



Under Surveillance

Lululemon: Sheer lunacy

by Sonya Colberg, Senior Investigative Reporter - 4/18/2013 1:44:10 PM

Lululemon Athletica's pants fiasco is just getting worse, forcing the yoga gear company into a futile battle that we believe will persist and lead to missed earnings.

Lululemon (NYSE:LULU) CEO Christine Day stated that the company's recent recall of too-sheer pants was limited: "So it's just the black pant in particular."

The pants debacle cost LULU an estimated \$75 million - \$86 million expected to cut earnings per share by 11 cents to 12 cents. But now, the company has pulled more garments and even more recalls could be ahead.

Last Friday, the company pulled clothing made of its candy-striped Luon fabric but did so quietly, notifying only a minority of customers who happened to catch the recall mention on LULU's Facebook page. This comes almost a month after the initial recall of the core black Luon women's pants. TheStreetSweeper wanted to ask LULU why the candy-striped bottoms were no longer listed on its website this week but LULU declined an interview.

Even more clothes may need to be recalled because the sheerness problem would be as bad or worse than the black Luon garments because of the characteristics of the fabric, according to a source with 29 years of experience, including many years with a key competitor.

Photographs show some colored pants offer little more coverage than panty hose.

The company, meanwhile, is striding forward in its tried-and-true fashion of not discounting, Day also assured analysts during the March 21 conference call.

Here's what she said:

"We achieved these results in a very brand-appropriate way, and did *not buy our comps through discounting*, which ultimately *would have harmed the brand*. We maintained a full price strategy up to the holidays, then used our traditional warehouse sales as an effective and low-risk way to *clear our inventory*." (italics added)

Just one week after she made that statement, the company quietly held a massive weekend sale.

LULU customers in New York, Dallas, Los Angeles and other cities sorted through racks loaded - and often reloaded - with numerous garments over three days. These were not just last season's styles and colors but also new styles, according to our checks of more than 20 stores. In one case, the sale was so secretive that an irate customer said that, the day before the sale began in a New York City store, an assistant manager left a message on her phone saying there would be no sale.

The sales - which clerks or educators typically referred to as "markdowns," (one former clerk says the word "sale" was strictly forbidden) - are common and continuing. Indeed, significant markdowns were offered in



many stores we checked on again last weekend.

Educators in Las Vegas and Seattle stores said that customers can always find a rack or two of new and older styles marked down. In fact, the sales are directed by corporate headquarters, as a Vegas educator said that, while the store can exercise autonomy, it also gets weekly calls from corporate to learn which items to mark down.

Photos showing recent sales racks in stores across the country, along with discounted inventory and price tags are here, [set2](#), [set3](#), [set4](#), [set5](#), [set6](#), [set7](#), [set8](#), [set9.](#), [set10](#), or [set11](#).

LULU's strategy of scarcity is the coveted key to keeping customers running to its stores to buy yoga gear on the spot at full price. This is not just something she alluded to in the March 21 conference call. Day has made it obvious time and again that brand-harming discounting is not the LULU way.

"Our guest knows that there's a limited supply, and it creates these fanatical shoppers," Day told The Wall Street Journal last year.

And in an interview on CNBC in January, Day reiterated LULU's disdain of promotions: "You're either going to play in that game of discount or you're not. And we're in the 'not' category," Day said.

Traffic decline

The problem clearly isn't just sheer pants. TheStreetSweeper has spoken with investigators who, over the course of more than a year, uncovered a disturbing drop in traffic in the 20 percent range.

These investigators were stationed outside LULU stores each week to track traffic at stores from Canada to Florida. They compiled a database of store visits and percentage of people who left stores with LULU shopping bags. This information paired with research on when products were released indicates that traffic has been softening and new products aren't driving traffic to the extent LULU once enjoyed.

Samples show the traffic peaked around Christmas time but is now running about 10 percent to 20 percent below the autumn numbers. The company had more products on markdown after these weeks of slow sales than ever, store checks show, and many discounts were on 2013 products.

Growing pains

LULU could help preserve the scarcity story - and not hurt the brand - by selling excess inventory at LULU's warehouses, as Day says LULU has been doing. But that could be done only if the warehouses could handle all the capacity.

LULU also has about a half-dozen outlet stores in the US, including a pop-up shop in Albertville, Min. set up as a short-term location due to expire by the first of March but then extended until the end of May, employees said.

They said everything is always about 20 percent to 40 percent off, including tank tops, shorts and other



inventory ranging from current styles to the Christmas season. Two other pop-up stores in New Jersey and Florida carry both sales and non-sales gear.

Even burning this excess clothing or giving them to the homeless would be better, potentially brand-saving, alternatives than holding big in-store sales, according to one investor.

Such substantial problems often develop in companies undergoing supernatural growth, such as LULU has seen, according to one analyst.

“I think their growth has finally caught up with them,” said Fred Russell, of Fredric E. Russell Investment Management Co.

These problems typically range from controlling suppliers to opening stores to training upper management, he said.

“Sooner or later they are going to get caught with their pants down,” Russell said. “That’s what happened with this quality issue.”

Disturbing trends

LULU has built a reputation - through scarcity and eavesdropping - that allowed the company to sell gear at a high price point. This, in turn, has driven healthy margins and earnings.

But now we believe the company is in a tailspin, producing lower quality products and products customers just don’t like (just two examples of scores of negative comments posted on Lululemon Addict and Lulumum about new products this week: “That silver lining tank is the epitome of hideous.” “Wow could those be more unflattering and cheap looking?”) Thus, LULU’s losing customers even as competitors rush to fill the gap. LULU has been forced into a spiral of discounting that we believe will be impossible to stop.

So LULU’s selling formerly full-price gear at a discount typically ranging from 20 percent to 40 percent, our store checks show. Company executives have already said they have not been able to account for various costs associated with the initial Luon issue. Ultimately, all considered, plus the fact that the lower-priced items stand to *harm the brand* and revenues, we believe that LULU will not emerge unscathed and will fail a desperate attempt to make its numbers.

Additional expenses

LULU is undoubtedly trying to handle the growing pants-gate quickly. In a recent update, the company said it will add two new Luon manufacturing sites by fall.

But there’s more bad news woven in here, too. Luon is trademarked but not patented by LULU and therefore exercises only limited control.

LULU’s 8-K says: In addition, because we own no patents or exclusive intellectual property rights in the technology, fabrics or processes underlying our products, our current and future competitors are able to



manufacture and sell products with performance characteristics, fabrication techniques and styling similar to our products.

So the coveted cloth may be vulnerable to the competition - the fabric expert said fabric knock-offs are common in the industry - yet another reason the company's P/E of 37.9 is nearly double the industry average of 19.

Two-year manufacturer sourcing timeframe

This move to find new manufacturing sources is extremely late in the game, according to the fabric expert interviewed by TheStreetSweeper.

No clothing retailer would ever leave the manufacturing of its core products in the hands of one manufacturer, the expert said.

"This is Sourcing 101," the expert said.

The source added that apparently the strict industry standards, which would have led to LULU catching the problem before defective pants reached consumers, have been relaxed by LULU.

Setting up two more manufacturers will take one to two years, according to the source who has taken a retailer through the same re-sourcing process LULU faces.

"They want to find out a second source, a third source? There's no need," Roger Lo, the chief financial officer with the Taiwanese manufacturer of the nylon-Lycra fabric, said in a telephone interview with TheStreetSweeper. "We think for this Luon from Eclat, we have so much effort on the research and development of this fabric. So it's very hard for Lululemon to find out other sources," Lo said.

It's also troubling that the pants glitch itself likely will be more expensive than the up to \$67 million in revenue losses estimated for the year, partially because Eclat will not be eating any losses.

"There is not any defect from our provided fabric," Lo told TheStreetSweeper. "There is no penalty."

Lo added that Eclat is working closely with LULU.

"We just want to help Lululemon to get through this problem," Lo said.

That could be tougher than striking a crane pose, especially if management doesn't come up with better explanations than the omnipresent quote uttered by the chief executive: "The truth of the matter is the only way that you can actually test for the issue is to put the pants on and bend over."

Degrading its core audience?

Five days after that too-visual explanation, a customer recounted for The New York Post and social media her personal experience of having to bend over to try to get her refund for the too-sheer pants from the company



with the notoriously stringent return policy.

“The sales associate then perused my butt in the dim lighting of the change room and deemed them ‘not sheer,’” Christina Phillips of Toronto posted on the company’s Facebook page.

The media field day continued the next day when LULU attempted to recover from yet another embarrassing misstep (recall Russell’s comments on companies growing too fast to attend to basics like communicating with employees) with a hasty assurance that the revealing pants would be refunded with “no questions asked.”

But the bend-over boondoggle went viral among yogis, angering social media commentators, including “Saundra,” who posted this comment:

March 25, 2013 at 4:18 am

Unbelievable and totally unacceptable that they would subject women to such a degrading and humiliating experience when returning a faulty item! I hope someone takes them to court for this! Their clothing will always be associated with degrading women and peering at women’s bums from now on. Such BAD public relations! Major fail!

Another person posted “this is literally rape.”

LULU stock had closed over \$70 on March 14 but in the heat of the controversy closed in the \$62 range on March 28, though it has fully recovered.

Blame game

LULU initially essentially blamed its defective pants on Eclat, the fabric manufacturer, according to LULU’s March 18 press release, which said in part, “We have used the same manufacturing partner on key fabrics since 2004...We are working closely with them to understand what happened during the period this fabric was made.”

Then two weeks later, April 3, the company released two statements. One indicated the fabric met the low end of testing standards and LULU backed off from saddling Eclat with all the blame: “After an evaluation... the company concluded that the current specification and testing protocols for the signature fabric luon that were developed in 2006 have not materially changed ...”

The second release announced that Sheree Waterson, the chief product officer, would step down April 15 as part of a product reorganization effort. The company wouldn’t confirm whether the pants debacle brought on the exit.

Waterson joined LULU in 2008, shortly after Day became president, chief operating officer and designate to replace the retiring CEO. Chief executive Day’s primary experience is two decades with Starbucks, while Waterson has 25 years of experience in the garment industry, including top positions with Speedo and Levi Strauss & Co.

The departure of LULU’s third-highest earner (Waterson made almost \$1.5 million annually and has exercised over \$11 million in options; Day makes about \$3.6 million and Currie makes about \$1.5 million) boosted the sagging stock but failed to lay the pants controversy to rest.



Waterson's departure "brings a new level of uncertainty to the Lululemon story," wrote Howard Tubin the next day. The analyst with RBC Capital Markets slashed the price target to \$70 from \$80 and cut LULU to "Sector Perform" from "Outperform," in a note that apparently dinged the stock again. Tubin said Waterson was instrumental in LULU's design process and was a strong creative asset for the company, the AP wrote. He said RBC will move to the sidelines with its rating "until we have better visibility on future product direction."

The downgrade followed Credit Agricole's slashing the PT to \$55 from \$79 on March 22, right after the conference call bearing the lowered expectations.

But LULU got some relief when Janney Capital Markets on April 15 raised the target to \$77 from \$71 and called the issue "short-term, identifiable and solvable," helping to boost the stock just above \$69.

Another positive note came through Barclay's initiation with an "overweight" and \$85 price target, citing confidence in LULU's handling of the pants glitch.

We acknowledge that some analysts believe the manufacturing issue has been fixed. That may be the case but what really matters here in the long term? It's just how much LULU's customer base and reputation have been damaged.

LULU lovers to CEO: step down

Some of LULU biggest fans say others need to follow Waterson out the door. Two LULU bloggers, Lululemon Addict and Lulumum, are calling for Day to step down.

Lulumum wrote: What I expected as a solution was that the captain of the ship who has proven herself to have zero experience in the garment industry would step down. Whatever the change, I hope this is a sign of drastic return back to the quality and sophisticated designs and materials that lululemon used to be (before their nose dive in quality)

Lululemon Addict wrote:

"I'll lay equal blame at (Waterson's) feet for lululemon's decline. While cutting back on quality to fatten profits is probably best laid at CEO Christine Day's feet, I'll blame the crappy product mix at Waterson's.

"Day has ruined everything special about lululemon ... It's time to bring in a new CEO, with a commitment to quality, who has experience in the apparel industry and an eye for style," the post continued.

Indeed, Peter Cohan, an author and Forbes contributor, said if the company loses a significant number of customers, "the board should definitely consider replacing (Day). If they don't lose customers and they pretty much stabilize the situation then I'd be inclined to say a blog is a blog and people are entitled to express their opinion."

Negative posts dominate LULU's own blog

LULU's blog on its own web site is heavy with posts from disenchanting customers. Check out these excerpts:



I guess you have not been reading the comments on your product pages, but EVERY pair of pants has at least a few comments on the declining quality of material...

It is so sad to see a company that promotes itself as in touch with the needs of yogis, crosfitters, and other athletes can't even put out a basic pair of pants for us to practice in. This issue is a growing trend in your clothes, and I really wish you'd show your loyal buyers that you're actually listening and FIX the problem.

Comment by Heather — March 19, 2013 @ 9:24 am

Great, you're accepting the crappy black luon back, but what about all the sheer colors? Too little too late for this buyer!

Comment by lulu lover — March 19, 2013 @ 3:09 am

I had a pair of pants, returned them as soon as I saw the "sheer-ness" and have gone to Nike clothes. You lost a customer

Comment by Jan — March 19, 2013 @ 11:57 am

And here are more excerpts from LULU's own blog, including the first post that details nine LULU products of inferior quality and ends with this comment:

Hmmmmm, sheer luon eh? That's the tip of the iceberg lulu.

Comment by Deanna — March 18, 2013 @ 9:23 pm

Sorry lulu...but we are breaking up. It's you, not me. I have had time to do some research on you today...about your CEO, your business practices and the decline in quality since you became a publicly traded company. I have also had the pleasure of dealing with the rude educators in your stores. When your "new" product is reintroduced, I can't trust that it won't be the same items you recalled.

Comment by bdcs — March 19, 2013 @ 5:55 pm

This excerpt of April 12 is one of a number of crop reviews, both good and bad.

Why isn't it clear to this company what there doing, the losses and risks their taking by selling this crud! If it keeps up, I surely will no longer be a customer and I can guarantee thousands would agree. Another great company with no quality and sheer issues will arise one day and everyone will forget about lulu..



Defect warnings mount

LULU recalled just the black Luon pants that accounted for about 17 percent of all women's pants in the store.

The company's web site warns that some colored pants also reveal too much but LULU still waited until April 12 to quietly pull its first set of colored pants - the Candy Stripe in aquamarine - from shelves. Online buyers who click here, for example, could see examples of the sheerness warnings for other colors. And, now with more warnings than a nuclear power plant, LULU posts yet another warning available with a click on the pictured bright pants. This time, it's dye bleeding or "color transfer," similar to the controversy surrounding the "Paris Pink" color problem that LULU slapped warning labels on last fall.

Day made a point of saying March 21, "So we no longer have dye issues, and so we can very much say that with confidence."

The sheer black pants problem is the fourth quality issue in just a year, including sheerness issues with some swimsuits for spring 2012, according to Credit Suisse analyst Christian Buss.

"We see some potential that (Lululemon) risks alienating its core customer bases should quality control issues persist," Buss wrote in a note to investors.

Quality problems for Lululemon actually go back at least to 2011. Posts in November 2011 say, "scratchier, and worst of all, slightly sheer" and "every now and then I run into these weird batches of Luon."

And sheerness complaints also include Luxtreme crops, Devotion Tees and astro Wunder Unders.

Damage control issues

It remains to be seen whether the current CEO can avoid the sort of missteps and mishandling of mistakes that long ago tarnished the company history. Missteps and controversy dogged founder and former executive Dennis "Chip" Wilson until the surfer-turned-billionaire stepped down last year while maintaining his position as board chairman.

The company has dealt with difficulties including a murder of one LULU employee by another inside a Lululemon store and sexual messages or other controversial messages written on shopping bags.

And in 2007, The New York Times tested Lululemon's "seaweed" fabric claims and found no evidence of seaweed in the company's VitaSea shirt.

The excuse for misleading consumers sounds awfully familiar:

"If you actually put it on and wear it, it is different from cotton," Wilson told The New York Times before LULU changed the labels. "That's my only test of it."

In less than a week, shares collapsed to an adjusted close of \$17.74 from \$22.15 on Nov. 14, 2007, the day the story was published.



So why didn't the company learn from that embarrassing incident six years ago about how important it is to thoroughly test before the product ever hits the shelves?

Note, also, how LULU tried to deflect blame to manufacturers rather than accepting the responsibility itself, both then and now. When the Times asked Wilson about product tags bearing claims of vitamin and mineral boosts from the "seaweed" shirts, he said, "That's coming from the manufacturer. If you feel the fabric, it feels a lot different."

This is what Day told Fortune in 2011:

"Our golden rule? You screw it up, you clean it up," she said.

"Lululemon's in trouble"

Though the roughly \$75 million - \$86 million cost of the pants fiasco includes factors such as additional cost of goods sold, it does not include costs such as sales lost as impatient customers switch to other brands.

Competitors could seize this opportunity to grab market share from LULU, said Forbes' Cohan. He suspects it partially hinges around the alpha female and her followers who want to wear the brand she wears.

"If a competitor can get to that alpha female," Cohan said, "and get her to start wearing their clothes instead of Lululemon, then Lululemon's in trouble."

Indeed, wolves are gathering at LULU's door. Competitors such as Under Armour (NYSE: UA), Nike (NYSE: NKE), Gap (NYSE: GPS) and newer private companies such as Lorna Jane and Sweaty Betty are plying attractive women's yoga gear.

Another competitor gaining ground is Nordstrom (NYSE: JWN), a company that Day sniffed to The Wall Street Journal, "We aren't Nordstrom ... We aren't your personal shopper."

At the same time competitors strengthen their yoga offerings, LULU's missing out on meeting the needs of women who aren't materialistic or ultra-slim.

Yoga devotee Lisa Veach suggests that pricey duds are the very antithesis of yoga.

"Yoga is all about inclusivity. It's not about spending \$75 on yoga pants. I think it's counter to the energy I'm trying to cultivate as I practice.

"Will these make me fly? What's the magic here?" asked Veach, an Edmond, Okla. yoga studio manager.

And LULU and other yoga websites contain numerous complaints of how hard it is to find bigger sizes, including this one posted on LULU's website:

Since the average sized American woman is a 14, and your sizes only go up to a 12 (which is listed as XL), maybe after your stock dropped this week, your bottom line might be helped by offering your products to a more realistic segment of society. It's not just the petite skinny women who take yoga or similar classes. Get



with the program, please. It's very off-putting.

Comment by Nance — March 19, 2013 @ 11:43 am

And these at Yoga Dork:

Eli

August 15, 2011 at 12:28 am

Ladies, I agreed with many of you that Lululemon IS SO OVER PRICEY AND THE SIZES ARE SO SMALL! I wear an small-medium size everywhere (including Athleta) and at Lulu has to be L or XL! It's ridicu...Only Athleta has good quality for their price, (check stuff on line to see what is made of) and good sizes, (REAL ONES) beautiful colors and the sales are great! my mom wears size 14 and only Athleta has it.

A woman who's comfortable in her 200-plus-pound body, lobs some fancy put-downs at "fattie haters" who say the lack of larger sizes is justifiable. She puts a bow on it with: "Next time, complain to lululemon about not making big enough sizes for all the fat chicks who want to wear them."

Concerning same-store sales, contradictions

Meanwhile, same-store sales growth has fluctuated for LULU, reaching 26 percent before dropping to 16 percent in the fourth quarter 2012. High single-digit same-store sales, or comp, is generally considered pretty good in retail. But investors likely will run for the exits if comp growth drops into the single digits.

And that drop is exactly what's expected to happen, according to John Currie, LULU's CFO, and the recent earnings report.

"Obviously the second quarter is probably the most impacted and our expectations would be a very low single digit comp, close to flat for Q2 as a result of the Luon issue," Currie said, according to a Seeking Alpha transcript. "The balance of the year, I'm not giving quarter by quarter guidance, but it comes out to roughly high single to low double digits."

That same conference call signals yet another reason for concern as Currie contradicted what he said two months earlier at the ICR Xchange.

At the Jan. 16 ICR Xchange, Currie said, "We did a good job of holding our pricing through to the end of the shopping season, marking down only after the holiday *for a brief period to clear the excess inventory...*" "Our inventory position is great. We've cleared the post-holiday, broken size runs, so we'll enter into 2013 with a very clean inventory position, *not a lot of aged inventory ...*" (italics added)

In March, he said:

"Inventory at the end of the fourth quarter was \$155.2 million, or *49.1% higher*, than at the end of the fourth quarter 2011. The increase is due to higher levels of spring seasonal product receipts and a *higher mix of winter carryover product* as we entered 2012 with a lighter carryover position due to the strong holiday sales in 2011." (italics added)



Insider trading

Finally, investors need look no further than the recent insider trading

track record to get a clear picture of management's view on future growth. Insiders have sold just over 584,000 shares, cashing out at \$42.5 million at an average price of \$72.81.

Top seller was Wilson, the founder and board director, who sold 300,000 shares at \$70.92, raising \$21.2 million.

Since September 2012, Day has sold 155,000 shares worth \$11.5 million. She has just 35,232 shares remaining which were the result of option grants. Day made the only purchase made by insiders when she bought 3,000 shares at \$25.41 in October 2009.

"Management isn't stupid," said analyst Russell. "All that insider selling tells me that they know the peak of growth is over."

Important Disclosure: Prior to publication of this investigative report, TheStreetSweeper's owners established a short position in Lululemon Athletica (NYSE: LULU) and stand to profit on any future declines in the share price.

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