemaker in September said it had resorted to discounting merchandise in China to clear inventory that wasn't selling well, which was in turn hurting demand for new products.

Lululemon Chief Financial Officer John Currie said earlier this month that his company, which has 25 stores in Australia and New Zealand plus a handful of showrooms elsewhere, eventually can have about as many stores internationally as it does in North America.

"The plans are far too aggressive, especially since it's almost a business version of buckshot where you're looking at a map of the world and putting a pin in places where they are," Burt Flickinger, a managing director at New York-based Strategic Resource Group, said in an interview.

New Competition

Closer to home, the rapid growth of recent years has drawn rivals into a yoga market Lululemon once had largely to itself.

In 2008, San Francisco-based Gap bought Athleta Inc., located in nearby Petaluma, for about $150 million and has been using its rival's playbook to expand, including hooking up with local yoga instructors, sponsoring classes such as Mommy & Me Yoga and training staff to make recommendations tailored to customers' interests.

While the chain had only 35 North American locations as of Jan. 28, compared with 186 for Lululemon, Gap plans to add 30 more Athleta stores this year.

Under Armour Inc. (UA), the sportswear maker famous for its moisture-wicking fabric, also is looking to boost sales to active women. In February, the company opened a test store with natural light and softer colors in its headquarters city of Baltimore to appeal more directly to women. Like Lululemon, Under Armour is advertising the apparel as sport- and street-appropriate. The company plans to open a second store this year.

'Niche Player'

Lululemon had "benefited from being considered a little bit of a niche player," Denise Lee Yohn, a San Diego-based branding consultant, said in an interview. "As they grow, then the larger, more established retailers maybe start seeing them more as a competitive threat -- and that puts more pressure on Lululemon to be more aggressive with their prices or their marketing."

There are early signs the competition is starting to drag on Lululemon's growth. Same-store sales in constant-dollar terms rose 10 percent in the three months ended Feb. 3, less than a third of its peak rate, and gained 7 percent in its most recent quarter, when it recalled one of its most popular line of pants because the fabric was too sheer.

Store Productivity

Sales per square foot were little changed in the quarter ended in February, down from a 47 percent gain in the first quarter its fiscal 2010, according to New York-based Buckingham Research.

Among the remaining bullish analysts is Faye Landes at Cowen & Co. in New York, who says she's not alarmed by the slowing gains.

Lululemon still is growing at "very, very robust levels which would be the envy of almost every other company," she said in an interview. "There's absolutely no evidence that they're even close to saturating the market."

Still, all of these challenges are hitting just as Lululemon is seeking a new CEO. Day, 51, said last week she'd step down once the company found a replacement. The company needs someone who can replicate Day's success in maintaining the company's culture and translate it abroad, said Sam Poser, an analyst at Sterne Agee & Leach Inc. in New York.

"They could hire the best product person in the world and if he or she doesn't fit into that culture, they won't sell any of this great stuff," Poser said in an interview. "No one will pay up for it."

New Customers

Another of the new CEO's goals will be to find new customers at home. To that end, the company has been adding apparel for golf and tennis to its stores and plans to introduce its first standalone men's store by 2016.

Perhaps more challenging will be getting its current customers to make more purchases on return trips once they've stocked their wardrobes and to bring in new shoppers outside of its base of yogis and runners, Sandford said.

"The lifestyle focus is definitely a way to garner competitive advantage and brand loyalty, but you're definitely chasing your sales a little bit instead of sustaining them over a long period of time," Sandford said. "You have to acquire new shoppers in order to drive a portion of your growth at some point."

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