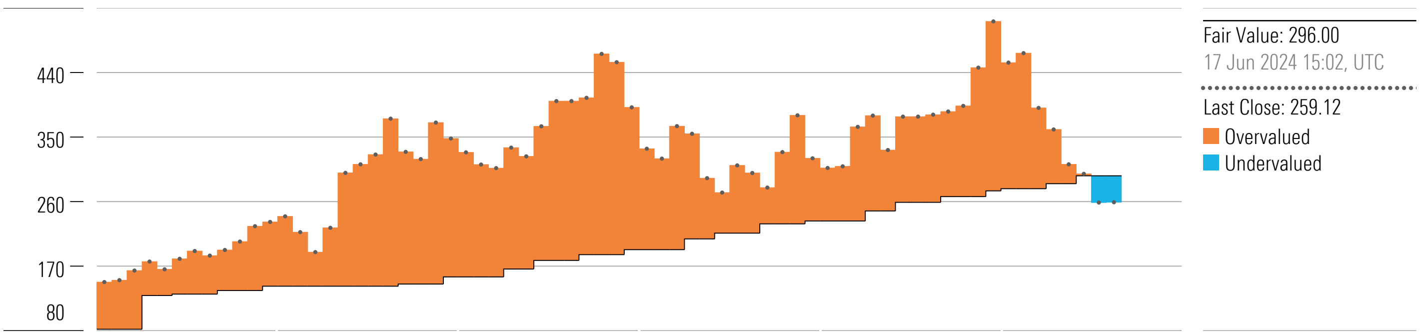
Morningstar Equity Analyst Report | Report as of 20 Aug 2024 22:16, UTC | Reporting Currency: USD | Trading Currency: USD | Exchange: NASDAQ - ALL MARKETS

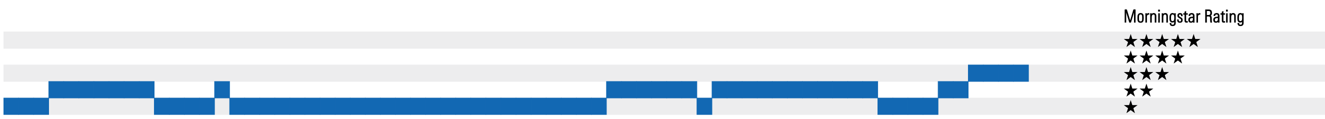
Lululemon Athletica Inc LULU ★★★ 20 Aug 2024 21:29, UTC

Last Price	Fair Value Estimate	Price/FVE	Market Cap	Economic Moat™	Equity Style Box	Uncertainty	Capital Allocation	ESG Risk Rating Assessment[1]
259.12 USD 19 Aug 2024	296.00 USD 17 Jun 2024 15:02, UTC	0.88	32.58 USD Bil 20 Aug 2024	Narrow	Mid Growth	High	Exemplary	7 Aug 2024 05:00, UTC

Price vs. Fair Value



	2019	2020	2021	2022	2023	YTD
Price/Fair Value	1.63	2.25	2.03	1.38	1.86	0.88
Total Return %	90.50	50.23	12.48	-18.16	59.59	-49.32



Total Return % as of 19 Aug 2024. Last Close as of 19 Aug 2024. Fair Value as of 17 Jun 2024 15:02, UTC.

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The primary analyst covering this company does not own its stock.

[1]The ESG Risk Rating Assessment is a representation of Sustainalytics' ESG Risk Rating.

Lululemon's Immense Popularity Is an Advantage, but Competition in North America Is Heating Up

Business Strategy & Outlook David Swartz, Senior Equity Analyst, 17 Jun 2024

We think Lululemon has a solid plan to expand its product assortment and geographic reach while building its core business. While there are many firms looking to compete in its categories, we believe Lululemon benefits from the athleisure fashion trend and will continue to achieve premium pricing due to the brand's popularity and the styling and quality of its products. Our narrow moat rating is based on the company's intangible brand asset.

We view the five-year plan laid out at Lululemon's April 2022 investor event as sound. The firm's three priorities are product innovation, e-commerce, and international expansion. We think product innovation is critical as many competitors sell women's leggings and other athleisure items of similar quality. Thus, Lululemon will need to introduce new fabrics and technology to hold its popularity in this critical category. The firm also plans to add to its assortment in men's (23% of 2023 sales) and expand its nascent athletic footwear line. While we believe these categories fit the Lululemon brand, they also bring it into direct competition with athletic apparel firms like Nike.

We see opportunity for Lululemon to expand outside its home region. Sales outside the Americas accounted for just 21% of its 2023 total, but this was up from 16% in the prior year. We believe Lululemon is building its brand overseas and has a large opportunity for new stores and larger online

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Sector
Consumer Cyclical

Industry
Apparel Retail

Business Description

Lululemon Athletica designs, distributes, and markets athletic apparel, footwear, and accessories for women, men, and girls. Lululemon offers pants, shorts, tops, and jackets for both leisure and athletic activities such as yoga and running. The company also sells fitness accessories, such as bags, yoga mats, and equipment. Lululemon sells its products through more than 700 company-owned stores in about 20 countries, e-commerce, outlets, and wholesale accounts. The company was founded in 1998 and is based in Vancouver, Canada.

sales in China, the second-largest activewear market. We project the firm will have 152 stores in mainland China by the end of 2024, up from 127 at the end of 2023 and 99 at the end of 2022. In 2033, we forecast Lululemon’s sales outside the Americas will reach $14.7 billion (up from $2 billion in 2023) and account for 52% of its total sales.

Bulls Say David Swartz, Senior Equity Analyst, 17 Jun 2024

- Lululemon’s digital sales increased to about $5 billion in 2023 from less than $100 million in 2010 but its stores have remained very productive. Its sales per square foot of about $1,600 are extremely high.
- Lululemon has a big opportunity in mainland China, which accounted for just 10% of its 2023 sales. China is already the second-largest sportswear market in the world.
- Lululemon is often credited with the development of athleisure, which we believe is a major change in how people dress and has increasingly broad appeal.

Bears Say David Swartz, Senior Equity Analyst, 17 Jun 2024

- Leggings and other key Lululemon items are offered by everyone from low-priced fast fashion to luxury apparel brands. The competitiveness of the sportswear industry continues to rise.
- As Lululemon expands beyond yoga into categories like running and training and offers footwear, it competes directly with established athletic apparel firms like Nike.
- Lululemon is expanding aggressively in countries in which awareness of its brand is relatively low. It may not have as much success in these regions as it has in North America.

Economic Moat David Swartz, Senior Equity Analyst, 17 Jun 2024

We assign a narrow moat rating to Lululemon based on its intangible brand asset. The company is often credited as the creator of the athleisure apparel trend and has become one of the largest activewear firms in the US and Canada. Despite significant competition, Lululemon has experienced double-digit sales growth every year since 2003; its revenue increased an astounding 23,000% over the past 19 years (to $9.6 billion in 2023 from $41 million in 2004). As evidence of its competitive advantage, Lululemon's adjusted returns on invested capital including goodwill have averaged 44% over the past five years. We forecast average annual adjusted ROICs including goodwill will exceed its weighted average cost of capital over the next 10 years as well. We estimate Lululemon's cost of capital at 10% and expect its adjusted ROICs including goodwill to average about 39% over the next decade.

We think Lululemon's high control over its sales process provides an advantage. Unlike many competitors, the company does not have a significant wholesale business. Instead, Lululemon mainly sells its product through company-owned, full-price physical stores and e-commerce. This model allows for control over pricing, discounting, expenses, product assortment, and marketing. Competitors who sell through partners lack this level of control and must share margin with retailers. Moreover, competing brands may lose their integrity if their product is discounted or sold through unpopular

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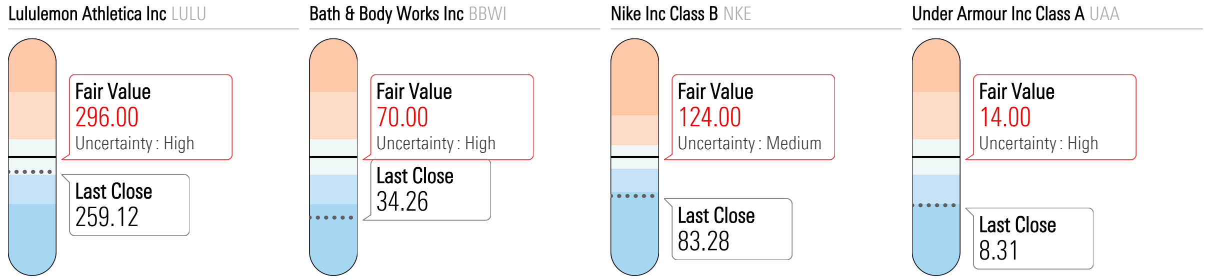
Competitors



	Lululemon Athletica Inc LULU	Bath & Body Works Inc BBWI	Nike Inc Class B NKE	Under Armour Inc Class A UAA
Economic Moat	Narrow	Narrow	Wide	None
Currency	USD	USD	USD	USD
Fair Value	296.00 17 Jun 2024 15:02, UTC	70.00 5 Jun 2024 16:10, UTC	124.00 2 Jul 2024 02:21, UTC	14.00 21 May 2024 20:06, UTC
1-Star Price	458.80	108.50	167.40	21.70
5-Star Price	177.60	42.00	86.80	8.40
Assessment	Fairly Valued 20 Aug 2024	Significantly Undervalued 20 Aug 2024	Significantly Undervalued 20 Aug 2024	Significantly Undervalued 20 Aug 2024
Morningstar Rating	★★★20 Aug 2024 21:29, UTC	★★★★★20 Aug 2024 21:25, UTC	★★★★★20 Aug 2024 21:26, UTC	★★★★★20 Aug 2024 21:26, UTC
Analyst	David Swartz, Senior Equity Analyst	Jaime M Katz, Senior Equity Analyst	David Swartz, Senior Equity Analyst	David Swartz, Senior Equity Analyst
Capital Allocation	Exemplary	Standard	Exemplary	Standard
Price/Fair Value	0.88	0.47	0.67	0.60
Price/Sales	3.34	1.05	2.48	0.67
Price/Book	7.71	—	8.67	1.98
Price/Earning	20.12	10.32	22.33	—
Dividend Yield	0.00%	2.34%	1.74%	0.00%
Market Cap	32.58 Bil	7.41 Bil	125.29 Bil	3.63 Bil
52-Week Range	226.01—516.39	27.30—52.99	70.75—123.39	6.17—9.50
Investment Style	Mid Growth	Small Value	Large Blend	Small Blend

retailers. We believe Lululemon's model helps to preserve its status as a premium brand and supports our view that it has a narrow moat.

Lululemon's chain of retail stores provides a durable competitive advantage. There has been much turmoil in the apparel retail space in the US, as billions of dollars in sales annually shift from physical stores to online retailers like wide-moat Amazon. Many apparel retailers, from large department stores to small specialty chains, have gone bankrupt or been forced to close stores amid store traffic and same-store sales declines. Lululemon, though, has experienced increasing sales and has expanded aggressively. Despite growth in its e-commerce business and pandemic disruption, Lululemon's sales per square foot were $1,609 in 2023, among the highest for any large apparel retailer in North America. We believe Lululemon's high-performing stores enhance its position as a premium fashion brand, supporting our view that it owns a narrow moat based on its intangible brand asset.

Lululemon's premium pricing allows for high gross margins, providing support for our narrow moat rating. The firm has achieved a gross margin above 55% in every year since 2018. Lululemon's five-year historical average gross margin of 56.6% significantly exceeds that of many competitors, such as wide-moat Nike, narrow-moat Adidas, no-moat Gap, and no-moat Urban Outfitters. Lululemon's gross margins are not directly comparable to those of rivals as many of them have significant wholesale sales. Moreover, the firm generates much of its revenue through sales of high-margin apparel priced around $100 per unit. In recent years, Lululemon has reduced its dependence on women's yoga pants with new products, including clothing for men (23% of 2023 sales), footwear, and fitness and leisure clothing for women. To support innovation, the firm consistently develops new fabrics. Lululemon maintains a white-space research and development department of about 50 people, including textile workers, scientists, and engineers. Although fabrics cannot be patented, its signature Luon fabric was developed two decades ago and was trademarked in 2005. It consists of a greater amount of nylon microfibers than a traditional polyester blend. Lululemon has produced several other performance fabrics, some of which are also trademarked (but not patented). Its apparel is designed to be bacteria- and smell-resistant and survive many washes. The material in its apparel is significantly more expensive than in traditional athletic shirts and pants, partly accounting for its relatively high pricing. Many of its competitors sell apparel with cheaper materials at lower price points. We think Lululemon protects the integrity of its brand by selling only high-quality apparel and it has continued to grow and improve margins despite the introduction of competing products by others. We forecast stable gross margins in the high 50s for Lululemon over the next decade as we believe its brand intangible asset provides a narrow moat.

Lululemon engages its customers by offering yoga and fitness classes in its stores. These popular classes increase customer goodwill and encourage its primary demographic of women interested in yoga and fitness to visit its stores on a frequent basis. Lululemon also sponsors yoga instructors known as Ambassadors, who teach yoga classes in their studios or Lululemon stores. They promote the company and vice versa. The program is more than 10 years old, and there are more than 2,000 Ambassadors worldwide. We believe Lululemon has local connections to its customer base that other apparel retailers do not have. Thus, we view its physical stores as a strength for the brand rather than the weakness they are perceived to be for many others.

Lululemon achieves market-leading prices in its key categories, also supporting our narrow moat rating. Its women's leggings typically retail for $89-$128. For comparison, premium yoga clothing competitors Beyond Yoga (owned by Levi Strauss) and Athleta (owned by Gap) sell similar leggings for about 20% less. Lululemon's website (as of June 2024) offers leggings that cost as much as $168 while most competitors' full-price items retail for much less than $100. Lululemon's high pricing extends to very basic clothing. We believe the company achieves high pricing for relatively undifferentiated apparel due to its strong brand.

We think the growth in yoga allows Lululemon to maintain its competitive position despite new entrants into the yoga apparel category. Although Lululemon produces apparel in highly congested categories like polo shirts, accessories, and jackets, we think it has held a unique market position in yoga since it was founded in 1998. The company's apparel was specifically created for the yoga market, and Lululemon has always maintained a close relationship with the practice. Aside from the Ambassadors program, Lululemon sponsors yoga events, festivals, and other fitness events. We believe yoga has matured into a major lifestyle choice and is far from being a fad. According to IBISWorld, the US market for yoga and Pilates studios was around $12 billion in 2023, up from just under about $6 billion in 2013. Further, the growth of this market has contributed to the adoption of leggings by women and girls. According to Euromonitor, the North America women's leggings market increased to $10.5 billion (at retail) in 2023 from just over $900 million in 2009.

Lululemon is supporting its brand by expanding outside North America, especially in China. The firm currently operates stores in 20 countries, most of which were added in the past 10 years. While its expansion has been at a measured pace in Western Europe and most of Asia, its sales in mainland China roughly doubled between 2021 and 2023 and will reach about $1.4 billion in 2024 as it plans to add about 25 stores to 2023's year-end total of 127. Moreover, Lululemon has an opportunity to open many more stores in the region as some of its competitors, such as Nike and Adidas, have thousands of Chinese stores. We forecast Lululemon's sales in mainland China will increase at a compound average annual growth rate of 24% over the next 10 years and reach 29% of its total sales, up from 10% in 2023. Meanwhile, there is an opportunity for many more stores in Western Europe given the size of the market in relation to Lululemon's small share. For example, the company only had nine stores in all of Germany at the end of 2023.

We think menswear supports the company's competitive position and brand. While Lululemon used to be strictly a women's brand, men's clothing now accounts for about almost a fourth of its total revenue. Part of the interest in Lululemon clothes for men is due to the increasing participation of men in yoga, which has grown enough that Nike introduced men's yoga apparel in 2018. However, most men purchase Lululemon gear for running rather than yoga. We think the high quality of its fabrics has attracted consumers despite the large number of firms in this market. Like its women's merchandise, Lululemon's men's apparel retails at premium prices. Most of its men's jackets, for example, retail for $150-$300, with some styles priced as high as $500. Lululemon generated $2.25 billion in men's sales in 2023, up from $527 million five years earlier. While Lululemon's men's business is small in comparison with some men's activewear and casual brands (such as no-moat PVH's Calvin Klein and Tommy Hilfiger), we think its growth suggests that male consumers respond to the brand.

We think the quality of Lululemon's apparel allows it to hold its narrow moat based on its intangible brand asset. Although there are many knockoffs and counterfeits of its key products, we believe consumers recognize that Lululemon uses fabrics and yarns that are superior to most. The firm understands it must innovate and frequently introduce new products to stay ahead of the competition. We believe it has done so successfully throughout its history. Although Lululemon could increase volume if it introduced inferior women's leggings at sub-$50 price points, it has (wisely, in our opinion) resisted the temptation to do so. Lululemon does not need to introduce lower-priced product as its premium-priced apparel continues to sell well. Moreover, the market continues to expand.

We do not believe Lululemon has any moat sources besides its intangible brand asset. The company lacks efficient scale or cost advantage as its production and distribution systems are like those of most apparel companies. Lululemon does not own any production facilities. Rather, its products are sourced from about 49 manufacturers and 67 fabric suppliers, nearly all of which are in Asia and supply competitors as well. Further, there are no switching costs or network effect.

Fair Value and Profit Drivers David Swartz, Senior Equity Analyst, 17 Jun 2024

We are raising our fair value estimate on Lululemon's shares to $296 per share from $285 after the firm’s 19.6% operating margin in the first quarter beat our estimate by 80 basis points. On the downside, comparable sales growth in the Americas was flat as the firm had some shortages of popular merchandise. We also think that competition is having a greater effect than in the past. We forecast Lululemon’s sales growth in the Americas in 2024 at 4%, well below typical double-digit rates. However, international sales growth is expected to be around 40% due to store openings and strong sales, especially in mainland China. Overall, we are holding our 2024 sales growth forecast at about 20% but are raising our EPS estimate to $14.50 from $14.30 previously. Our forecast implies 2024 adjusted price/earnings of 20 and enterprise value/adjusted EBITDA of about 11 on expected EBITDA of $2.9 billion (27% margin).

In the long run, we believe Lululemon’s annual sales growth rates will settle at about 11%-12%. These are strong rates for any international apparel company but are below historical levels as the sales base has gotten larger and as competition is unrelenting. In the Americas, we forecast compound average annual sales growth of 6% over the next decade. While Lululemon has achieved higher growth than this in the past, it already has over 400 stores in this region and competition is high. In its mainland China segment, we forecast 24% compound average annual sales growth on store openings and the growth of the nation’s sportswear market. Finally, we estimate 20% compound average annual sales growth in the rest of the world, with most of the store openings in Western Europe and parts of Asia.

We forecast segment-level operating margins of 38% and 35% in the Americas and mainland China, respectively, over the next 10 years. We forecast a 20% operating margin in the rest of the world as Lululemon lacks store density in Western Europe and Asia and the brand’s popularity is lower than in North America.

We believe Lululemon can hold its impressive gross margins of around 58% on premium pricing and lower costs. The company has made improvements in its supply chain, and we think it can achieve cost efficiencies as its men's and international businesses grow. We also forecast Lululemon's operating margins over the next 10 years will hold around the recent low-20s levels.

Risk and Uncertainty David Swartz, Senior Equity Analyst, 17 Jun 2024

We assign a High Uncertainty Rating to Lululemon. The firm, like many others, has faced supply issues and elevated inventories in recent quarters. It also faces the risk of reduced consumer spending on apparel due to inflation. However, it has handled these challenges better than most of its competitors.

Women's bottoms are the highest-sales and -profit products for Lululemon and attract most of its new customers. The firm achieves premium pricing on women's leggings, with many styles priced above $100 per unit. Thus, Lululemon depends on the continuation of the athleisure trend that it helped create. While we believe athleisure is not a fad, fashion trends can change quickly. Also, many firms, from multinationals to tiny startups, sell low-priced leggings. Lululemon must continuously introduce innovative products to maintain its price leadership and remain popular with women. But as specific styles of clothing cannot be patented, the firm has limited ability to prevent copycats.

To meet expectations, Lululemon will need to generate significant growth in regions where it has limited history and brand recognition. In 2023, Lululemon generated just 21% of its sales outside the Americas. However, the firm has aggressive expansion plans, and we forecast its yearly sales outside the region will grow at double-digit percentage rates for at least the next decade.

We do not believe Lululemon has any material environmental, social, or governance risks. However, like its peers, it is subject to controversies related to the treatment of workers in the international clothing supply chain.

Capital Allocation David Swartz, Senior Equity Analyst, 17 Jun 2024

We assign an Exemplary Capital Allocation Rating to Lululemon. The company's 15-year average annual shareholder return (as of June 2024) of 29% is extraordinary and greatly exceeds the 15% average annual return of the apparel retail sector of the Morningstar US Market Total Return Index over the same period. Lululemon has experienced outstanding growth as its sales increased to over $9 billion in 2023 from $41 million in 2004.

Lululemon's consistent profitability and free cash flow have allowed it to grow without any debt. Over the past 10 years, the company has generated an annual average of about $540 million in free cash flow to the firm while spending $300 million per year on capital expenditures. Much of the investment has gone into new stores and expanded e-commerce, which we think has created significant value. Even as it has grown, adjusted ROICs including goodwill have largely remained in the 40%-50% range and operating margins have held in the 18%-22% range. In future years, we expect Lululemon to continue to open new stores and increase its digital sales while maintaining high operating margins and ROICs. We estimate long-term operating margins in the low-20s and yearly ROICs of about 35%-40%.

We expect Lululemon to remain debt-free and generate significant cash flow. We forecast annual free cash flow to the firm will reach $2 billion by the end of this decade, more than enough to finance its growth plans. Thus, it should have considerable cash available to return to shareholders. Lululemon has repurchased more than $3 billion in shares since the beginning of 2018. At times, Lululemon has repurchased shares at high valuations that were well above our fair value estimates, which has potentially reduced shareholder value. We forecast Lululemon will generate about $7.7 billion in free cash flow to the firm over the next five years and use nearly all of it for buybacks. Like many high-growth companies, it does not pay a dividend, and we do not expect it will do so in the foreseeable future.

Lululemon has grown organically, and we expect this will continue to be the case. We anticipate it will continue to expand geographically, introduce new products, and build its digital capabilities. The firm has had some missteps (such as its now defunct Ivivva chain) but has generally been very successful with its internal investments, and we think it will continue to be so. The company's only external investment came in mid-2020 when it bought Mirror for about $450 million. This acquisition proved to be a big mistake, as the product has already been discontinued and Lululemon had to write down its value. We do not believe acquisitions will be an integral part of the firm's plans going forward.

Analyst Notes Archive

Lululemon Earnings: On Track to Meet Expectations Despite Slowdown in Americas; Shares Expensive David Swartz, Senior Equity Analyst, 6 Jun 2024

After dropping 40% since the beginning of the year, narrow-moat Lululemon's shares rose 10% in June 5 postmarket trading as its first-quarter results surpassed prior guidance and our estimates. The firm lifted its 2024 EPS outlook to $14.27-$14.47 from $14-$14.20, which should lead us to increase our $285 fair value estimate by a low-single-digit percentage. However, of some concern, sales growth in the Americas (73% of the total) was well below typical double-digit rates; comparable sales in the region were flat. The company cited some shortages of women's merchandise, but we also think that strong sales of bags over the past year may have masked a slowdown in core leggings. Competition in this category is nothing new, but we think it is intensifying.

Lululemon matched our estimate with 10% sales growth in the quarter. Sales in mainland China (14% of the total) and the rest of the world (13% of the total) rose 45% and 27%, respectively, on comparable sales growth rates above 20% and store openings for each. We think Lululemon's store expansion opportunities in North America are limited, but we also believe it can add hundreds of stores to its

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current base of 127 in mainland China. We think the brand is increasingly seen as a premium brand and market leader in the region. However, it has also been a challenging market for non-Chinese activewear brands for political and other reasons in recent years. In our model, Lululemon's sales outside North America reach half its total sales in about 10 years.

Lululemon's 57.7% gross margin in the quarter beat our estimate by 20 basis points, while its 19.6% operating margin was 80 basis points better. Its $2.54 in EPS was $0.15 above our estimate. We forecast the firm can hold current gross and operating margins of about 58% and 22%-23%, respectively, in the long run. Given competitive pressures and the likelihood of slower sales growth, we do not anticipate much improvement in these margins.

Lululemon Earnings: Rare Sign of Weakness Overshadows Solid Results; Shares Expensive David Swartz, Senior Equity Analyst, 22 Mar 2024

Narrow-moat Lululemon's fourth-quarter results exceeded our estimates, which had been raised after its January preannouncement. However, the firm acknowledged that sales have slowed in the first quarter in the US and it issued disappointing 2024 sales growth guidance of 11%-12%, shy of historical levels and our 14% estimate. Consequently, Lululemon's shares fell by about 11% on March 21 postmarket trading. Even so, as the company's 2024 EPS outlook of $14.00-$14.20 aligns with our $14.12 estimate and as it has a history of conservative guidance, we expect to increase our $278 fair value estimate by a low-single-digit percentage. We rate Lululemon's shares, which trade at about 30 times forward earnings, as overvalued.

Led by a 17% increase in digital sales, Lululemon's 16% fourth-quarter sales growth eclipsed our 15% estimate. Its same-store sales growth of 12% was lower than recent levels, but certainly impressive in comparison with activewear peers. Its gross and operating margins of 59.4% and 28.5%, respectively, both exceeded our estimates by 70 basis points and led to EPS of $5.29, which beat our forecast by $0.30. In the long run, we think Lululemon's gross margins will remain around 58%, while sales leverage, product mix, and international expansion will lift its operating margins to about 26% by 2030 from about 23% in 2023.

Regarding the outlook, the activewear market is increasingly competitive and many industry participants have warned of weak demand in the US in 2024. Lululemon has seemingly been immune to competition and economic conditions for years but, realistically, its domestic store and sales growth is slowing. Specifically, the firm's 2023 comparable sales growth was 8% in the Americas and it opened just 19 stores (net). However, the firm still has great ambitions in other regions, especially China where it achieved 39% same-store sales growth in 2023 and has just 127 stores, far fewer than some competitors.

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Lululemon: Shares Remain Overvalued Despite Small Guidance Increase David Swartz, Senior Equity Analyst, 8 Jan 2024

As usual, narrow-moat Lululemon updated its fourth-quarter outlook ahead of planned investor meetings in January. As has typically been the case over the past few years, its outlook update was upward, as it lifted its ranges for sales guidance to $3.17 billion-$3.19 billion from $3.135 billion-$3.17 billion, gross margin to 58.6%-58.7% from 58.3%-58.6%, and EPS to $4.96-$5.00 from $4.85-$4.93. We view these revisions as minor and believe that they were widely anticipated by investors given the firm's usual practice of providing a conservative holiday season outlook. Indeed, Lululemon's shares dipped about 1% in the immediate aftermath of the update, probably because investors had hoped for a greater revision, especially as most estimates (including ours) were already at the high end or above the prior guidance ranges.

We are adjusting our estimates to the high end of the new guidance, causing our fair value estimate to rise slightly to $278 from $275. Even so, with shares up about 50% over the past year and now trading at about 35 times our expected 2024 EPS of about $14, we continue to have valuation and competitive concerns. Although we acknowledge Lululemon generates superior sales growth and margins and has seemingly been immune to competition and market pressures over the past few years, we caution that it operates in a market with minimal barriers to entry and many envious copycats, some of which are directly targeting Lululemon. For example, wide-moat Nike recently announced that it is now offering leggings priced over $100 per pair while rising competitors like Alo Yoga and Levi's-owned Beyond Yoga are stepping up store openings, many of which are near existing Lululemon shops.

Lululemon Earnings: Strong Momentum Leading Into a Competitive Holiday Period; Shares Overvalued David Swartz, Senior Equity Analyst, 8 Dec 2023

As has been typical, narrow-moat Lululemon's third-quarter sales and earnings exceeded its guidance and our expectations. These results bode well for a good finish to the year despite concerns about slowing consumer spending on apparel and a promotional holiday period across the industry. We expect to lift our $267 per share fair value estimate by a mid-single-digit percentage. However, we view Lululemon's shares, trading at more than 35 times expected 2023 EPS, as overvalued, based on our 10-year discounted cash flow model and the threat of ever-increasing competition in athleisure.

Lululemon's 19% sales growth in the quarter eclipsed our 18% forecast. By channel, e-commerce sales (41% of total) beat our 17% estimate with 18% sales growth, while 19% growth in store sales (49% of total) was shy of our 21% forecast. Looking ahead, the company noted significant industry discounting in the early part of the holiday shopping season and suggested it may invest in traditional advertising, which is unusual for the firm. Lululemon guided to high-single-digit percentage sales growth in North America in the fourth quarter, a slowdown from the recent pace, but aligning with our expectation for moderating growth in the region. Overall, although its fourth-quarter sales growth guidance of 13%-14%

is slightly below our 14.5% estimate, the firm has a history of conservative guidance, so we rate the difference as insignificant.

Lululemon's adjusted gross and adjusted operating margins of 58.1% and 19.8%, respectively, were up 220 and 80 basis points over last year and 50 and 110 basis points above our estimates. Like others in the apparel industry, its gross margin benefited from lower transportation costs. While this factor should boost the fourth-quarter gross margin as well, higher planned marketing spending will partially offset this benefit. In the long run, we think it can maintain annual 58% gross margins and build its operating margins to 25%-26% from 22%-23% at present.

Lululemon Earnings: Strategic Moves and Brand Strength Overcome Economic Concerns; Shares Expensive David Swartz, Senior Equity Analyst, 1 Sep 2023

Lululemon's second-quarter results eclipsed our forecast despite soft apparel demand in North America. We believe the company is benefiting from the popularity of athleisure, its brand intangible asset (the source of our narrow moat), and its Power of Three x 2 plan for product innovation, international growth, and omnichannel investments. The firm raised its 2023 respective ranges for sales growth and EPS to 17%-18% from 16%-17% and to $12.02-$12.17 from $11.74-$11.94. While it may be a slight disappointment that it did not lift these ranges more given the results, management commentary about continuing momentum, and product launches, economic conditions are unsettled, and Lululemon has a history of low guidance.

We expect to raise our $259 per share fair value estimate by a mid-single-digit percentage due to the second-quarter outperformance and outlook. However, we rate Lululemon, trading at about 30 times earnings in a competitive market, as overvalued.

Lululemon's 18% sales growth in the quarter beat our 16% estimate. By segment, its 15% online sales (41% of the quarter's total) growth was shy of our 20% forecast, but 21% growth in store sales (50% of the total) was above our 14% estimate. Over the long term, we forecast annual online and offline sales growth of about 14% and 7%, respectively. Although Lululemon's international awareness and e-commerce is less developed than in North America, its partnerships with wide-moat Alibaba's Tmall and wide-moat JD.com in China and a new deal with no-moat Zalando in Europe should allow for quicker progress.

Lululemon's gross and operating margins of 58.8% and 21.7%, respectively, were 30 and 50 basis points above our estimates. Like other apparel firms, the company is benefiting from lower freight costs. In the long run, we think it can hold gross margins around 58% and improve its operating margins to about 25% as it continues to gain share, achieve premium pricing, and build its digital sales.

Lululemon Earnings: Year Off to Strong Start With No Signs of Slowdown; Valuation Stretched David

Morningstar Equity Analyst Report | Report as of 20 Aug 2024 22:16, UTC | Reporting Currency: USD | Trading Currency: USD | Exchange: NASDAQ - ALL MARKETS Page 12 of 23

Lululemon Athletica Inc LULU ★★★ 20 Aug 2024 21:29, UTC

Last Price	Fair Value Estimate	Price/FVE	Market Cap	Economic Moat™	Equity Style Box	Uncertainty	Capital Allocation	ESG Risk Rating Assessment[1]
259.12 USD 19 Aug 2024	296.00 USD 17 Jun 2024 15:02, UTC	0.88	32.58 USD Bil 20 Aug 2024	Narrow	Mid Growth	High	Exemplary	7 Aug 2024 05:00, UTC

Swartz, Senior Equity Analyst, 2 Jun 2023

Lululemon Athletica posted typically stellar results in its first quarter as 24% sales growth soared past our 19% estimate. Moreover, it appears to be untouched by the slowing demand for apparel in North America, reporting low markdown rates and offering solid guidance. We think it is benefiting from the strength of its brand—the source of our narrow moat rating—and its relatively high-income customer base. We expect to lift our $247 fair value estimate by a mid-single-digit percentage. Even so, we view Lululemon shares, up about 13% in postmarket trading, as overpriced. Our concerns stem from the rising competition in activewear, the uncertainty related to international expansion, and the hefty valuation. Even though we forecast Lululemon can achieve 11% annual sales growth and lift operating margin to about 25% from 22% over the next decade, its current P/E of about 30 is high in relation to our projection of midteens annual EPS growth.

Lululemon’s first-quarter sales outperformance was mainly due to its store operations (comparable sales up 13%). The company received a boost from the end of virus-related restrictions in China (12% of the quarter’s sales), where its sales rose 79%. Lululemon has added about 30 stores in China over the past year, bringing its total to about 120, and we forecast it can reach 400 stores within 10 years. However, there is risk to this forecast, given the company's limited history in the region and rising competition. Lululemon has targeted a fourfold increase in international sales between 2021 and 2026, but we model such sales to roughly triple.

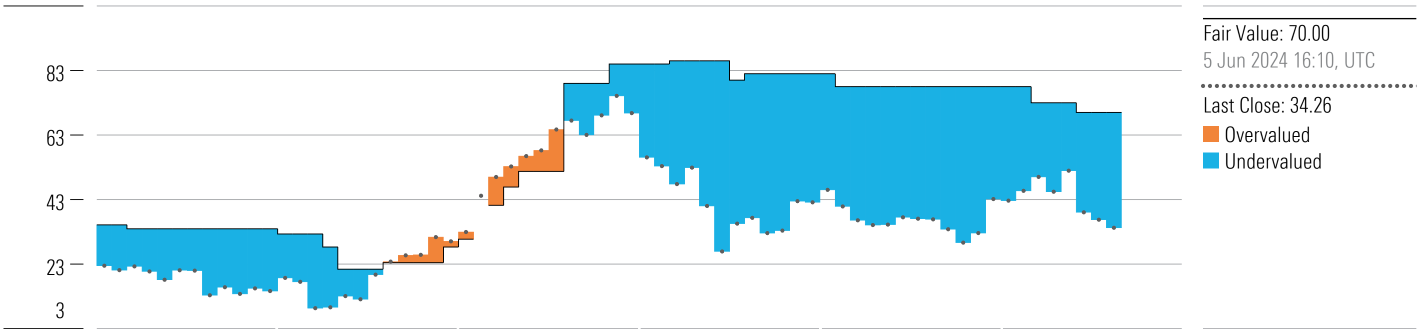
Lululemon’s gross and operating margins of 57.5% and 20.1%, respectively, beat our estimates by 50 and 140 basis points. Lower shipping rates are providing a boost, as they are for others in the industry. The firm has committed to higher marketing spending this year, which we view as a reasonable investment, given its sales momentum.

Morningstar Equity Analyst Report | Report as of 20 Aug 2024 22:16, UTC | Reporting Currency: USD | Trading Currency: USD | Exchange: NASDAQ - ALL MARKETS

Lululemon Athletica Inc LULU ★★★ 20 Aug 2024 21:29, UTC

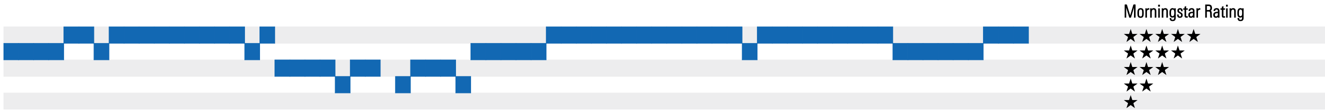
Competitors Price vs. Fair Value

Bath & Body Works Inc BBWI



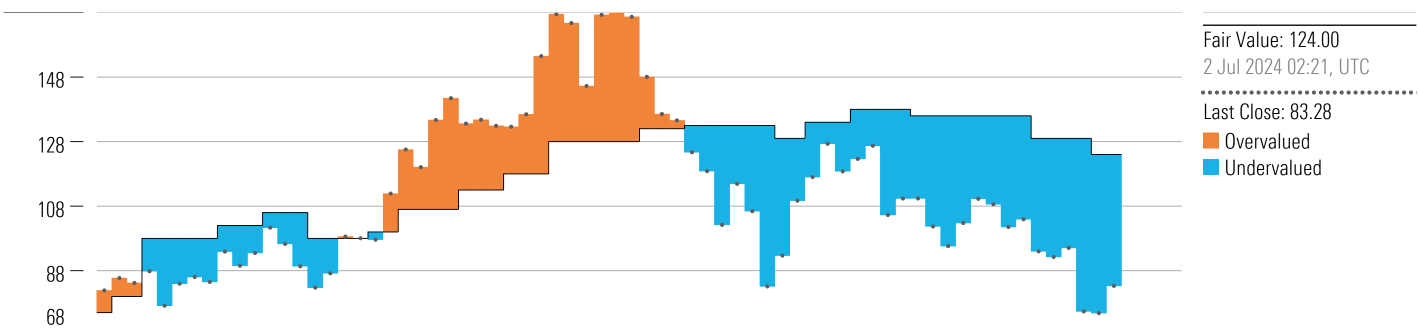
	2019	2020	2021	2022	2023	YTD
Price/Fair Value	0.43	1.06	0.82	0.51	0.55	0.47
Total Return %	-24.74	106.90	126.30	-38.47	4.32	-19.69

Morningstar Rating



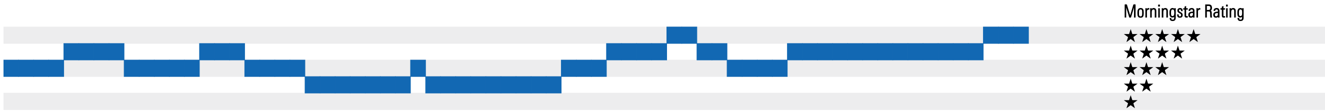
Total Return % as of 19 Aug 2024. Last Close as of 19 Aug 2024. Fair Value as of 5 Jun 2024 16:10, UTC.

Nike Inc Class B NKE



	2019	2020	2021	2022	2023	YTD
Price/Fair Value	0.96	1.32	1.30	0.87	0.80	0.67
Total Return %	37.87	40.64	18.61	-29.04	-6.03	-22.61

Morningstar Rating



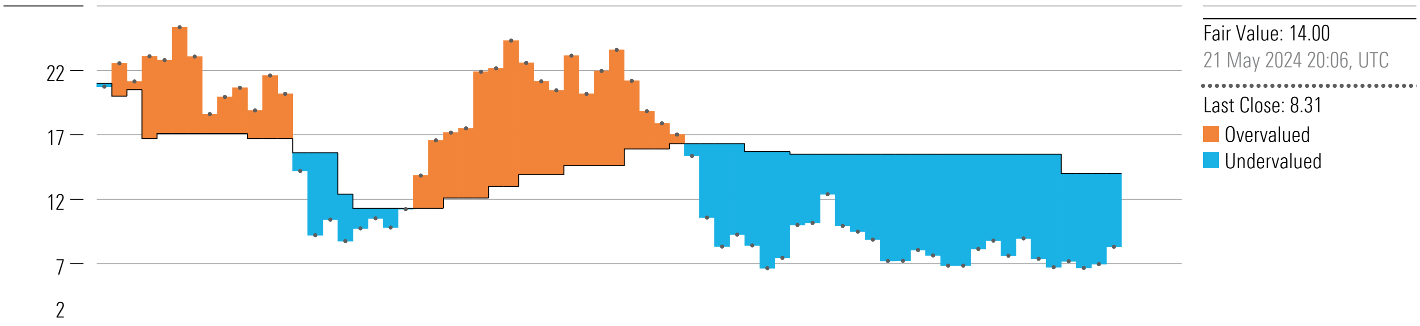
Total Return % as of 19 Aug 2024. Last Close as of 19 Aug 2024. Fair Value as of 2 Jul 2024 02:21, UTC.

Morningstar Equity Analyst Report | Report as of 20 Aug 2024 22:16, UTC | Reporting Currency: USD | Trading Currency: USD | Exchange: NASDAQ - ALL MARKETS

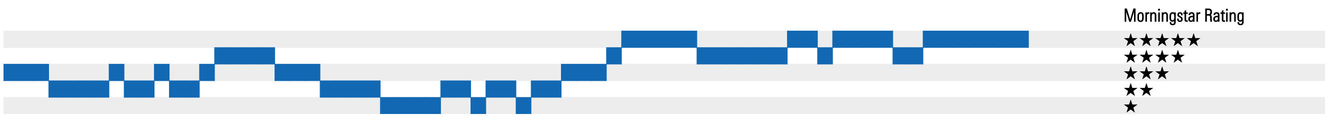
Lululemon Athletica Inc LULU ★★★ 20 Aug 2024 21:29, UTC

Competitors Price vs. Fair Value

Under Armour Inc Class A UAA



	2019	2020	2021	2022	2023	YTD
Price/Fair Value	1.29	1.42	1.33	0.66	0.57	0.60
Total Return %	22.24	-20.51	23.41	-52.05	-13.48	-5.46



Total Return % as of 19 Aug 2024. Last Close as of 19 Aug 2024. Fair Value as of 21 May 2024 20:06, UTC.

Morningstar Equity Analyst Report | Report as of 20 Aug 2024 22:16, UTC | Reporting Currency: USD | Trading Currency: USD | Exchange: NASDAQ - ALL MARKETS Page 15 of 23

Lululemon Athletica Inc LULU ★★★ 20 Aug 2024 21:29, UTC

Last Price	Fair Value Estimate	Price/FVE	Market Cap	Economic Moat™	Equity Style Box	Uncertainty	Capital Allocation	ESG Risk Rating Assessment[1]
259.12 USD 19 Aug 2024	296.00 USD 17 Jun 2024 15:02, UTC	0.88	32.58 USD Bil 20 Aug 2024	Narrow	Mid Growth	High	Exemplary	7 Aug 2024 05:00, UTC

Morningstar Historical Summary

Financials as of 30 Apr 2024

Fiscal Year, ends 31 Jan	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	YTD	TTM
Revenue (USD Mil)	1,591	1,797	2,061	2,344	2,649	3,288	3,979	4,402	6,257	8,111	2,209	9,827
Revenue Growth %	16.1	13.0	14.6	13.8	13.0	24.1	21.0	10.6	42.1	29.6	10.4	15.6
EBITDA (USD Mil)	440	434	442	509	603	828	1,051	1,035	1,599	2,018	528	2,629
EBITDA Margin %	27.7	24.2	21.5	21.7	22.8	25.2	26.4	23.5	25.6	24.9	23.9	26.8
Operating Income (USD Mil)	391	376	369	421	495	706	889	850	1,375	1,726	433	2,238
Operating Margin %	24.6	20.9	17.9	18.0	18.7	21.5	22.3	19.3	22.0	21.3	19.6	22.8
Net Income (USD Mil)	280	239	266	303	259	484	646	589	975	855	321	1,581
Net Margin %	17.6	13.3	12.9	12.9	9.8	14.7	16.2	13.4	15.6	10.5	14.5	16.1
Diluted Shares Outstanding (Mil)	146	144	141	137	136	134	131	131	130	128	126	127
Diluted Earnings Per Share (USD)	1.91	1.66	1.89	2.21	1.90	3.61	4.93	4.50	7.49	6.68	2.54	12.46
Dividends Per Share (USD)	—	—	—	—	—	—	—	—	—	—	—	—

Valuation as of 31 Jul 2024

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	Recent Qtr	TTM
Price/Sales	4.7	3.8	4.0	4.3	5.4	8.1	11.2	8.7	5.5	7.1	3.9	3.3
Price/Earnings	34.2	28.8	31.5	39.1	42.7	54.1	82.0	58.8	35.2	64.9	24.0	20.7
Price/Cash Flow	23.1	42.9	24.2	25.7	24.3	58.5	69.0	37.2	63.3	33.2	15.9	13.8
Dividend Yield %	—	—	—	—	—	—	—	—	—	—	—	—
Price/Book	7.3	6.9	7.4	7.5	11.4	18.3	21.0	19.0	13.4	18.3	8.8	7.7
EV/EBITDA	16.6	15.8	19.1	19.6	25.6	36.6	43.4	48.8	26.0	32.0	0.0	0.0

Operating Performance / Profitability as of 30 Apr 2024

Fiscal Year, ends 31 Jan	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	YTD	TTM
ROA %	24.3	18.8	20.4	20.4	14.1	23.7	24.1	15.8	21.4	16.2	4.6	25.5
ROE %	28.2	21.9	25.1	25.4	17.5	31.8	38.0	26.1	36.8	29.0	7.6	41.9
ROIC %	28.2	21.9	25.1	25.4	17.5	31.8	30.3	19.5	28.0	21.8	5.7	31.5
Asset Turnover	1.4	1.4	1.6	1.6	1.4	1.6	1.5	1.2	1.4	1.5	0.3	1.6

Financial Leverage

Fiscal Year, ends 31 Jan	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	Recent Qtr	TTM
Debt/Capital %	—	—	—	—	—	—	23.8	19.8	20.2	21.5	21.4	—
Equity/Assets %	87.6	84.1	78.2	82.0	79.9	69.4	59.5	61.1	55.4	56.2	61.8	—
Total Debt/EBITDA	—	—	—	—	—	0.0	0.7	0.8	0.6	0.5	2.7	—
EBITDA/Interest Expense	—	—	—	—	—	—	—	—	—	—	—	—

Morningstar Analyst Historical/Forecast Summary as of 17 Jun 2024

Financials

			Estimates		
Fiscal Year, ends 28 Jan 2024	2023	2024	2025	2026	2027
Revenue (USD Mil)	8,111	9,619	10,730	12,041	13,396
Revenue Growth %	29.6	18.6	11.6	12.2	11.3
EBITDA (USD Mil)	2,018	2,587	2,897	3,179	3,555
EBITDA Margin %	24.9	26.9	27.0	26.4	26.5
Operating Income (USD Mil)	1,726	2,207	2,500	2,734	3,059
Operating Margin %	21.3	23.0	23.3	22.7	22.8
Net Income (USD Mil)	1,289	1,622	1,814	1,914	2,141
Net Margin %	15.9	16.9	16.9	15.9	16.0
Diluted Shares Outstanding (Mil)	128	127	125	120	116
Diluted Earnings Per Share(USD)	10.07	12.77	14.50	15.94	18.38
Dividends Per Share(USD)	0.00	0.00	0.00	0.00	0.00

Forward Valuation

			Estimates		
	2023	2024	2025	2026	2027
Price/Sales	4.8	6.0	3.0	2.7	2.4
Price/Earnings	30.5	35.5	18.0	16.3	14.2
Price/Cash Flow	—	—	—	—	—
Dividend Yield %	—	—	—	—	—
Price/Book	12.5	13.6	6.5	4.9	4.5
EV/EBITDA	19.7	22.2	11.1	10.1	9.0

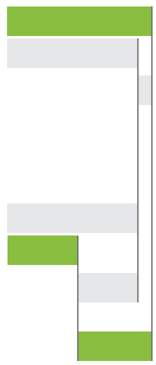
Morningstar Equity Analyst Report | Report as of 20 Aug 2024 22:16, UTC | Reporting Currency: USD | Trading Currency: USD | Exchange: NASDAQ - ALL MARKETS

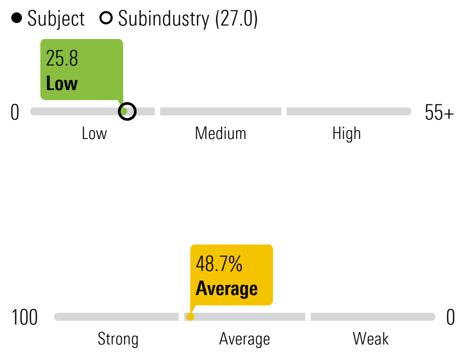
Lululemon Athletica Inc LULU ★★★ 20 Aug 2024 21:29, UTC

Last Price	Fair Value Estimate	Price/FVE	Market Cap	Economic Moat™	Equity Style Box	Uncertainty	Capital Allocation	ESG Risk Rating Assessment[1]
259.12 USD 19 Aug 2024	296.00 USD 17 Jun 2024 15:02, UTC	0.88	32.58 USD Bil 20 Aug 2024	Narrow	Mid Growth	High	Exemplary	7 Aug 2024 05:00, UTC

ESG Risk Rating Breakdown

Exposure	
Company Exposure[1]	25.8
– Manageable Risk	23.3
Unmanageable Risk[2]	**2.5**
Management	
Manageable Risk	23.3
– Managed Risk[3]	11.4
Management Gap[4]	**12.0**
Overall Unmanaged Risk	**14.4**





- Exposure represents a company's vulnerability to ESG risks driven by their business model
- Exposure is assessed at the Subindustry level and then specified at the company level
- Scoring ranges from 0-55+ with categories of low, medium, and high-risk exposure

- Management measures a company's ability to manage ESG risks through its commitments and actions
- Management assesses a company's efficiency on ESG programs, practices, and policies
- Management score ranges from 0-100% showing how much manageable risk a company is managing

ESG Risk Rating

ESG Risk Ratings measure the degree to which a company's value is impacted by environmental, social, and governance risks, by evaluating the company's ability to manage the ESG risks it faces.

1. A company's Exposure to material ESG issues 2. Unmanageable Risk refers to risks that are inherent to a particular business model that cannot be managed by programs or initiatives 3. Managed Risk = Manageable Risk multiplied by a Management score of 48.7% 4. Management Gap assesses risks that are not managed, but are considered manageable 5. ESG Risk Rating Assessment = Overall Unmanaged Risk = Management Gap plus Unmanageable Risk

ESG Risk Rating Assessment[5]

ESG Risk Rating is of Aug 07, 2024. Highest Controversy Level is as of Aug 08, 2024. Sustainalytics Subindustry: Retail Apparel. Sustainalytics provides Morningstar with company ESG ratings and metrics on a monthly basis and as such, the ratings in Morningstar may not necessarily reflect current Sustainalytics' scores for the company. For the most up to date rating and more information, please visit: sustainalytics.com/esg-ratings/.

Peer Analysis 07 Aug 2024

Peers are selected from the company's Sustainalytics-defined Subindustry and are displayed based on the closest market cap values

Company Name	Exposure	Management	ESG Risk Rating
Lululemon Athletica Inc	25.8 | Low (0–55+)	48.7 | Average (100–0)	14.4 | Low (0–40+)
Bath & Body Works Inc	45.2 | Medium (0–55+)	47.7 | Average (100–0)	26.2 | Medium (0–40+)
VF Corp	29.2 | Low (0–55+)	55.7 | Strong (100–0)	14.4 | Low (0–40+)
Nike Inc	30.8 | Low (0–55+)	43.6 | Average (100–0)	18.7 | Low (0–40+)
Under Armour Inc	29.9 | Low (0–55+)	50.1 | Strong (100–0)	16.3 | Low (0–40+)

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Appendix
Historical Morningstar Rating

Lululemon Athletica Inc LULU 20 Aug 2024 21:29, UTC

Dec 2024	Nov 2024	Oct 2024	Sep 2024	Aug 2024	Jul 2024	Jun 2024	May 2024	Apr 2024	Mar 2024	Feb 2024	Jan 2024
—	—	—	—	★★★	★★★	★★★	★★★	★★	★★	★	★
Dec 2023	Nov 2023	Oct 2023	Sep 2023	Aug 2023	Jul 2023	Jun 2023	May 2023	Apr 2023	Mar 2023	Feb 2023	Jan 2023
★	★	★★	★★	★★	★★	★★	★★	★★	★★	★★	★★
Dec 2022	Nov 2022	Oct 2022	Sep 2022	Aug 2022	Jul 2022	Jun 2022	May 2022	Apr 2022	Mar 2022	Feb 2022	Jan 2022
★★	★	★★	★★	★★	★★	★★	★★	★	★	★	★
Dec 2021	Nov 2021	Oct 2021	Sep 2021	Aug 2021	Jul 2021	Jun 2021	May 2021	Apr 2021	Mar 2021	Feb 2021	Jan 2021
★	★	★	★	★	★	★	★	★	★	★	★
Dec 2020	Nov 2020	Oct 2020	Sep 2020	Aug 2020	Jul 2020	Jun 2020	May 2020	Apr 2020	Mar 2020	Feb 2020	Jan 2020
★	★	★	★	★	★	★	★	★	★★	★	★
Dec 2019	Nov 2019	Oct 2019	Sep 2019	Aug 2019	Jul 2019	Jun 2019	May 2019	Apr 2019	Mar 2019	Feb 2019	Jan 2019
★	★	★★	★★	★★	★★	★★	★★	★★	★	★	★

Bath & Body Works Inc BBWI 20 Aug 2024 21:25, UTC

Dec 2024	Nov 2024	Oct 2024	Sep 2024	Aug 2024	Jul 2024	Jun 2024	May 2024	Apr 2024	Mar 2024	Feb 2024	Jan 2024
—	—	—	—	★★★★★	★★★★★	★★★★★	★★★★	★★★★	★★★★	★★★★	★★★★
Dec 2023	Nov 2023	Oct 2023	Sep 2023	Aug 2023	Jul 2023	Jun 2023	May 2023	Apr 2023	Mar 2023	Feb 2023	Jan 2023
★★★★	★★★★★	★★★★★	★★★★★	★★★★★	★★★★★	★★★★★	★★★★★	★★★★★	★★★★★	★★★★	★★★★★
Dec 2022	Nov 2022	Oct 2022	Sep 2022	Aug 2022	Jul 2022	Jun 2022	May 2022	Apr 2022	Mar 2022	Feb 2022	Jan 2022
★★★★★	★★★★★	★★★★★	★★★★★	★★★★★	★★★★★	★★★★★	★★★★★	★★★★★	★★★★★	★★★★★	★★★★★
Dec 2021	Nov 2021	Oct 2021	Sep 2021	Aug 2021	Jul 2021	Jun 2021	May 2021	Apr 2021	Mar 2021	Feb 2021	Jan 2021
★★★★	★★★★	★★★★	★★★★	★★★★	★★	★★★	★★★	★★★	★★	—	★★★
Dec 2020	Nov 2020	Oct 2020	Sep 2020	Aug 2020	Jul 2020	Jun 2020	May 2020	Apr 2020	Mar 2020	Feb 2020	Jan 2020
★★★	★★	★★★	★★★	★★★	★★★	★★★★★	★★★★	★★★★★	★★★★★	★★★★★	★★★★★
Dec 2019	Nov 2019	Oct 2019	Sep 2019	Aug 2019	Jul 2019	Jun 2019	May 2019	Apr 2019	Mar 2019	Feb 2019	Jan 2019
★★★★★	★★★★★	★★★★★	★★★★★	★★★★★	★★★★	★★★★★	★★★★★	★★★★	★★★★	★★★★	★★★★

Nike Inc Class B NKE 20 Aug 2024 21:26, UTC

Dec 2024	Nov 2024	Oct 2024	Sep 2024	Aug 2024	Jul 2024	Jun 2024	May 2024	Apr 2024	Mar 2024	Feb 2024	Jan 2024
—	—	—	—	★★★★★	★★★★★	★★★★★	★★★★	★★★★	★★★★	★★★★	★★★★
Dec 2023	Nov 2023	Oct 2023	Sep 2023	Aug 2023	Jul 2023	Jun 2023	May 2023	Apr 2023	Mar 2023	Feb 2023	Jan 2023
★★★★	★★★★	★★★★	★★★★	★★★★	★★★★	★★★★	★★★★	★★★	★★★	★★★	★★★
Dec 2022	Nov 2022	Oct 2022	Sep 2022	Aug 2022	Jul 2022	Jun 2022	May 2022	Apr 2022	Mar 2022	Feb 2022	Jan 2022
★★★★	★★★★	★★★★★	★★★★★	★★★★	★★★★	★★★★	★★★★	★★★	★★★	★★★	★★
Dec 2021	Nov 2021	Oct 2021	Sep 2021	Aug 2021	Jul 2021	Jun 2021	May 2021	Apr 2021	Mar 2021	Feb 2021	Jan 2021
★★	★★	★★	★★	★★	★★	★★	★★	★★★	★★	★★	★★
Dec 2020	Nov 2020	Oct 2020	Sep 2020	Aug 2020	Jul 2020	Jun 2020	May 2020	Apr 2020	Mar 2020	Feb 2020	Jan 2020
★★	★★	★★	★★	★★★	★★★	★★★	★★★	★★★★	★★★★	★★★★	★★★
Dec 2019	Nov 2019	Oct 2019	Sep 2019	Aug 2019	Jul 2019	Jun 2019	May 2019	Apr 2019	Mar 2019	Feb 2019	Jan 2019
★★★	★★★	★★★	★★★	★★★★	★★★★	★★★★	★★★★	★★★	★★★	★★★	★★★

Morningstar Equity Analyst Report | Report as of 20 Aug 2024 22:16, UTC | Reporting Currency: USD | Trading Currency: USD | Exchange: NASDAQ - ALL MARKETS

Under Armour Inc Class A UAA 20 Aug 2024 21:26, UTC

Dec 2024 —	Nov 2024 —	Oct 2024 —	Sep 2024 —	Aug 2024 ★★★★★	Jul 2024 ★★★★★	Jun 2024 ★★★★★	May 2024 ★★★★★	Apr 2024 ★★★★★	Mar 2024 ★★★★★	Feb 2024 ★★★★★	Jan 2024 ★★★★
Dec 2023 ★★★★	Nov 2023 ★★★★★	Oct 2023 ★★★★★	Sep 2023 ★★★★★	Aug 2023 ★★★★★	Jul 2023 ★★★★	Jun 2023 ★★★★★	May 2023 ★★★★★	Apr 2023 ★★★★	Mar 2023 ★★★★	Feb 2023 ★★★★	Jan 2023 ★★★★
Dec 2022 ★★★★	Nov 2022 ★★★★	Oct 2022 ★★★★★	Sep 2022 ★★★★★	Aug 2022 ★★★★★	Jul 2022 ★★★★★	Jun 2022 ★★★★★	May 2022 ★★★★	Apr 2022 ★★★	Mar 2022 ★★★	Feb 2022 ★★★	Jan 2022 ★★
Dec 2021 ★★	Nov 2021 ★	Oct 2021 ★★	Sep 2021 ★★	Aug 2021 ★	Jul 2021 ★★	Jun 2021 ★★	May 2021 ★	Apr 2021 ★	Mar 2021 ★	Feb 2021 ★	Jan 2021 ★★
Dec 2020 ★★	Nov 2020 ★★	Oct 2020 ★★	Sep 2020 ★★★	Aug 2020 ★★★	Jul 2020 ★★★	Jun 2020 ★★★★	May 2020 ★★★★	Apr 2020 ★★★★	Mar 2020 ★★★★	Feb 2020 ★★★	Jan 2020 ★★
Dec 2019 ★★	Nov 2019 ★★★	Oct 2019 ★★	Sep 2019 ★★	Aug 2019 ★★★	Jul 2019 ★★	Jun 2019 ★★	May 2019 ★★	Apr 2019 ★★	Mar 2019 ★★★	Feb 2019 ★★★	Jan 2019 ★★★

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Overview

At the heart of our valuation system is a detailed projection of a company's future cash flows, resulting from our analysts' research. Analysts create custom industry and company assumptions to feed income statement, balance sheet, and capital investment assumptions into our globally standardized, proprietary discounted cash flow, or DCF, modeling templates. We use scenario analysis, indepth competitive advantage analysis, and a variety of other analytical tools to augment this process. Moreover, we think analyzing valuation through discounted cash flows presents a better lens for viewing cyclical companies, high-growth firms, businesses with finite lives (e.g., mines), or companies expected to generate negative earnings over the next few years. That said, we don't dismiss multiples altogether but rather use them as supporting cross-checks for our DCF-based fair value estimates. We also acknowledge that DCF models offer their own challenges (including a potential proliferation of estimated inputs and the possibility that the method may miss shortterm market-price movements), but we believe these negatives are mitigated by deep analysis and our longterm approach.

Morningstar's equity research group ("we," "our") believes that a company's intrinsic worth results from the future cash flows it can generate. The Morningstar Rating for stocks identifies stocks trading at a discount or premium to their intrinsic worth—or fair value estimate, in Morningstar terminology. Five-star stocks sell for the biggest risk adjusted discount to their fair values, whereas 1-star stocks trade at premiums to their intrinsic worth.

Four key components drive the Morningstar rating: (1) our assessment of the firm's economic moat, (2) our estimate of the stock's fair value, (3) our uncertainty around that fair value estimate and (4) the current market price. This process ultimately culminates in our singlepoint star rating.

1. Economic Moat

The concept of an economic moat plays a vital role not only in our qualitative assessment of a firm's long-term investment potential, but also in the actual calculation of our fair value estimates. An economic moat is a structural feature that allows a firm to sustain excess profits over a long period of time. We define economic profits as returns on invested capital (or ROIC) over and above our estimate of a firm's cost of capital, or weighted average cost of capital (or WACC). Without a moat, profits are more susceptible to competition. We have identified five sources of economic moats: intangible assets, switching costs, network effect, cost advantage, and efficient scale.

Companies with a narrow moat are those we believe are more likely than not to achieve normalized excess returns for at least the next 10 years. Wide-moat companies are those in which we have very high confidence that excess returns will remain for 10 years, with excess returns more likely than not to remain for at least 20 years. The longer a firm generates economic profits, the higher its intrinsic value. We believe low-quality, no-moat companies will see their normalized returns gravitate toward the firm's cost of capital more quickly than companies with moats.

When considering a company's moat, we also assess whether there is a substantial threat of value destruction, stemming from risks related to ESG, industry disruption, financial health, or other idiosyncratic issues. In this context, a risk is considered potentially value destructive if its occurrence would eliminate a firm's economic profit on a cumulative or midcycle basis. If we deem the probability of occurrence sufficiently high, we would not characterize the company as possessing an economic moat.

2. Estimated Fair Value

Combining our analysts' financial forecasts with the firm's economic moat helps us assess how long returns on invested capital are likely to exceed the firm's cost of capital. Returns of firms with a wide economic moat rating are assumed to fade to the perpetuity period over a longer period of time than the returns of narrow-moat firms, and both will fade slower than no-moat firms, increasing our estimate of their intrinsic value.

Our model is divided into three distinct stages:

Stage I: Explicit Forecast

In this stage, which can last five to 10 years, analysts make full financial statement forecasts, including items such as revenue, profit margins, tax rates, changes in workingcapital accounts, and capital spending. Based on these projections, we calculate earnings before interest, after taxes (EBI) and the net new investment (NNI) to derive our annual free cash flow forecast.

Stage II: Fade

The second stage of our model is the period it will take the company's return on new invested capital—the return on capital of the next dollar invested ("RONIC")—to decline (or rise) to its cost of capital. During the Stage II period, we use a formula to approximate cash flows in lieu of explicitly modeling the income statement, balance sheet, and cash flow statement as we do in Stage I. The length of the second stage depends on the strength of the company's economic moat. We forecast this period to last anywhere from one year (for companies with no economic moat) to 10–15 years or more (for wide-moat companies). During this period, cash flows are forecast using four assumptions: an average growth rate for EBI over the period, a normalized investment rate, average return on new invested capital (RONIC), and the number of years until perpetuity, when excess returns cease. The investment rate and return on new invested capital decline until a perpetuity value is calculated. In the case of firms that do not earn their cost of capital, we assume marginal ROICs rise to the firm's cost of capital (usually attributable to less reinvestment), and we may truncate the second stage.

Stage III: Perpetuity

Once a company's marginal ROIC hits its cost of capital, we calculate a continuing value, using a standard perpetuity formula. At perpetuity, we assume that any growth or decline or investment in the business neither creates nor destroys value and that any new investment provides a return in line with estimated WACC.

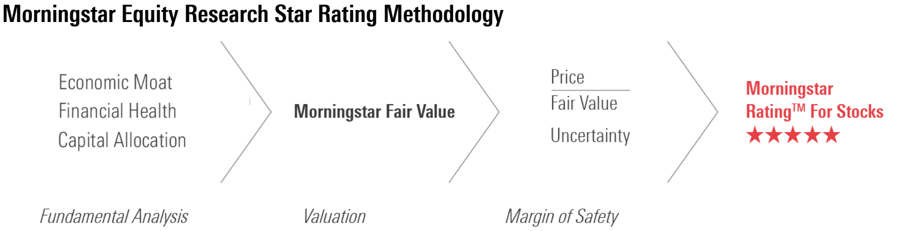
Because a dollar earned today is worth more than a dollar earned tomorrow, we discount our projections of cash flows in stages I, II, and III to arrive at a total present value of expected future cash flows. Because we are modeling free cash flow to the firm—representing cash available to provide a return to all capital providers—we discount future cash flows using the WACC, which is a weighted average of the costs of equity, debt, and preferred stock (and any other funding sources), using expected future proportionate long-term, market-value weights.

3. Uncertainty Around That Fair Value Estimate

Morningstar's Uncertainty Rating is designed to capture the range of potential outcomes for a company's intrinsic value. This rating is used to assign the margin of safety required before investing, which in turn explicitly drives our stock star rating system. The Uncertainty Rating is aimed at identifying the confidence we should have in assigning a fair value estimate for a given stock.

Our Uncertainty Rating is meant to take into account anything that can increase the potential dispersion of future outcomes for the intrinsic value of a company, and any-

Morningstar Equity Research Star Rating Methodology



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thing that can affect our ability to accurately predict these outcomes. The rating begins with a suggested rating produced by a quantitative process based on the trailing 12-month standard deviation of daily stock returns. An analyst overlay is then applied, with analysts using the suggested rating, historical rating data, and their own knowledge of the company to inform them as they make the final Uncertainty Rating decision. Ultimately, the rating decision rests with the analyst. Analysts take into account many characteristics when making their final decision, including cyclical factors, operational and financial factors such as leverage, company-specific events, ESG risks, and anything else that might increase the potential dispersion of future outcomes and our ability to estimate those outcomes.

Our recommended margin of safety—the discount to fair value demanded before we'd recommend buying or selling the stock—widens as our uncertainty of the estimated value of the equity increases. The more uncertain we are about the potential dispersion of outcomes, the greater the discount we require relative to our estimate of the value of the firm before we would recommend the purchase of the shares. In addition, the Uncertainty Rating provides guidance in portfolio construction based on risk tolerance.

Our Uncertainty Ratings are: Low, Medium, High, Very High, and Extreme.

	Margin of Safety	
Qualitative Analysis Uncertainty Ratings	★★★★★Rating	★Rating
Low	20% Discount	25% Premium
Medium	30% Discount	35% Premium
High	40% Discount	55% Premium
Very High	50% Discount	75% Premium
Extreme	75% Discount	300% Premium

Our uncertainty rating is based on the interquartile range, or the middle 50% of potential outcomes, covering the 25th percentile–75th percentile. This means that when a stock hits 5 stars, we expect there is a 75% chance that the intrinsic value of that stock lies above the current market price. Similarly, when a stock hits 1 star, we expect there is a 75% chance that the intrinsic value of that stock lies below the current market price.

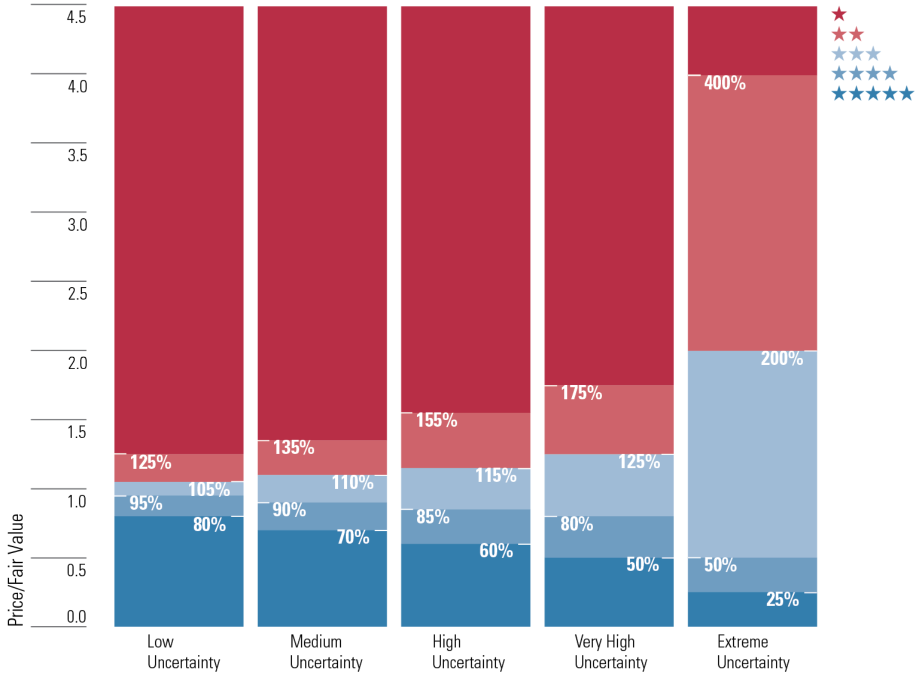
4. Market Price

The market prices used in this analysis and noted in the report come from exchange on which the stock is listed which we believe is a reliable source.

For more details about our methodology, please go to https://shareholders.morningstar.com

Morningstar Star Rating for Stocks

Morningstar Equity Research Star Rating Methodology



Once we determine the fair value estimate of a stock, we compare it with the stock's current market price on a daily basis, and the star rating is automatically re-calculated at the market close on every day the market on which the stock is listed is open. Our analysts keep close tabs on the companies they follow, and, based on thorough and ongoing analysis, raise or lower their fair value estimates as warranted.

Please note, there is no predefined distribution of stars. That is, the percentage of stocks that earn 5 stars can fluctuate daily, so the star ratings, in the aggregate, can serve as a gauge of the broader market's valuation. When there are many 5-star stocks, the stock market as a whole is more undervalued, in our opinion, than when very few companies garner our highest rating.

We expect that if our base-case assumptions are true the market price will converge on our fair value estimate over time generally within three years (although it is impossible to predict the exact time frame in which market prices may adjust).

Our star ratings are guideposts to a broad audience and individuals must consider their own specific investment goals, risk tolerance, tax situation, time horizon, income needs, and complete investment portfolio, among other factors.

The Morningstar Star Ratings for stocks are defined below:

★★★★★ We believe appreciation beyond a fair risk adjusted return is highly likely over a multiyear time frame. Scenario analysis developed by our analysts indicates that the current market price represents an excessively pessimistic outlook, limiting downside risk and maximizing upside potential.

★★★★ We believe appreciation beyond a fair risk-adjusted return is likely.

★★★ Indicates our belief that investors are likely to receive a fair risk-adjusted return (approximately cost of equity).

★★ We believe investors are likely to receive a less than fair risk-adjusted return.

★ Indicates a high probability of undesirable risk-adjusted returns from the current market price over a multiyear time frame, based on our analysis. Scenario analysis by our analysts indicates that the market is pricing in an excessively optimistic outlook, limiting upside potential and leaving the investor exposed to Capital loss.

Other Definitions

Last Price: Price of the stock as of the close of the market of the last trading day before date of the report.

Capital Allocation Rating: Our Capital Allocation (or Stewardship) Rating represents our assessment of the quality of management's capital allocation, with particular emphasis on the firm's balance sheet, investments, and shareholder distributions. Analysts consider compan-

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ies' investment strategy and valuation, balance sheet management, and dividend and share buyback policies. Corporate governance factors are only considered if they are likely to materially impact shareholder value, though either the balance sheet, investment, or shareholder distributions. Analysts assign one of three ratings: "Exemplary", "Standard", or "Poor". Analysts judge Capital Allocation from an equity holder's perspective. Ratings are determined on a forward looking and absolute basis. The Standard rating is most common as most managers will exhibit neither exceptionally strong nor poor capital allocation.

Capital Allocation (or Stewardship) analysis published prior to Dec. 9, 2020, was determined using a different process. Beyond investment strategy, financial leverage, and dividend and share buyback policies, analysts also considered execution, compensation, related party transactions, and accounting practices in the rating.

Capital Allocation Rating: Our Capital Allocation (or Stewardship) Rating represents our assessment of the quality of management's capital allocation, with particular emphasis on the firm's balance sheet, investments, and shareholder distributions. Analysts consider companies' investment strategy and valuation, balance sheet management, and dividend and share buyback policies. Corporate governance factors are only considered if they are likely to materially impact shareholder value, though either the balance sheet, investment, or shareholder distributions. Analysts assign one of three ratings: "Exemplary", "Standard", or "Poor". Analysts judge Capital Allocation from an equity holder's perspective. Ratings are determined on a forward looking and absolute basis. The Standard rating is most common as most managers will exhibit neither exceptionally strong nor poor capital allocation.

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Sustainalytics ESG Risk Rating Assessment: The ESG Risk Rating Assessment is provided by Sustainalytics; a Morningstar company.

Sustainalytics' ESG Risk Ratings measure the degree to which company's economic value at risk is driven by environment, social and governance (ESG) factors.

Sustainalytics analyzes over 1,300 data points to assess a company's exposure to and management of ESG risks. In other words, ESG Risk Ratings measures a company's unmanaged ESG Risks represented as a quantitative score. Unmanaged Risk is measured on an open-ended scale starting at zero (no risk) with lower scores representing less unmanaged risk and, for 95% of cases, the unmanaged ESG Risk score is below 50.

Based on their quantitative scores, companies are grouped into one of five Risk Categories (negligible, low, medium, high, severe). These risk categories are absolute, meaning that a 'high risk' assessment reflects a comparable degree of unmanaged ESG risk across all subindustries covered.

The ESG Risk Rating Assessment is a visual representation of Sustainalytics ESG Risk Categories on a 1 to 5 scale. Companies with Negligible Risk = 5 Globes, Low Risk = 4, Medium Risk = 3 Globes, High Risk = 2 Globes, Severe Risk = 1 Globe. For more information, please visit sustainalytics.com/esg-ratings/

Ratings should not be used as the sole basis in evaluating a company or security. Ratings involve unknown risks and uncertainties which may cause our expectations not to occur or to differ significantly from what was expected and should not be considered an offer or solicitation to buy or sell a security.

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