

THOMSON REUTERS STREETEVENTS

EDITED TRANSCRIPT

LULU - Q2 2014 Lululemon Athletica Inc Earnings Call

EVENT DATE/TIME: SEPTEMBER 11, 2014 / 1:00PM GMT

OVERVIEW:

Co. reported 2Q14 net revenue of \$390.7m and net income of \$48.7m or \$0.33 per diluted share. Expects FY14 net revenues to be \$1.78-1.80b and diluted EPS to be approx. \$1.51-1.56. Expects 3Q14 revenues to be \$420-425m and diluted EPS to be \$0.36-0.38.



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

Adrienne Tennant *Janney Capital Markets - Analyst*

Jessica Schmidt *KeyBanc Capital Markets - Analyst*

Brian Tunick *JPMorgan - Analyst*

Oliver Chen *Citigroup - Analyst*

Camilo Lyon *Canaccord Genuity - Analyst*

Lorraine Hutchinson *BofA Merrill Lynch - Analyst*

Kimberly Greenberger *Morgan Stanley - Analyst*

Omar Saad *ISI Group - Analyst*

Bob Drbul *Nomura Securities Intl - Analyst*

Betty Chen *Mizuho Securities USA - Analyst*

Lindsay Drucker Mann *Goldman Sachs - Analyst*

Tom Filandro *Susquehanna Financial Group - Analyst*

Faye Landes *Cowen and Company - Analyst*

Howard Tubin *RBC Capital Markets - Analyst*

Paul Lejuez *Wells Fargo Securities, LLC - Analyst*

Dorothy Lakner *Topeka Capital Markets - Analyst*

Janet Kloppenburg *JJK Research - Analyst*

Ben Shamsian *Sterne, Agee & Leach - Analyst*

Dana Telsey *Telsey Advisory Group - Analyst*

PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Lululemon Athletica second-quarter 2014 results conference call.

(Operator Instructions)

As a reminder, today's conference call is being recorded. I would now like to turn the conference over to 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 second-quarter 2014 conference call. A copy of today's press release is available on the Investor's 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 end this morning, a recording of today's call will be available as a replay for 30 days on the Investor section of the website. Hosting our call is Laurent Potdevin, the Company's CEO; John Currie, the Company's CFO; and Tara Poseley, our Chief Product Officer will also 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 facts 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. For today's call, we have a limit of one hour, so please limit yourself to one question at a time to give others an opportunity to have their question addressed. With that, I will turn it over to Laurent

Laurent Potdevin - *Lululemon Athletica Inc - CEO*

Good morning, everyone. The results we are sharing with you today are beginning to reflect the ongoing work that is being done across our entire organization, and our sales and bottom line for the quarter finished slightly ahead of plan. We are early in the process of getting back to consistently delivering amazing and innovative product to our guests, along with unmatched guest experiences. We obviously don't aspire to flat same-store sales and earnings that are down year-over-year, and yet are confident that work and investments we are making is building the foundation that will fully unlock Lululemon's long-term global potential.

On our last call, I let out four key priorities, product, brand, guest experience, and international expansion, and our second quarter results indicate consistent progress against those priorities. On the product front, product flows were (inaudible) forth in our sales trend in the second quarter. This was particularly evident in July, as we changed into additional trends in bottoms, and leveraged our fast turn team to create mesh product, which brought newness and excitement in stores and online.

Additionally, our transitional collection which was a new strategy to bridge summer and fall was incredibly well-received by our guests, and created the upside we saw in July by selling through faster than anticipated. While our assortment are not optimal this year, we have started to shift our mix with further improvement expected in 2015.

We have also emphasized our commitment to building our foundation over the next 18 months, in order to set ourselves up for global growth. One of these foundational areas to strengthen is our go-to-market process, and although it's still early, we are hitting each milestone in the implementation of the calendar that we have set to achieve. At this time, we have completed the [cadence] of the calendar, resulting in four additional weeks of creative space for our designers, as they start the design of fall 2015.

This past quarter, our Whitespace workshop has started partnering with our ambassadors on three different fronts. First, co-creating innovative technical and beautiful product with a small group of early ambassadors.

Second, gaining a deep insight into the athlete/product relationship, and third, testing and validating product development in upcoming launches. The information we derive from our workshop projects, combined with the world-class product engine will drive the innovation that our guests love.

Moving on to brand and guest experience. On our last call, I spoke about one of our most unique yet under leveraged asset, our 1,500 strong army of ambassadors. These athletes are leader in their communities, they embody our lifestyle, and reflect our amazing culture in everything that they do. They are the authentic voices in our communities, whose local stories and insights are shifting our global brand, and we are committed to building and nurturing this group of inspirational athletes.



One of the ways, we are harnessing the collective power of this group is through the online ambassador forum we recently launched. Through this forum, more than a thousand of our ambassadors are collecting and sharing feedback with each other, the Lululemon store, and the product and Whitespace teams here in Vancouver.

Our SeaWheeze half marathon event in Vancouver, which brings together running, yoga and community, was once again a tremendous and inspiring success, and we are thrilled to see our annual event become such a sought after destination. We hosted more than 10,000 runners, 70% of whom were from outside of Vancouver, and 50% are from outside of Canada.

In fact, registration for 2015 took place yesterday, and sold out in 36 minutes. This event truly embodies the spirit of Lululemon, and we are rolling out locally relevant experiences in San Francisco, Los Angeles, New York and Toronto from October through December that will reflect that same spirit.

This year, the SeaWheeze event took place on the heels of the opening our flagship Robson store in Vancouver, a beautiful 4,500 square foot space featuring in-store digital storytelling, dedicated space for mens and women, and onsite product personalization. This new space serves as an example of the directions we are taking, with similar openings scheduled to take place in Miami and Santa Monica in the next quarter.

The store opening was supported with community events that truly showcase the engagement that currently exists among our guests. The store performance in its opening week performed at 141% to plan, which was the highest volume store globally, reaching a 18% penetration in mens sales, the highest in North America.

To further elevate our guest experience and global brand awareness, we are relocating our Soho store in New York and opening both mens and women's standalone locations kitty-corner to each other on [Prince] and [Wooster], with the mens location opening by late fall 2014. This will provide unique experiences for both men and women in spaces that are designed uniquely for their needs. I look forward to seeing how these two stores build a steady partnership, while still making sure to one-up each other every now and then.

Once again, the Ivivva business performed very well, with a positive comp of 36% this quarter. We recently launched a dreams and goals program for all our stores and showrooms to connect with our young guests, and we are incredibly excited about the potential of this growing brand. And we continue to invest in our infrastructure to support our goals.

We made significant headwinds in improving our online guest experience by opening another distribution center to improve the service level to our guests by delivering product faster. The distribution center is located in Columbus, Ohio.

Our new guest order management system went live on July 11. This is a major pillar in our one guest omni-channel strategy, enabling efficient routing of orders among all distribution centers. And this quarter, our back backroom app which allows us to process sales in-store from our online inventory created incremental opportunities, and enhanced the experience for our guests by giving them access to a broader product selection.

Moving on to our international expansion. We are seeing continued demand in brand strength globally, with our London store continuing to perform strongly, and we look forward to opening our second store in Chelsea by December 2014. We are on track to build a network of showrooms in both Europe and Asia through 2014 and 2015, and by the end of 2017 to have 20 stores in both regions. And we are very happy to announce that we have secured a fantastic location in Singapore in the Ion Mall, and are on track for a Q4 opening.

We are also in the final stages of securing our first location in Hong Kong scheduled to open early 2015. On the heels of the successful opening in London in the spring, and a continuation of strong demand and performance, we continue to look to opportunities to accelerate market entry into other regions, including being in discussions with a potential partner in the Middle East to enter the regions by Q4 2015.

Before I turn the call over to John, I want to mention that we are all looking forward to having Advent back as a shareholder. Advent was an early investor in Lululemon, and David Mussafer and Steve Collins were both instrumental in helping to guide our growth in the early years. We look forward to having their guidance once again, as we write the next Lululemon chapter.

To summarize, we are on track in building the foundation for our next phase of growth, and we continue to focus on innovation and product, brand, guest experience, and international growth. We are amplifying our brand storytelling, better leveraging our (inaudible) and seeing steady improvement on product innovation and assortment. The foundational work we are doing today, strengthening our leadership position in the market that we originated. And with that, I will turn the call over to John to review the financials.

John Currie - Lululemon Athletica Inc - CFO

Thank you, Laurent. I will begin by reviewing the details of our second quarter of 2014, and then I will update you on our outlook for the third quarter and the full year of FY14. For Q2 total net revenue rose 13.4% to \$390.7 million, from \$344.5 million in the second quarter of 2013. The increase in revenue was driven by total comparable store sales on a combined basis including e-commerce of 0%, comprised of 30% growth online, and our bricks-and-mortar store sales decline of 5%, all on a constant dollar basis.

The addition of 44 net new corporate-owned stores since Q2 of 2013, 29 net new stores in the United States, 1 store in Canada, 1 in Australia, 3 stores in New Zealand, 1 in the UK, and 9 Iivva stores. And offset with a foreign exchange impact of a weaker Canadian and Australian dollar, which had the effect of decreasing reported revenues by \$5.1 million or 1.3%.

We were able to deliver above our Q2 expectations coming into the quarter due to strong performance of fall transition product that we were able to pull forward from Q3 and drive sales in July. During quarter, we opened 7 net new corporate-owned stores, 5 in the US, 2 Iivva, and 1 in Australia and New Zealand, offset with 1 closure in Australia.

We ended the quarter with 270 total stores, versus 266 a year ago. There are now 206 stores in our comp base, 39 of those in Canada, 136 in the United States, 23 in Australia and New Zealand, and 8 Iivva.

At the end of Q2, we also have a total of 93 showrooms in operation, 42 Lululemon in North America, 18 internationally, and 33 Iivva. Corporate-owned stores represented 75.3% of total revenue or \$294 million, versus 79.5% or \$273.8 million in the second quarter of last year.

Revenues from our direct-to-consumer channel totaled \$63.5 million or 16.2% of total revenue, versus \$49.4 million or 14.3% of total revenue in the second quarter of last year. Other revenue, which includes strategic sales, show rooms, pop-ups and outlets totaled \$[33.2] million or 8.5% of revenue for the second quarter, versus \$21.4 million or 6.2 million of revenue in the second quarter of last year.

Gross profit for the second quarter was \$197.3 million or 50.5% of net revenue, compared to \$186 million or 54% of net revenue in Q2 2013. The factors which contributed to this 350 basis point decline in gross margin were product margin decline of 260 basis points due primarily to a higher mix, sales mix of lower margin seasonal product, and higher input costs, in particular with print and textured fabrics, 40 basis points of deleverage from occupancy and depreciation, 70 basis points deleverage from continued investment in our design, merchandising and product engine functions, and 50 basis points deleverage from the foreign exchange impact on product costs due to the weakening of the Canadian and Australian dollar. These were offset with a decrease in markdowns and discounts of 70 basis points, compared to the second quarter of FY13.

SG&A expenses were \$129.4 million or 33.1% of net revenue, compared to \$107 million or 31.1% of net revenue for the same period last year. This 17.3% SG&A dollar increase is due to an increase in operating expenses associated with new stores, showrooms and outlets, including higher store wages to reflect merit and base pay market adjustments, increased variable operating costs associated with the year-over-year growth in our e-commerce business, increases in expenses at our store support center including salaries, administrative expenses, professional fees, and management incentive compensation.

And in addition, we recognized \$1.3 million in foreign exchange losses attributable primarily to the revaluation of US dollar cash balances in our Canadian subsidiary, which increased overall SG&A. This is compared to a \$4.4 million foreign exchange gain in Q2 of 2013. These were offset with a weaker Canadian and Australian dollar, which on translation decreased reported SG&A by \$2.6 million or 2%.

As a percent of revenue, our second quarter SG&A deleveraged 200 basis points. As a result, operating income for the first quarter was \$67.9 million or 17.4% of net revenue, compared with \$79 million or 22.9% of net revenue in Q2 2013.

Tax expense for the quarter was \$21 million, or at a rate of 30.1%, compared to \$23.8 million at a tax rate of 29.7% in the second quarter of 2013. Net income for the quarter was \$48.7 million or \$0.33 per diluted share, compared to net income of \$56.5 million or \$0.39 per diluted share for the second quarter of 2013.

Our weighted average diluted shares outstanding for the quarter were 145.5 million versus 145.9 million a year ago. This takes into account the weighted impact of 1.4 million shares repurchased during the quarter, at an average price of \$39 -- sorry, \$39.24 per share.

The impact of the share buyback on diluted EPS for the quarter was nominal due to the timing of when the shares were repurchased. Capital expenditures were \$26.7 million for the quarter, compared to \$23 million in the second quarter last year, with the increase associated with new stores, renovations, IT, head office capital.

Turning to our balance sheet highlights, we ended the quarter with \$725.1 million in cash and cash equivalents. Inventory at the end of the second quarter was \$176.5 million or [8.3]% higher than at the end of the second quarter of 2013, reflecting a sequential improved ratio of inventory to forward sales versus the first quarter of this year.

This now leads me to our outlook for the third quarter and full FY14. We anticipate Q3 revenue in the range of \$420 million to \$425 million. This is based on comparable store sales -- sorry, comparable sales percentage increase in the low single-digits on a constant dollar basis compared to the second quarter of 2013, and assumes a Canadian Dollar at CAD0.91 to the US dollar, and 19 new store openings, 1 in Canada, 15 in the US, and 3 in vivva.

Consistent with Q2, we expect gross margin to be approximately 51%. 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 a weaker Canadian and Australian dollar compared to last year.

We expect SG&A deleverage as a percentage of revenue compared to the third quarter of 2013, driven primarily from the run rate of strategic investments made last year, and incremental spend in traffic and revenue-driving initiatives that we mentioned last quarter. The majority of these costs associated with the driving traffic initiatives will be incurred in the back half of the year, as the timing of some costs slip from Q3 to Q2. Our SG&A outlook also reflects pre-opening costs related to the 19 stores planned to open in Q3, and additional stores planned to open in early Q4 of 2014.

Assuming a tax rate of 30.2% and 144.7 million diluted average shares outstanding, we expect diluted earnings per share in the second quarter to be in the range of \$0.36 to \$0.38 per share. For the full FY14, we expect net revenue for the year to be in the range of \$1.78 billion to \$1.8 billion.

We expect to open 47 corporate-owned stores, which as Laurent mentioned earlier now includes our first store in Asia in Singapore, and our first mens 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 impacting Q2 and Q3.

We expect SG&A to deleverage as a percentage of revenue compared to 2013. This is primarily due to continued strategic investments in areas such as IT, international, traffic-driving initiatives, and lapping both \$17 million in foreign exchange gains realized 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 \$1.51 to \$1.56, or \$1.72 to \$1.77 normalized for the non-recurring tax adjustment we incurred in the first quarter.

This is based on 145.2 million diluted weighted average shares outstanding. Our guidance does not reflect any estimate of shares repurchased in future quarters, and it assumes an overall effective tax rate of 38.5%, which includes the one-time tax adjustment, or 30.2% excluding this tax adjustment. We expect capital expenditures to range between \$110 million and \$115 million for FY14, 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 will turn the call over to the operator for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Our first question is from Adrienne Tennant of Janney Capital Markets. You may begin.

Adrienne Tennant - *Janney Capital Markets - Analyst*

Good morning. Can you hear me?

Laurent Potdevin - *Lululemon Athletica Inc - CEO*

Yes.

Adrienne Tennant - *Janney Capital Markets - Analyst*

Okay, great. Well, congratulations on the improvement in the product.

Laurent, can you talk about what percentage of the July flows and are -- go forward are in the seasonal versus the core category?

And then, John, if you can talk about the inventory, you had to pull some of it forward because demand was good. So where does that put you in terms of inventory flows going into the early part of fall season. So if you can talk a little bit about that? And then really quickly, the Canadian comps versus US, if you can talk to that? Thank you so much.

Laurent Potdevin - *Lululemon Athletica Inc - CEO*

As far as the breakdown, I mean, we had this strategy of launching the transitional line that was a bridge between summer and fall that was received really well, and the sell-through was higher than anticipated. And so, we had a plan of selling about three weeks of those in July, as well as the first few weeks of August, and we pretty much moved all of that product in July. So that probably created a void in the first two weeks of August. What is the break down exactly?

Tara Poseley - *Lululemon Athletica Inc - Chief Product Officer*

So I [mentioned, the question], also about the balance of season versus this quarter so. And as we have talked about in the last call, in Q1 the balance as we move into the back half of the year is going about 40% in core, which is similar to where it had trended in 2012. John, do you want to?

John Currie - *Lululemon Athletica Inc - CFO*

Yes, on your question on pulling inventory from Q3 into July. Moving the transition line up into July helped July sales, relative to what we expected when we gave guidance. That did leave us a little bit lighter in that product for August, but still had some remaining that has helped us through August, but a little bit lighter than what we expected. So when you look at our revenue guidance from last quarter for the full year, it has really just been a shift from Q3 into Q2. And the other question on the comps, on a combined basis, US was up slightly low single-digits, and Canada was down mid single-digits.



Adrienne Tennant - *Janney Capital Markets - Analyst*

Okay. Thanks so much, and best of luck.

John Currie - *Lululemon Athletica Inc - CFO*

Thanks.

Laurent Potdevin - *Lululemon Athletica Inc - CEO*

Thank you. Our next question is from Ed Yruma of KeyBanc Capital Markets. You may begin.

Jessica Schmidt - *KeyBanc Capital Markets - Analyst*

Hello, this is Jessica Schmidt on for Ed. Thanks for taking my question. Laurent, you have been in the position for awhile now, so where do you think you still need to invest to get systems and processes to where you really want them to be? And do you think you have the necessary tools to manage the business?

Laurent Potdevin - *Lululemon Athletica Inc - CEO*

So I really do feel that we have got the necessary tool. As I mentioned on the call, and actually on the prior call, I mean, we are on this journey of building the foundation, and I am really excited to see the team hitting all of the milestones so far. I mean, it is a really deep project that we will see all of its results pay off by the first quarter of 2016. But one of the first milestones, being to free up a lot of our designer's time and giving them a lot more room to create has been achieved, and we have rebalanced the whole calendar. So that first milestone is incredibly critical in our process of really building the most technical and innovative products. So we have the investments.

We are still building the team, but we have made a lot of progress in getting a lot of things -- amazing talent on board. And so, I am really excited. It's by no means a finished project, and there is still much work to be done. But we are very much on track -- both from a human capital standpoint, from a financial standpoint, and from a technology and process standpoint.

Operator

Thank you. Our next question is from Brian Tunick of JPMorgan. You may begin.

Brian Tunick - *JPMorgan - Analyst*

Thanks. Good morning. I guess, two questions. I am sorry if we missed any comments you made about the second quarter comp drivers, whether it was traffic or conversion. We are curious, in terms of traffic, if there is any sense of loyalist versus new customers, what you are seeing there?

And then on the SG&A, John, just some more color on this timing shift? Can you give us some idea of how much spending is shifting into the second half? And it looked a little like you may have reduced your fourth quarter implied earnings guidance. So we are just wondering, was it comp or anything else in Q4 that might be taking a more conservative view? Thanks very much.



John Currie - *Lululemon Athletica Inc - CFO*

Okay. On your first question, I mean, for the past couple quarters, traffic has been down, and that has what has negatively impacted our comp. But in Q2, actually traffic turned slightly positive, so that is encouraging. But the comp is adversely impacted by lower conversion and average basket, which is consistent with the fact that our product assortment wasn't ideal. But again, encouraging in terms of the trends.

In terms of the shift in SG&A, I was really referring to some of the paid search and other traffic driving initiatives that we planned for the three quarters when we gave guidance last quarter. With sales trending a little bit higher at the back half of Q2, we didn't spend as much of that as we had originally anticipated. It is a shift of maybe \$2 million to \$3 million from Q2 forward.

And then your last question, regarding Q4. Of course, I haven't broken out Q4 in the past, so really the guidance I am giving today doesn't indicate a drop in Q4. It is consistent with what we have included in my guidance, when I gave it last quarter.

Operator

Thank you. Our next question is from Oliver Chen of Citigroup. You may begin.

Oliver Chen - *Citigroup - Analyst*

Hello, congrats on the momentum here. I had a bigger picture question for Tara and Laurent. What are your longer-term ideas in terms of how we prioritize like the factors that will keep you ahead of the competition with respect to product?

And then, a financial question is on the gross margin side, is our expectation for merchandise margins to continue to show the positive traction, and product mix to continue to be a headwind? Thank you.

Laurent Potdevin - *Lululemon Athletica Inc - CEO*

I mean, to -- before I let Tara maybe getting more into the product, and really the bigger -- the bigger strategic moves are really in ramping up everything we do with our Whitespace workshop, and combining that with our ambassadors. I mean, as I have said since day one, I mean, our ambassadors are truly our most underleveraged asset. They are the voice -- the authentic voice of this brand, and we have done a lot of work in having the Whitespace and the ambassadors collaborate in looking at new activities, looking at problems they want to solve during the activities. And we have a lot in the pipeline, both from a performance standpoint, from a raw material standpoint, and from a category standpoint, and we will be sharing that when we are ready.

And obviously, not to forget all of the work that we are doing to boost our international expansion, and that we are getting really strong demand internationally. And we have started to really accelerate the pace of our roll-out with the Singapore store opening, the final addition soon of the Hong Kong location, and the second location in London.

Tara Poseley - *Lululemon Athletica Inc - Chief Product Officer*

Okay. I think, hello, Oliver, how are you? I think Laurent stated it well, I think, going through with the team over the last six months, we have been in the process of building our three to five year product, raw material strategies, and innovation strategies. So obviously Laurent, as Laurent stated, we are not going to share those, because it's proprietary. But that work is in motion, and the teams are executing against it, really tight project plans against all of those areas are in place. So we look forward to sharing those as we go into the future.



Operator

Thank you. Our next question is from Camilo Lyon of Canaccord Genuity. You may begin.

Camilo Lyon - *Canaccord Genuity - Analyst*

Thanks. Good morning. I was hoping you could give some color on the new DC opening, how that is expected, or is expected to help product flows this year, or is that a 2015 benefit?

And then, if you could update us on the two new mills that you have added this year, and their contribution to your improving product flows?

Laurent Potdevin - *Lululemon Athletica Inc - CEO*

On the DC, the facility which we just opened in Columbus, Ohio, and the biggest improvement right now is the service level to our guest. Right? With the opening of that facility, we now have additional product, and we are reaching over 85% of our guests in two days. So as we head into Q3 and Q4, we are really excited to see that level of service improve. And then starting in January, we will be delivering the stores, from the facility.

What was the second part of the question? (Multiple Speakers).

Operator

Thank you. Our next question is from Lorraine Hutchinson from Bank of America. You may begin.

Lorraine Hutchinson - *BofA Merrill Lynch - Analyst*

Thank you. Good morning. John, as we think about the gross margin trajectory going forward, is your expectation that you will be able to get back into the mid 50%, or is the focus on fashion and seasonal product going to keep the margin down in the low 50% going forward?

John Currie - *Lululemon Athletica Inc - CFO*

As we have said, in the near-term, you are likely to see gross margin in a similar range to what you have seen in Q2. The work underway that Tara's team and Jennifer's team are doing on the go-to-market calendar over the next couple years, we see significant improvement in gross margin coming from those initiatives. I think it is -- as we have said in the past, maybe 300 or more basis points.

And then in terms of pricing architecture, we are really not at a point of talking about whether there will be significant changes that would impact product margin. So for the time being, I assume that that would not be a factor. But bottom, bottom line, just with the improvements on the process side, we see getting back closer to that mid 50% level.

Lorraine Hutchinson - *BofA Merrill Lynch - Analyst*

And what is the time frame on that?

John Currie - *Lululemon Athletica Inc - CFO*

Well, not until we get into 2016 and these initiatives have really taken hold, and have impacted the seasons that we will be delivering in 2016.

Lorraine Hutchinson - *BofA Merrill Lynch - Analyst*

Great. Thank you.

Operator

Thank you. Our next question is from Kimberly Greenberger of Morgan Stanley. You may begin.

Kimberly Greenberger - *Morgan Stanley - Analyst*

Great. Thank you. I just had a follow-up question on Lorraine's gross margin question. Obviously, understanding you don't want to reveal any trade secrets about the work you are doing on the supply chain. We are just trying to understand the move from the low 50%*s*, with the mid 50%*s* in gross margin. Is that being driven by an ability to take price in the assortment? Are you looking at trying to save on average unit costs? Maybe if you can just help us understand what the levers are that could get you there? Thanks.

John Currie - *Lululemon Athletica Inc - CFO*

It is really not based on taking pricing. That is always the last lever that we want to be pulling. It is primarily based on efficiencies. The obvious ones being reduction in air freight and some of the other costs, efficiencies coming from the new DC. But also just much smoother and more efficient process, from design all the way through to delivering to the stores.

Operator

Thank you. Our next question is from Omar Saad of ISI Group. You may begin.

Omar Saad - *ISI Group - Analyst*

Thanks. Good morning. Two questions. First one is, on the success you are seeing in the [transitional merchandise assortment], what is really going on there? What are you learning? What is so good about the assortment really driving that business, and how can you carry forward that momentum, and build upon it going forward? Any insights especially around product and stylings that is driving it?

And the second question, I have is on Ivivva. You mentioned a really good number there, a comp number there. I know it is really small. Maybe you could talk about the long-term vision for that concept and brand, and how it's going to fit versus the Lululemon brand and complement it, and where you see that going long-term? Thanks.

Tara Poseley - *Lululemon Athletica Inc - Chief Product Officer*

So I will answer the success of the transition lines. I think it really underscores what I have been talking about over the last two quarters, about our opportunity to be really consistent in bringing beauty and technical back to our product. And I think that line definitely illustrated that. I also think the work that the team did with print, and also some of the print that we chased into in the quarter, also we saw great response there. So again, it is just that newness and beauty, but always underscored by great technical products. Do you want to talk about Ivivva?



Laurent Potdevin - *Lululemon Athletica Inc - CEO*

Yes, this is Laurent, especially having a 12 year old daughter, I am very, very excited about the work that we are doing with Ivivva. There is so much correlation with what we are doing at Lululemon. And when you see the dreams and goals program that we rolled out for little girls, it has been incredibly well-embraced by our young guests. And with sales now getting into -- close to \$1000 per square foot, we are very happy with the results, and we are creating the next-generation of Lululemon guests. So a very exciting prospect, and in the meantime we are doing great work with our-- in our community with little girls. So, yes, we see a bright future with Ivivva.

Operator

Thank you. Our next question is from Bob Drbul of Nomura Securities. You may begin.

Bob Drbul - *Nomura Securities Intl - Analyst*

Hello, good morning. John, I was wondering if you could give us commentary around new store productivity trends, US, Canada, mens productivity, Ivivva productivity?

John Currie - *Lululemon Athletica Inc - CFO*

Okay. Just making sure I don't miss any part of the question. New store productivity, again in Q2, new store productivity was coming in around \$1,100 to \$1,200 a square foot. That is similar to where we have been coming in for the last year or more.

And in terms of mens, we don't really break up productivity by mens. In terms of comp, mens comped up 5%. But again, I don't have the productivity broken out. And as Laurent mentioned, Ivivva, it is on track to end the year somewhere a little over a \$1,000 per square foot productivity.

Bob Drbul - *Nomura Securities Intl - Analyst*

Got it. Okay. And I am not sure if I missed it, but did you give a full year e-com sales estimate that is included in the guidance today?

John Currie - *Lululemon Athletica Inc - CFO*

We didn't break out full year e-commerce estimate. E-commerce is, in Q2 it was running about 16%. Typically, it goes up a little bit in the fourth quarter, but we haven't specified an e-commerce number for the year.

Operator

Thank you. Our next question is from Betty Chen of Mizuho Securities. You may begin.

Betty Chen - *Mizuho Securities USA - Analyst*

Well, thank you. Good morning. Congrats on the progress. I was wondering, John, if you can talk a little bit more to the SG&A deleverage? Should we expect the magnitude to be similar to what we saw in the first half? Or given the shift in timing, should it be a little bit greater, and whether we should expect that growth rate to continue in 2015?

And then my second question is related to earlier, what were the womens comps during the second quarter? And how did that measure against Q1, if we saw any sequential improvement? Thanks.

John Currie - Lululemon Athletica Inc - CFO

Okay. SG&A, the guidance I have given say, for Q3 I think I see a margin profile pretty similar to Q2. The thing to watch for as you look at our second half, and I mentioned Q2 was skewed a little bit by non-recurring sort of foreign exchange gains last year, versus losses this year. And that simply comes from, the balance sheet date revaluing the US dollars held in the Canadian Company. So it is really not an indication of the health of the business.

But if you look at last year the Canadian dollar dropped significantly. So for the full year last year, as I said in my prepared remarks, the foreign exchange gain that was offsetting our SG&A was about \$17 million, and most of that was in the back half. So we wouldn't expect to have that benefit again this year.

Also last year, because we missed our budget and plans, our bonus accruals were reduced primarily in the back half. And that was sort of a high single-digit millions benefit to SG&A this year that we won't enjoy -- sorry, last year that we won't enjoy this year. It seems strange to say, enjoy a lack of a bonus, but anyway.

Women's comp, as I said that mens was plus 5[%], I believe women's was just slightly negative.

Operator

Thank you. Our next question is from Lindsay Drucker-Mann of Goldman Sachs. You may begin.

Lindsay Drucker Mann - Goldman Sachs - Analyst

Thanks. Good morning, everyone. I wanted to ask another gross margin question. In the last couple quarters, we have seen some pretty nice sequential improvement in the rate of decline in your product margins. You called out last quarter 110 basis points of discounts that hurt, and you didn't call it out this quarter. And then, also some of the negative mix impact got better.

I was actually curious, how do we think about what is embedded in your gross margin guidance for the back half of the year? Could you actually get a bit of a tail wind from discounts that you put into place in the fourth quarter, or are we looking at the Q2 kind of run rate of product margin compression being pretty similar?

John Currie - Lululemon Athletica Inc - CFO

Yes. Looking at the back half, and your question on discounts -- I don't think I called it out but markdowns and discounts were a little bit lighter in Q2 this year than last year. The back half, there might be a little bit of a tailwind because we had an online warehouse sale last year. We may not duplicate that this year. But other than that, the items in our gross margin guidance -- there continues to be some tailwind from product mix.

FX, again, the Canadian dollar continuing lower will impact us sort of 30 to 50 basis points. And with lower year-over-year revenue, there is deleverage on our fixed costs, occupancy and depreciation and the cost of the product team. So those continue to be the main pieces of the gross margin guidance.

Operator

Thank you. Our next question is from Tom Filandro of Susquehanna Financial Group. You may begin.



Tom Filandro - *Susquehanna Financial Group - Analyst*

Thanks for taking my question, and nice execution. I had a question on the DTC channel. I was hoping you could give us a sense of like, what is driving the acceleration? Is it transactions, average dollar growth, anticipation of what we should see for the balance of the year? And can you also address what the contraction was in that channel? I think it was down 220, so for the period?

And then Laurent, just very quickly, I think you mentioned this earlier about the omni-channel initiative in-store, driving some performance there. Can you expand on exactly what it is you are doing in store to offer that customer the full assortment? Thank you very much.

Laurent Potdevin - *Lululemon Athletica Inc - CEO*

Well, we have rolled out -- well, the pilot earlier this year, maybe even at the end of last actually. And we have rolled out to all stores now this back back room app. So it is an iPod device that is rolled out in all of our stores, that give access to the entire online inventory for [so we can strategically] service our guest. So when you are in-store, you not only obviously have access to the in store inventory, but now you have access to the whole online inventory. And we have seen a great momentum in growing this business, with last quarter to about 1% of our retail sales. So much better service for our guests, and much better use of our online inventory.

And we have also rolled out a new guest sort of management system, that allows us to flow the orders better through the different DCs. So that was the back back room app. And obviously, we have set up a full group in-house to really look at the guest experience. And as we build further technology, we are obviously going to enhance -- we are going to continue to play with technology and enhance the service that we are providing, and maximizing the inventory between the channels.

John Currie - *Lululemon Athletica Inc - CFO*

And your question on DTC, as I said in the prepared remarks, e-commerce comped up 30%. That was driven pretty much entirely by increased traffic, so strong traffic growth continues. Not much of a change, in terms of conversion or average order value.

Your other question, I think you said down 220 basis points, you might be looking at the margin -- the DTC margin that is contained in the Q. But if that is what you are getting at, it is really just the flow-through of the lower gross margin. Most of the costs related to DTC are variable, other than the product margin.

Operator

Thank you. Our next question is from Faye Landes of Cowen and Company. You may begin.

Faye Landes - *Cowen and Company - Analyst*

Hello. I am just hoping that you can elaborate a little bit more on inventory. The -- pretty consistently, your -- the products that sell really well, sell out ahead of -- earlier than you have expected. Which is in some ways, is a high class problem obviously, but you are also leaving money on the table. I don't remember the last quarter where that didn't happen. So can you talk about how you plan to adjust things, so that you can fully capitalize on the opportunities that you have?

Tara Poseley - *Lululemon Athletica Inc - Chief Product Officer*

Okay, I will take that one. Hello, Faye.



Faye Landes - *Cowen and Company - Analyst*

Hello.

Tara Poseley - *Lululemon Athletica Inc - Chief Product Officer*

Yes. So what we talked about in Q1, where we had seen the high comp [weaken] with the seasonal goods, and we had overplanned our expectation for us. So what we did for Q3, obviously, we weren't able to effect Q2. But what we did for Q3, was really shift that core investment and open to buy into the seasonal product.

We went back and looked at sell-throughs on all of our seasonal product in Q1, made sure we are planning our APSs appropriately in Q3. And really did that diligence, in making sure we were investing appropriately. But we will -- I mean, we also do really value the scarcity model. We have a very low markdown rate in the brand, which I love. So it has always got that fine balance. That is what we are looking and perfecting towards.

And then, as part of -- what we had talked about -- I think we had mentioned this earlier, we are in the process of implementing a new planning and allocation tool. That will be fully live for the planning of winter 2015, and we are on time and on budget with the execution and implementation of that tool.

Operator

Thank you. Our next question is from Howard Tubin of RBC Capital Markets. You may begin.

Howard Tubin - *RBC Capital Markets - Analyst*

Thanks. Can you just update us on where you stand on like senior level hires, and what senior level open positions are still there?

Laurent Potdevin - *Lululemon Athletica Inc - CEO*

Yes, we have got four senior level positions open. We are in the final stages of the HR and brand and community search. And we are probably about half way through the process with the CFO search, and the managing director for Europe search.

Howard Tubin - *RBC Capital Markets - Analyst*

Okay. Thank you.

Operator

Thank you. Our next question is from Paul Lejuez of Wells Fargo. You may begin.

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

Hey, thanks. Sorry if I missed any comments about the showrooms, but can you maybe talk about how your showrooms are performing, what percent of them are you happy with? And which geographies do you feel most comfortable that the brand is resonating? Thanks.

John Currie - Lululemon Athletica Inc - CFO

Maybe I will take that. We had probably the most showrooms we have ever had opened during the quarter, I think it was 90, 93? 33 of those are Ivivva, which is a real expansion of the showroom program for Ivivva. And the show rooms in North America for Lululemon continue to perform as they have, and they are our barometer for when our market is ready for a store.

I think more interestingly, the international showrooms, speaking broadly, the ones in Asia are doing extremely well, much better than the counterparts that we had in the US, as we expanded into the US. So Singapore, Hong Kong, Shanghai, those showrooms are very strong, which is an indication that there had already been brand awareness in Asia.

In Europe, with the London store opening well ahead of our expectations. And the other showrooms in London are continuing to perform very well, again, because there's growing brand awareness in London. And the other European showrooms are really doing quite similar to how the US showrooms did, when we really expanded that program back in 2009. So they are on track. They are building brand awareness, and we are building showroom sales, which is one of the indications of when we are ready to open stores. So I would say, our overall, the European showrooms are on track.

Operator

Thank you. Our next question comes from Dorothy Lakner of Topeka Capital Markets. You may begin.

Dorothy Lakner - Topeka Capital Markets - Analyst

Thanks. Good morning, everyone, and congratulations on the progress. Just a question for, I guess, either Laurent or Tara.

In terms of the milestones that we should be looking at into the back half of the year, as to where you are in the calendar, and getting to where you want to be from a product standpoint, what should we be looking for as that product comes into the stores in the second half of the year? You were obviously able to chase more in second quarter. What should we be looking for in the third and into holiday?

Tara Poseley - Lululemon Athletica Inc - Chief Product Officer

So for the back half, obviously, the go-to-market calendar and all the work that we are doing with that, we commenced that in Q1 of this year. So obviously, that did not affect Q3 and Q4 of this year, since that was already bought and commercialized at that time. So in relation to the back half of the year, it was rebalancing the core versus the seasonal, which I just talked about a few minutes ago, and just making sure we are investing appropriately in the seasonal.

We have continue to really focus with the design team, on making sure we are getting all of that beauty and technical, always technical, back into our product. Because we are very proud that we are the originators of that, and that in this space and a lot of focus there. So that is really, that is a focus this year. And then just using our [fast turn] where we can, and continue to chase them into product. A good example of that, is using the fast turn team to create a special capsule, a little capsule product to arrive right before Black Friday for some (inaudible) price selling during that weekend.

Operator

Thank you. Our next question is from Janet Kloppenburg of JJK Research. You may begin.



Janet Kloppenburg - *JJK Research - Analyst*

Hello, everybody. Congratulations on the progress being made. Tara, just a question on the product mix. I think you have introduced a lot of new bottoms, to try and reinvigorate that core category. I was wondering if you could talk about the performance there in your outlook, as we go forward for that category?

And Laurent, I think you had defined \$10 million in incremental SG&A spending on traffic-driving initiatives for the stores, and for the entire business. And I am wondering if that -- there was impact in the SG&A line from that in the second quarter, or if most of that will be incurred in the back half? Or if we potentially could see more investment there? Thanks so much.

Tara Poseley - *Lululemon Athletica Inc - Chief Product Officer*

Yes, Janet, and you are right. We had talked about that Q3 was going to be a focus on really reinvigorating our core products, starting with the bottom. And early signs are, that (inaudible) there are some emerging core that is in store now that we are excited about. And as we move into -- I am not going to call it out with (inaudible), because that is proprietary information, but we are seeing good signs there.

And then as we move into Q4, the other area that we have -- or we are very clear that we needed to continue to evolve, and create newness within tops and the tanks. And we are also will be testing some new emerging core among those areas as well. And then the fast turn team will continue to also be testing and learning, and getting that insight and information that we can chase into the future quarters.

Laurent Potdevin - *Lululemon Athletica Inc - CEO*

And then to the second part of your question, we had allocated \$7 million to drive traffic through increased page search, online campaigns, e-mail segmentation and redesigning our product notifications, that are so relevant to our guests. And most of that spend will happen in the back half of the year. In Q2 I think we spent less than \$1 million on it, and we looked at sell-through and inventory, and saved that investment for the second part of the year.

Operator

Thank you. Our next question is from Sam Poser of Sterne, Agee. You may begin.

Ben Shamsian - *Sterne, Agee & Leach - Analyst*

Hello, it's Ben Shamsian in for Sam. Thanks for taking my call. I wanted to get a little bit more on the brick-and-mortar side of the business. Can you provide us with the traffic in the brick-and-mortar stores? And then if you could, the comps by month in the brick-and-mortar?

John Currie - *Lululemon Athletica Inc - CFO*

Traffic in bricks-and-mortar was up sort of mid single-digits, but I don't break out monthly comps. I will say though that, July ended up a little stronger than our expectations, because of -- as we have talked about the pull-forward of the transition line.

Chris Tham - *Lululemon Athletica Inc - SVP of Finance*

Operator, I know there is many people still left in the queue, but we have time for one more question.



Operator

Our next question is from Dana Telsey of Telsey Advisory Group. You may begin.

Dana Telsey - *Telsey Advisory Group - Analyst*

Good morning, everyone. Can you talk a little bit on where do you stand on some of the improvements in -- from the third-party consultants, what you are learning as they look at the organization and the processes?

And then just lastly, Tara, what -- on the new line where you have seen the big improvement, on the style, price, how are the learnings able to influence the other product flows in short-term? And is the margin on this product, do you see that developing early and the ability to have improved margin? Thank you.

Tara Poseley - *Lululemon Athletica Inc - Chief Product Officer*

Okay. So the third-party consultants that we brought into help us with reengineering our go-to-market calendar, we have had really good insights. I think on the whole, it is a lot around how we were sequencing events within the calendar, and we are going through a process of resequencing how we bring product to market.

Some things were happening too late in the process that need to be moved forward. I am not going to get into all that detail, but we really, really honed in on what those pieces are, and are going through the process of a redesign of every single quarter for each season. And we are on track by Q1 of 2016, to have a fully operational go-to-market calendar.

And then, I think -- Dana, what was your second question, it was about style and price, and what we can do in the short-term? We -- this is a very scrappy and entrepreneurial culture which I deeply value, and we literally are learning minute by minute about our assortments, as we see that getting in, and using our fast turn team when we can, to react quickly to get those learnings in, And then also, in fusing that into -- any of the learnings into the future seasons that are in process and being worked on.

Operator

Thank you. I would now like to turn the conference back over to Laurent Potdevin for closing remarks.

Laurent Potdevin - *Lululemon Athletica Inc - CEO*

Well, we would like to thank you all for joining us today, and we look forward to talking to you again in the quarter. Thank you so much.

Operator

Ladies and gentlemen, this concludes today's conference. Thanks for your participation, and have a wonderful day.

DISCLAIMER

Thomson Reuters reserves the right to make changes to documents, content, or other information on this web site without obligation to notify any person of such changes.

In the conference calls upon which Event Transcripts are based, companies may make projections or other forward-looking statements regarding a variety of items. Such forward-looking statements are based upon current expectations and involve risks and uncertainties. Actual results may differ materially from those stated in any forward-looking statement based on a number of important factors and risks, which are more specifically identified in the companies' most recent SEC filings. Although the companies may indicate and believe that the assumptions underlying the forward-looking statements are reasonable, any of the assumptions could prove inaccurate or incorrect and, therefore, there can be no assurance that the results contemplated in the forward-looking statements will be realized.

THE INFORMATION CONTAINED IN EVENT TRANSCRIPTS IS A TEXTUAL REPRESENTATION OF THE APPLICABLE COMPANY'S CONFERENCE CALL AND WHILE EFFORTS ARE MADE TO PROVIDE AN ACCURATE TRANSCRIPTION, THERE MAY BE MATERIAL ERRORS, OMISSIONS, OR INACCURACIES IN THE REPORTING OF THE SUBSTANCE OF THE CONFERENCE CALLS. IN NO WAY DOES THOMSON REUTERS OR THE APPLICABLE COMPANY ASSUME ANY RESPONSIBILITY FOR ANY INVESTMENT OR OTHER DECISIONS MADE BASED UPON THE INFORMATION PROVIDED ON THIS WEB SITE OR IN ANY EVENT TRANSCRIPT. USERS ARE ADVISED TO REVIEW THE APPLICABLE COMPANY'S CONFERENCE CALL ITSELF AND THE APPLICABLE COMPANY'S SEC FILINGS BEFORE MAKING ANY INVESTMENT OR OTHER DECISIONS.

©2014, Thomson Reuters. All Rights Reserved.

