

LULULEMON ATHLETICA INC.

FORM 10-Q (Quarterly Report)

Filed 09/10/09 for the Period Ending 08/02/09

| | |
|-------------|--|
| Telephone | 604-732-6124 |
| CIK | 0001397187 |
| Symbol | LULU |
| SIC Code | 2300 - Apparel & Other Finishd Prods of Fabrics & Similar Matl |
| Industry | Apparel/Accessories |
| Sector | Consumer Cyclical |
| Fiscal Year | 02/01 |

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-Q

(Mark One)

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE
SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended August 2, 2009

OR

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE
SECURITIES EXCHANGE ACT OF 1934**

For the transition period from to

Commission file number 001-33608

lululemon athletica inc.

(Exact name of registrant as specified in its charter)

Delaware

*(State or other jurisdiction of
incorporation or organization)*

**2285 Clark Drive,
Vancouver, British Columbia**

(Address of principal executive offices)

20-3842867

*(I.R.S. Employer
Identification No.)*

V5N 3G9

(Zip Code)

Registrant's telephone number, including area code: 604-732-6124

Former name, former address and former fiscal year, if changed since last report: N/A

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files. Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company
(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

At September 8, 2009, there were 50,843,956 shares of the registrant's common stock, par value \$0.01 per share, outstanding.

Exchangeable and Special Voting Shares:

At September 8, 2009 there were outstanding 19,408,346 exchangeable shares of Lulu Canadian Holding, Inc., a wholly-owned subsidiary of the registrant. Exchangeable shares are exchangeable for an equal number of shares of the registrant's common stock.

In addition, at September 8, 2009, the registrant had outstanding 19,408,346 shares of special voting stock, through which the holders of exchangeable shares of Lulu Canadian Holding, Inc. may exercise their voting rights with respect to the registrant. The special voting stock and the registrant's common stock generally vote together as a single class on all matters on which the common stock is entitled to vote.



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PART I
FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

lululemon athletica inc.
CONSOLIDATED BALANCE SHEETS
(Amounts in thousands, except per share amounts)

| | August 2, 2009 (Unaudited) | February 1, 2009 |
|--|----------------------------------|---------------------|
| ASSETS | | |
| Current assets | | |
| Cash and cash equivalents | \$ 83,797 | \$ 56,797 |
| Accounts receivable | 5,789 | 4,029 |
| Inventories | 46,542 | 52,051 |
| Prepaid expenses and other current assets | 6,604 | 4,111 |
| | <u>142,732</u> | <u>116,988</u> |
| Property and equipment, net | 61,265 | 61,662 |
| Goodwill and intangible assets, net | 8,525 | 8,160 |
| Deferred income taxes | 6,974 | 19,373 |
| Other non-current assets | 6,330 | 5,453 |
| | <u>\$ 225,826</u> | <u>\$ 211,636</u> |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Current liabilities | | |
| Accounts payable | \$ 3,073 | \$ 5,269 |
| Accrued liabilities | 17,936 | 22,103 |
| Accrued compensation and related expenses | 6,996 | 5,862 |
| Income taxes payable | — | 2,133 |
| Unredeemed gift card liability | 6,758 | 9,278 |
| Other current liabilities | 505 | 690 |
| | <u>35,268</u> | <u>45,335</u> |
| Other non-current liabilities | 13,298 | 11,301 |
| Deferred income taxes | 181 | 158 |
| | <u>48,747</u> | <u>56,794</u> |
| Stockholders' equity | | |
| Undesignated preferred stock, \$0.01 par value, 5,000 shares authorized, none issued and outstanding | — | — |
| Exchangeable stock, no par value, 30,000 shares authorized, issued and outstanding 19,420 and 19,517 shares | — | — |
| Special voting stock, \$0.00001 par value, 30,000 shares authorized, issued and outstanding 19,420 and 19,517 shares | — | — |
| Common stock, \$0.01 par value, 200,000 shares authorized, issued and outstanding 50,829 and 50,422 shares | 508 | 504 |
| Additional paid-in capital | 146,919 | 155,961 |
| Retained earnings | 25,290 | 9,528 |
| Accumulated other comprehensive income (loss) | 4,362 | (11,151) |
| | <u>177,079</u> | <u>154,842</u> |
| | <u>\$ 225,826</u> | <u>\$ 211,636</u> |

See accompanying notes to the interim consolidated financial statements

lululemon athletica inc.

CONSOLIDATED STATEMENTS OF OPERATIONS
(Amounts in thousands, except per share amounts)

| | <u>Thirteen Weeks Ended August 2, 2009</u> | <u>Thirteen Weeks Ended August 3, 2008</u> | <u>Twenty-Six Weeks Ended August 2, 2009</u> | <u>Twenty-Six Weeks Ended August 3, 2008</u> |
|--|--|--|--|--|
| | (Unaudited) | | | |
| Net revenue | \$ 97,721 | \$ 85,484 | \$ 179,401 | \$ 162,424 |
| Cost of goods sold | 52,557 | 41,108 | 99,213 | 76,947 |
| Gross profit | 45,164 | 44,376 | 80,188 | 85,477 |
| Selling, general and administrative expenses | 30,832 | 28,832 | 56,003 | 57,987 |
| Income from operations | 14,332 | 15,544 | 24,185 | 27,490 |
| Other income, net | 23 | 211 | 101 | 489 |
| Income before income taxes | 14,355 | 15,755 | 24,286 | 27,979 |
| Provision for income taxes | 5,111 | 3,415 | 8,524 | 7,169 |
| Net income from continuing operations | 9,244 | 12,340 | 15,762 | 20,810 |
| Net loss from discontinued operations | — | (1,192) | — | (1,186) |
| Net income | <u>\$ 9,244</u> | <u>\$ 11,148</u> | <u>\$ 15,762</u> | <u>\$ 19,624</u> |
| Basic earnings (loss) per share | | | | |
| Continuing operations | \$ 0.13 | \$ 0.18 | \$ 0.22 | \$ 0.31 |
| Discontinued operations | — | (0.02) | — | (0.02) |
| Net basic earnings per share | \$ 0.13 | \$ 0.16 | \$ 0.22 | \$ 0.29 |
| Diluted earnings (loss) per share | | | | |
| Continuing operations | \$ 0.13 | \$ 0.18 | \$ 0.22 | \$ 0.29 |
| Discontinued operations | — | (0.02) | — | (0.02) |
| Net diluted earnings per share | \$ 0.13 | \$ 0.16 | \$ 0.22 | \$ 0.27 |
| Basic weighted-average number of shares | | | | |
| outstanding | 69,948 | 68,107 | 70,176 | 67,892 |
| Diluted weighted-average number of shares | | | | |
| outstanding | 70,401 | 70,376 | 70,473 | 70,800 |

See accompanying notes to the interim consolidated financial statements

lululemon athletica inc.

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
(Amounts in thousands)

| | Exchangeable Stock | | Special Voting Stock | | Common Stock | | Additional Paid-in Capital | Retained Earnings | Other Comprehensive Income (Loss) | Total |
|--|--------------------|-------------|----------------------|-------------|---------------|---------------|----------------------------|-------------------|-----------------------------------|------------------|
| | Shares | Par Value | Shares | Par Value | Shares | Par Value | | | | |
| Balance at February 1, 2009 | 19,517 | \$ — | 19,517 | \$ — | 50,422 | \$ 504 | \$ 155,961 | \$ 9,528 | \$(11,151) | \$154,842 |
| Comprehensive income: | | | | | | | | | | |
| Net income | | | | | | | | 15,762 | | 15,762 |
| Foreign currency translation adjustment | | | | | | | | | 15,513 | 15,513 |
| Comprehensive income | | | | | | | | | | 31,275 |
| Stock-based compensation | | | | | | | 2,816 | | | 2,816 |
| Excess tax benefit from stock-based compensation | | | | | | | (12,024) | | | (12,024) |
| Common stock issued upon exchange of exchangeable shares | (97) | | (97) | | 97 | 1 | (1) | | | — |
| Restricted stock issuance | | | | | 15 | | | | | — |
| Stock options exercised | | | | | 295 | 3 | 167 | | | 170 |
| Balance at August 2, 2009 | <u>19,420</u> | <u>\$ —</u> | <u>19,420</u> | <u>\$ —</u> | <u>50,829</u> | <u>\$ 508</u> | <u>\$ 146,919</u> | <u>\$25,290</u> | <u>\$4,362</u> | <u>\$177,079</u> |

See accompanying notes to the interim consolidated financial statements

lululemon athletica inc.

CONSOLIDATED STATEMENTS OF CASH FLOWS
(Amounts in thousands)

| | Twenty-Six Weeks Ended August 2, 2009 | Twenty-Six Weeks Ended August 3, 2008 |
|---|---|---|
| | (Unaudited) | |
| Cash flows from operating activities | | |
| Net income | \$ 15,762 | \$ 19,624 |
| Net loss from discontinued operations | — | (1,186) |
| Net income from continuing operations | 15,762 | 20,810 |
| Items not affecting cash | | |
| Depreciation and amortization | 9,552 | 7,199 |
| Stock-based compensation | 2,816 | 3,741 |
| Deferred income taxes | 518 | (2,403) |
| Excess tax benefits from stock-based compensation | — | (2,661) |
| Other, including net changes in other non-cash balances | | |
| Prepaid expenses | (2,269) | (899) |
| Inventory | 8,514 | (5,501) |
| Accounts payable | (1,955) | (3,837) |
| Accrued liabilities | (2,996) | 2,451 |
| Income taxes payable | (1,882) | (7,554) |
| Other non-cash balances | 1,070 | (158) |
| Net cash provided by operating activities — continuing operations | 29,130 | 11,187 |
| Net cash used in operating activities — discontinued operations | — | (45) |
| | 29,130 | 11,142 |
| Cash flows from investing activities | | |
| Purchase of property and equipment | (5,344) | (19,284) |
| Investment in and advances to franchises | (959) | (2,796) |
| Net cash used in investing activities — continuing operations | (6,303) | (22,081) |
| Net cash used in investing activities — discontinued operations | — | — |
| | (6,303) | (22,081) |
| Cash flows from financing activities | | |
| Proceeds from exercise of stock options | 171 | 333 |
| Excess tax benefits from stock-based compensation | — | 2,661 |
| Net cash provided by financing activities — continuing operations | 171 | 2,994 |
| Net cash provided by financing activities — discontinued operations | — | — |
| | 171 | 2,994 |
| Effect of exchange rate changes on cash | 4,002 | (865) |
| Increase (decrease) in cash and cash equivalents from continuing operations | 27,000 | (8,810) |
| Cash and cash equivalents from continuing operations, beginning of period | \$ 56,797 | \$ 52,545 |
| Cash and cash equivalents from continuing operations, end of period | \$ 83,797 | \$ 43,735 |

See accompanying notes to the interim consolidated financial statements

lululemon athletica inc.

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

(Amounts in thousands, except per share amounts and store count information, unless otherwise indicated)

NOTE 1. NATURE OF OPERATIONS AND BASIS OF PRESENTATION

Nature of operations

lululemon athletica inc., a Delaware corporation (“lululemon”, together with its subsidiaries unless the context otherwise requires, the “Company”) is engaged in the design, manufacture and distribution of healthy lifestyle inspired athletic apparel, which is sold through a chain of corporate-owned and operated retail stores, direct to consumers through our e-commerce sales channel, through independent franchises and through a network of wholesale accounts. At August 2, 2009 the Company’s primary markets are Canada and the United States where 42 and 62 corporate-owned stores were in operation, respectively, and Australia where 6 franchised stores were in operation. There were 104 and 103 corporate-owned stores in operation as of August 2, 2009 and February 1, 2009 respectively.

Basis of presentation

The unaudited interim consolidated financial statements as of August 2, 2009 and for the twenty-six week periods ended August 2, 2009 and August 3, 2008 are presented using the United States dollar and have been prepared by the Company under the rules and regulations of the Securities and Exchange Commission (“SEC”). In the opinion of management, the financial information is presented in accordance with United States generally accepted accounting principles (“GAAP”) for interim financial information and, accordingly, does not include all of the information and footnotes required by GAAP for complete financial statements. The financial information as of February 1, 2009 is derived from the Company’s audited consolidated financial statements and notes for the fiscal year ended February 1, 2009, included in Item 8 in the fiscal 2008 Annual Report on Form 10-K. These unaudited interim consolidated financial statements reflect all adjustments which in the opinion of management are necessary to provide a fair statement of the results for the interim periods presented. These unaudited interim consolidated financial statements should be read in conjunction with the Company’s consolidated financial statements and related notes included in the Company’s 2008 Annual Report on Form 10-K filed with the SEC on March 27, 2009.

The Company’s fiscal year ends on the Sunday closest to January 31st of the following year. This typically results in a fifty-two week year, but occasionally gives rise to an additional week, resulting in a fifty-three week year.

Our business is affected by the pattern of seasonality common to most retail apparel businesses. The results for the periods presented are not necessarily indicative of future financial results.

NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Revenue recognition

Revenues from the Company’s gift cards are recognized when tendered for payment, or upon redemption. Outstanding customer balances are included in “Unredeemed gift card liability” on the consolidated balance sheets. There are no expiration dates on the Company’s gift cards, and lululemon does not charge any service fees that cause a decrement to customer balances.

While the Company will continue to honor all gift cards presented for payment, management may determine the likelihood of redemption to be remote for certain card balances due to, among other things, long periods of inactivity. In these circumstances, to the extent management determines there is no requirement for remitting card balances to government agencies under unclaimed property laws, card balances may be recognized in the consolidated statements of earnings in “Net revenue.” For the thirteen and twenty-six weeks ended August 2, 2009, net revenue recognized on unredeemed gift card balances was \$189 and \$1,626, respectively. There was no net revenue recognized on unredeemed gift card balances during the year ended February 1, 2009.

lululemon athletica inc.

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Income Taxes

The Company follows the liability method with respect to accounting for income taxes. Deferred tax assets and liabilities are determined based on temporary differences between the carrying amounts and the tax basis of assets and liabilities. Deferred income tax assets and liabilities are measured using enacted tax rates that will be in effect when these differences are expected to reverse, except for the amount of earnings related to our foreign operations where repatriation is not contemplated in the foreseeable future. Deferred income tax assets are reduced by a valuation allowance, if based on the weight of available evidence, it is more likely than not that some portion or all of the deferred tax assets will not be realized.

The recognition of a deferred income tax asset is based primarily on management's forecasts, including current and proposed tax legislation, current and anticipated taxable income, utilization of previously unrealized non-operating loss carryforwards and regulatory reviews of tax filings. Given judgments and estimates required and the sensitivity of the results to the significant assumptions used, the accounting estimates used in relation to the recognition of deferred income tax assets are subject to measurement uncertainty and are susceptible to a material change if the underlying assumptions change.

We file income tax returns in the U.S., Canada and various foreign and state jurisdictions. We are subject to income tax examination by tax authorities in all jurisdictions from our inception to date. Our policy is to recognize interest expense and penalties related to income tax matters as tax expense. At February 1, 2009, we do not have any significant accruals for interest related to unrecognized tax benefits or tax penalties. Our intercompany transfer pricing policies will be subject to audits by various foreign tax jurisdictions. Although we believe that our intercompany transfer pricing policies and tax positions are reasonable, the final determination of tax audits or potential tax disputes may be materially different from that which is reflected in our income tax provisions and accruals.

United States income taxes and foreign withholding taxes are not provided on undistributed earnings of foreign subsidiaries which are considered to be indefinitely reinvested in the operations of such subsidiaries. The amount of these earnings was approximately \$85,311 at August 2, 2009.

During the second quarter of fiscal 2009, an adjustment was made to deferred tax assets and additional paid-in capital in the amount of \$12,024 relating to windfall recorded in the year ended February 1, 2009 in excess of taxes payable. A similar entry for \$192 was recorded in the same period related to windfall recorded in the first quarter of fiscal 2009. The Company has concluded that the adjustment was not material to the financial statements.

Recent accounting pronouncements

In June 2009, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standard No. 168 ("SFAS 168"), *The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles*. This standard replaces SFAS No. 162, *The Hierarchy of Generally Accepted Accounting Principles*, and establishes only two levels of GAAP, authoritative and non-authoritative. The FASB Accounting Standards Codification (the "Codification") will become the source of authoritative, nongovernmental GAAP, except for rules and interpretive releases of the SEC, which are sources of authoritative GAAP for SEC registrants. All other non-grandfathered, non-SEC accounting literature not included in the Codification will become non-authoritative. This standard is effective for financial statements for interim or annual reporting periods ending after September 15, 2009. As the Codification was not intended to change or alter existing GAAP, it will not have any impact on our consolidated financial statements.

In April 2008 the FASB issued FASB Staff Position ("FSP") No. FAS 142-3 ("FSP 142-3"), *Determination of the Useful Life of Intangible Assets*, which amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under SFAS No. 142. This pronouncement requires enhanced disclosures concerning a company's treatment of costs incurred to renew or extend the term of a recognized intangible asset. FSP 142-3 is effective for financial statements issued for fiscal

lululemon athletica inc.

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

years beginning after December 15, 2008. The effective date, as well as the adoption date for the Company, was February 2, 2009. Although FSP 142-3 may impact the Company's reporting in future financial periods, the Company has determined that the standard did not have any impact on its historical consolidated financial statements at the time of adoption.

In February 2008, the FASB issued FSP 157-2 that partially delays the effective date of Statement of Financial Accounting Standard No. 157, *Fair Value Measurements* ("SFAS No. 157") for one year for non-financial assets and liabilities that are recognized or disclosed at fair value in the financial statements on a non-recurring basis. The effective date, as well as the adoption date for the Company, was February 2, 2009 for non-financial assets and liabilities that are recognized or disclosed at fair value on a non-recurring basis. The Company has determined that the provisions of the standard which have been adopted did not have any impact on its consolidated financial statements at the time of adoption. The Company is currently evaluating the potential impact of the remaining provisions of SFAS 157.

In December 2007, the FASB issued Statement of Financial Accounting Standard No. 141R, *Business Combinations (revised 2007)* ("SFAS 141R"). SFAS 141R replaces SFAS 141 and requires the acquirer of a business to recognize and measure the identifiable assets acquired, the liabilities assumed, and any non-controlling interest in the acquiree at fair value. SFAS 141R also requires transaction costs related to the business combination to be expensed as incurred. The effective date, as well as the adoption date for the Company, was February 2, 2009. Although SFAS 141R may impact the Company's reporting in future financial periods, the Company has determined that the standard did not have any impact on its historical consolidated financial statements at the time of adoption.

NOTE 3. STOCK-BASED COMPENSATION*Share option plans*

The Company's employees participate in various stock-based compensation plans, which are either provided by the Company or by a principal stockholder of the Company.

Stock-based compensation expense charged to income for the plans was \$2,816 and \$3,741 for the twenty-six weeks ended August 2, 2009 and August 3, 2008, respectively. Total unrecognized compensation cost as at August 2, 2009 was \$12,546 for all stock option plans, which is expected to be recognized over a weighted-average period of 2.7 years.

Company stock options

A summary of the Company's stock options and restricted shares activity as of August 2, 2009 and changes during the period then ended is presented below:

| | Number of Stock Options | Weighted- Average Exercise Price | Number of Restricted Shares | Weighted- Average Grant Fair Value |
|-------------------------------|-------------------------------|---|-----------------------------------|---|
| Balance at February 1, 2009 | 1,905 | \$ 10.83 | 9 | \$ 24.04 |
| Granted | 631 | \$ 9.36 | 15 | \$ 13.83 |
| Exercised | 295 | \$ 0.58 | — | \$ — |
| Forfeited | — | \$ — | — | \$ — |
| Balance at August 2, 2009 | 2,241 | \$ 11.76 | 24 | \$ 17.72 |
| Exercisable at August 2, 2009 | 445 | \$ 11.25 | — | \$ — |

lululemon athletica inc.

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

Stockholder- sponsored stock options

During the twenty-six weeks ended August 2, 2009 holders of the exchangeable shares converted 97 exchangeable shares into 97 shares of common stock of the Company for no additional consideration. In connection with the exchange of exchangeable shares, an equal number of outstanding shares of the Company's special voting stock were cancelled.

During the twenty-six weeks ended August 2, 2009 there were no grants or forfeitures related to any of the stock options issued and outstanding under the stockholder-sponsored awards.

Employee stock purchase plan

The Company's Board of Directors and stockholders approved the Company's Employee Stock Purchase Plan ("ESPP") in September 2007. The ESPP allows for the purchase of common stock of the Company by all eligible employees. Eligible employees may elect to have whatever portion of his or her base salary equates, after deduction of applicable taxes, to either 3%, 6% or 9% of his or her base salary withheld during each payroll period for purposes of purchasing shares of our common stock under the ESPP. Additionally, we, or the subsidiary employing the participant, will make a cash contribution as additional compensation to each participant equal to one-third of the aggregate amount of that participant's contribution for that pay period, which will be used to purchase shares of our common stock, subject to certain limits as defined in the ESPP. The maximum number of shares available under the ESPP is 3,000 shares. During the quarter ended August 2, 2009, there were 15 shares purchased under the ESPP, which were funded by the Company through open market purchases.

NOTE 4. PROVISION FOR IMPAIRMENT AND LEASE EXIT COSTS

During the twenty-six weeks ended August 2, 2009, in conjunction with the Company's ongoing assessment to ensure that each of the Company's properties fit into the Company's strategy, the Company recorded a charge of \$820 in lease exit costs related certain locations and reversed lease exit costs of \$714 previously recorded in the fourth quarter of fiscal 2008. The fair market values were estimated using an expected present value technique.

A reconciliation of the associated provision for impairment and lease exit costs is as follows:

| | Lease Exit and Other Related Costs | Asset Impairment | Total |
|---|---|-----------------------------|----------------|
| Provision for impairment and lease exit costs at February 1, 2009 | \$ 1,189 | \$ — | \$1,189 |
| Costs incurred | 1,620 | — | 1,620 |
| Cash payments | (800) | — | (800) |
| Reversals | (714) | — | (714) |
| Provision for impairment and lease exit costs at August 2, 2009 | <u>\$ 1,295</u> | <u>\$ —</u> | <u>\$1,295</u> |

NOTE 5. LEGAL PROCEEDINGS

On April 2, 2009, three former hourly Company employees filed a class action lawsuit in San Diego Superior Court entitled *Mia Stephens et al v. lululemon athletica inc.* The lawsuit alleges that the Company violated various California Labor Code sections by requiring employees to wear lululemon clothing during working hours without reimbursing such employees for the cost of the clothing and by paying certain bonus payments to its employees in the form of lululemon gift cards redeemable only for lululemon merchandise. The complaint also alleges that the Company owes waiting time penalties as the result of failing to pay employees all wages due at the time of termination. The plaintiffs are seeking an unspecified amount of damages. The Company intends to vigorously defend the matter.

lululemon athletica inc.

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

On March 26, 2009, a former hourly Company employee filed a class action lawsuit in Orange County Superior Court, California entitled *Brett Kohlenberg et al v. lululemon athletica inc.* The lawsuit alleges that the Company violated various California Labor Code sections by failing to pay its employees for certain rest and meal breaks and “off the clock” work, and for penalties related to waiting times and failure to provide itemized wage statements. The plaintiff is seeking an unspecified amount of damages. The Company intends to vigorously defend the matter.

We are a party to various other legal proceedings arising in the ordinary course of our business, but we are not currently a party to any legal proceeding that management believes would have a material adverse effect on our consolidated financial position or results of operations.

NOTE 6. EARNINGS PER SHARE

The details of the computation of basic and diluted earnings per share are as follows:

| | Thirteen Weeks Ended August 2, 2009 | Thirteen Weeks Ended August 3, 2008 | Twenty-six Weeks Ended August 2, 2009 | Twenty-six Weeks Ended August 3, 2008 |
|--|---|---|---|---|
| Net income from continuing operations | \$ 9,244 | \$ 12,340 | \$ 15,762 | \$ 20,810 |
| Net loss from discontinued operations | — | (1,192) | — | (1,186) |
| Net income | \$ 9,244 | \$ 11,148 | \$ 15,762 | \$ 19,624 |
| Basic weighted-average number of shares outstanding | 69,948 | 68,107 | 70,176 | 67,892 |
| Basic earnings per share: | | | | |
| Net income from continuing operations | \$ 0.13 | \$ 0.18 | \$ 0.22 | \$ 0.31 |
| Net loss from discontinued operations | — | (0.02) | — | (0.02) |
| Net income | \$ 0.13 | \$ 0.16 | \$ 0.22 | \$ 0.29 |
| Basic weighted-average number of shares outstanding | 69,948 | 68,107 | 70,176 | 67,892 |
| Effect of stock options assumed exercised | 453 | 2,269 | 297 | 2,907 |
| Diluted weighted-average number of shares outstanding | 70,401 | 70,376 | 70,473 | 70,800 |
| Diluted earnings per share: | | | | |
| Net income from continuing operations | \$ 0.13 | \$ 0.18 | \$ 0.22 | \$ 0.29 |
| Net loss from discontinued operations | — | (0.02) | — | (0.02) |
| Net income | \$ 0.13 | \$ 0.16 | \$ 0.22 | \$ 0.27 |

Our calculation of weighted-average shares includes the common stock of the Company as well as the exchangeable shares. Exchangeable shares are the equivalent of common shares in all respects. For the thirteen and twenty-six weeks ended August 2, 2009, 896 and 1,313 stock options were anti-dilutive to earnings and therefore have been excluded from the computation of diluted earnings per share.

lululemon athletica inc.

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

NOTE 7. SUPPLEMENTARY FINANCIAL INFORMATION

A summary of certain balance sheet accounts is as follows:

| | August 2, 2009 | February 1, 2009 |
|---|-------------------|---------------------|
| Accounts receivable: | | |
| Trade accounts receivable | \$ 3,690 | \$ 3,171 |
| Other accounts receivable | 2,104 | 863 |
| Allowance for doubtful accounts | (5) | (5) |
| | <u>\$ 5,789</u> | <u>\$ 4,029</u> |
| Inventories: | | |
| Finished goods | \$ 45,558 | \$ 52,828 |
| Raw materials | 2,009 | 558 |
| Provision to reduce inventory to market value | (1,025) | (1,335) |
| | <u>\$ 46,542</u> | <u>\$ 52,051</u> |
| Property and equipment: | | |
| Leasehold improvements | \$ 56,235 | \$ 52,101 |
| Furniture and fixtures | 17,715 | 16,581 |
| Computer hardware and software | 23,099 | 19,411 |
| Equipment and vehicles | 271 | 279 |
| Accumulated amortization and depreciation | (36,055) | (26,710) |
| | <u>\$ 61,265</u> | <u>\$ 61,662</u> |
| Goodwill and intangible assets: | | |
| Goodwill | \$ 738 | \$ 738 |
| Changes in foreign currency exchange rates | 149 | 36 |
| | <u>887</u> | <u>774</u> |
| Reacquired franchise rights | 10,162 | 10,162 |
| Non-competition agreements | 694 | 694 |
| Accumulated amortization | (4,161) | (3,162) |
| Changes in foreign currency exchange rates | 943 | (308) |
| | <u>7,638</u> | <u>7,386</u> |
| | <u>\$ 8,525</u> | <u>\$ 8,160</u> |
| Other non-current assets: | | |
| Prepaid rent and security deposits | \$ 889 | \$ 872 |
| Deferred lease cost | 1,619 | 1,718 |
| Advances to and investments in franchise | 3,822 | 2,863 |
| | <u>\$ 6,330</u> | <u>\$ 5,453</u> |
| Accrued liabilities: | | |
| Inventory purchases | \$ 9,672 | \$ 15,772 |
| Sales tax collected | 2,679 | 1,681 |
| Accrued rent | 1,401 | 1,147 |
| Impairment and lease exit costs | 1,295 | 1,189 |
| Other | 2,889 | 2,314 |
| | <u>\$ 17,936</u> | <u>\$ 22,103</u> |
| Other non-current liabilities: | | |
| Deferred lease liability | \$ 9,242 | \$ 7,326 |
| Tenant inducements | 4,056 | 3,975 |
| | <u>\$ 13,298</u> | <u>\$ 11,301</u> |

lululemon athletica inc.

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

NOTE 8. SEGMENT REPORTING

The Company's reportable segments are comprised of corporate-owned stores, franchises and other. Phone sales, warehouse sales, e-commerce sales and showrooms sales have been combined into other. Information for these segments from continuing operations is detailed in the table below:

| | Thirteen Weeks Ended August 2, 2009 | Thirteen Weeks Ended August 3, 2008 | Twenty-six Weeks Ended August 2, 2009 | Twenty-six Weeks Ended August 3, 2008 |
|--|---|---|---|---|
| Net revenue: | | | | |
| Corporate-owned stores | \$ 85,091 | \$ 78,334 | \$ 157,993 | \$ 147,685 |
| Franchises | 2,989 | 4,267 | 5,680 | 8,804 |
| Other | 9,641 | 2,883 | 15,728 | 5,935 |
| | <u>\$ 97,721</u> | <u>\$ 85,484</u> | <u>\$ 179,401</u> | <u>\$ 162,424</u> |
| Income from operations before general corporate expense: | | | | |
| Corporate-owned stores | \$ 23,466 | \$ 23,758 | \$ 41,648 | \$ 46,824 |
| Franchises | 1,112 | 2,290 | 2,051 | 4,369 |
| Other | 5,141 | 674 | 7,033 | 1,297 |
| | 29,719 | 26,722 | 50,732 | 52,489 |
| General corporate expense | 15,387 | 11,179 | 26,547 | 24,999 |
| Income from operations | 14,332 | 15,544 | 24,185 | 27,490 |
| Other income, net | 23 | 211 | 101 | 489 |
| Income before income taxes | <u>\$ 14,355</u> | <u>\$ 15,755</u> | <u>\$ 24,286</u> | <u>\$ 27,979</u> |
| Capital expenditures: | | | | |
| Corporate-owned stores | \$ 1,919 | \$ 8,124 | \$ 3,011 | \$ 13,176 |
| Corporate | 1,066 | 2,560 | 2,333 | 6,108 |
| | <u>\$ 2,985</u> | <u>\$ 10,684</u> | <u>\$ 5,344</u> | <u>\$ 19,284</u> |
| Depreciation: | | | | |
| Corporate-owned stores | \$ 3,463 | \$ 2,520 | \$ 6,583 | \$ 4,621 |
| Corporate | 1,811 | 1,095 | 2,969 | 2,068 |
| | <u>\$ 5,274</u> | <u>\$ 3,615</u> | <u>\$ 9,552</u> | <u>\$ 6,688</u> |

NOTE 9. DISCONTINUED OPERATIONS

During the first quarter of fiscal 2008 the Company committed to plans to wind-up operations in Japan and in the second quarter of fiscal 2008 the plans were finalized and disposition of the assets commenced with closure of three of the four corporate-owned stores that the Company was operating as a joint venture with Descente Ltd. The fourth corporate-owned store was closed during the third quarter of fiscal 2008. The shut down costs related to the closure of the stores in Japan were fully accrued in the second quarter of fiscal 2008. The Company and Descente Ltd. agreed to end all operations as a joint venture in the third quarter of fiscal 2008.

lululemon athletica inc.

NOTES TO THE INTERIM CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

The results of discontinued operations are summarized as follows:

| | <u>Twenty-six Weeks Ended August 2, 2009</u> | <u>Twenty-six Weeks Ended August 3, 2008</u> |
|-------------------------------------|--|--|
| Revenue | \$ — | \$ 2,541 |
| Expenses | — | (3,812) |
| Minority interest | — | 85 |
| Net loss on discontinued operations | <u>\$ —</u> | <u>\$ (1,186)</u> |

The net loss from discontinued operations represents all activity up to August 2, 2009.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Some of the statements contained in this Form 10-Q and any documents incorporated herein by reference constitute forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and the Private Securities Litigation Reform Act of 1995. All statements, other than statements of historical facts, included or incorporated in this Form 10-Q are forward-looking statements, particularly statements which relate to expectations, beliefs, projections, future plans and strategies, anticipated events or trends and similar expressions concerning matters that are not historical facts, such as statements regarding our future financial condition or results of operations, our prospects and strategies for future growth, the development and introduction of new products, and the implementation of our marketing and branding strategies. In many cases, you can identify forward-looking statements by terms such as "may", "will", "should", "expects", "plans", "anticipates", "believes", "estimates", "intends", "predicts", "potential" or the negative of these terms or other comparable terminology.

The forward-looking statements contained in this Form 10-Q and any documents incorporated herein by reference reflect our current views about future events and are subject to risks, uncertainties, assumptions and changes in circumstances that may cause events or our actual activities or results to differ significantly from those expressed in any forward-looking statement. Although we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future events, results, actions, levels of activity, performance or achievements. Readers are cautioned not to place undue reliance on these forward-looking statements. A number of important factors could cause actual results to differ materially from those indicated by the forward-looking statements, including, but not limited to, those factors described in "Risk Factors" and "Management's Discussion and Analysis of Financial Condition and Results of Operations" of our Annual Report on Form 10-K for fiscal 2008 filed on March 27, 2009. These factors include without limitation:

- our ability to sustain operational and performance levels in a volatile worldwide economy;
- our ability to manage operations at our current size or manage growth effectively;
- our ability to locate suitable locations to open new stores and to attract customers to our stores;
- our ability to successfully expand in new markets outside of North America;
- our ability to finance our growth and maintain sufficient levels of cash flow;
- increased competition causing us to reduce the prices of our products or to increase significantly our marketing efforts in order to avoid losing market share;
- our ability to effectively market and maintain a positive brand image and to protect the lululemon brand and related goodwill;
- our ability to maintain our historical levels of comparable store sales or average sales per square foot;
- our ability to continually innovate and provide our consumers with improved products;
- the ability of our suppliers or manufacturers to produce or deliver our products in a timely or cost-effective manner;
- our lack of long-term supplier contracts;
- our lack of patents or exclusive intellectual property rights in our fabrics and manufacturing technology;
- our ability to attract and maintain the services of our senior management and key employees;
- the availability and effective operation of management information systems and other technology;
- changes in consumer preferences or changes in demand for technical athletic apparel and other products;
- our ability to accurately forecast consumer demand for our products;
- our ability to accurately anticipate and respond to seasonal or quarterly fluctuations in our operating results;
- our ability to maintain effective internal controls; and
- changes in general economic or market conditions, including as a result of political or military unrest or terrorist attacks.

The forward-looking statements contained in this Form 10-Q reflect our views and assumptions only as of the date of this Form 10-Q and are expressly qualified in their entirety by the cautionary statements included in this Form 10-Q. Except as required by applicable securities law, we undertake no obligation to update any forward-looking statement to reflect events or circumstances after the date on which the statement is made or to reflect the occurrence of unanticipated events.

Our fiscal year ends on the Sunday closest to January 31st of the following year. This typically results in a fifty-two week year, but occasionally gives rise to an additional week, resulting in a fifty-three week year.

Overview

The world economy slowed considerably during fiscal 2008 as problems in global financial markets became more widespread and consumers cut back on retail spending amid fears of a global recession. Our sales growth slowed in the latter part of the third quarter of fiscal 2008, driven in part by this reduced spending. This challenging economic climate and the continued weakness of the Canadian dollar continued to negatively affect our financial results during the thirteen and twenty-six week periods ended August 2, 2009.

In response to the changes in the world economy and the impact on our operating results, we have taken several steps to address the deterioration in the retail environment and address our support structure. These steps, which we discussed in our Annual Report on Form 10-K for fiscal 2008 filed with the SEC on March 27, 2009, included the development and implementation of several important initiatives as part of our strategy designed to increase customer traffic in our corporate-owned store locations, reduce infrastructure expenses and improve our operating results.

We continue to realize the positive effects of our cost reductions and efficiency initiatives and expect the impact of such initiatives on our financial results to continue through the remainder of fiscal 2009. These targeted cost reductions and associated efficiency efforts were designed to structure our business for long-term profitable growth and to protect our brand integrity. We believe our continued strong cash flow generation, solid balance sheet and healthy liquidity provide us with the financial flexibility to continue executing the initiatives we implemented at the end of fiscal 2008 as well as make investments at strategic times which will benefit our company.

Operating Segment Overview

lululemon is a designer and retailer of technical athletic apparel operating primarily in North America and Australia. Our yoga-inspired apparel is marketed under the lululemon athletica brand name. We offer a comprehensive line of apparel and accessories including fitness pants, shorts, tops and jackets designed for athletic pursuits such as yoga, dance, running and general fitness. As of August 2, 2009, our branded apparel was principally sold through 115 corporate-owned and franchise stores that are primarily located in Canada and the United States. We believe our vertical retail strategy allows us to interact more directly with and gain insights from our customers while providing us with greater control of our brand. For the second quarter of fiscal 2009, approximately 62% of our net revenue was derived from sales of our products in Canada, 38% of our net revenue was derived from the sales of our products in the United States and an immaterial amount of our net revenue was derived from sales of our products outside of North America.

Our net revenue has grown from \$40.7 million in fiscal 2004 to \$353.5 million in fiscal 2008. This represents a compound annual growth rate of 72%. Our net revenue from continuing operations also increased from \$162.4 million in the first two quarters of fiscal 2008 to \$179.4 million in the first two quarters of fiscal 2009, representing a 10% increase. Our increase in net revenue from fiscal 2004 to fiscal 2008 resulted from the addition of retail locations in North America, including 34 net openings in fiscal 2008 and 31 net openings in fiscal 2007, and comparable store sales growth as high as 34%, which we realized in fiscal 2007. Our ability to open new stores and grow sales in existing stores has been driven by increasing demand for our technical athletic apparel and a growing recognition of the lululemon athletica brand. We believe our superior products, strategic store locations, inviting store environment, grassroots marketing approach and distinctive corporate culture are responsible for our strong financial performance.

We have three reportable segments: corporate-owned stores, franchises and other. We report our segments based on the financial information we use in managing our businesses. While we receive financial information for each corporate-owned store, we have aggregated all of the corporate-owned stores into one reportable segment due to the similarities in the economic and other characteristics of these stores. Our franchises segment accounted for 3% of our net revenues from continuing operations in the first two quarters of fiscal 2009, 5% of our net revenues from continuing operations in fiscal 2008 and 7% of our net revenues from continuing operations in fiscal 2007. Opening new franchise stores is not a significant part of our near-term growth strategy, and we therefore expect that if the revenue derived from our franchise stores continues to comprise less than 10% of the net revenue we report in future fiscal years, we will re-evaluate our segment reporting disclosures. Our other operations accounted for less than 10% of our net revenues from continuing operations in each of the first two quarters of fiscal 2009, fiscal 2008 and fiscal 2007.

Results of Continuing Operations

Thirteen Weeks Results

The following table summarizes key components of our results of operations for the thirteen weeks ended August 2, 2009 and August 3, 2008. The operating results are expressed in dollar amounts as well as relevant percentages, presented as a percentage of net revenue.

| | Thirteen Weeks Ended | | | |
|--|--|-----------------|---------------|-------------|
| | August 2, 2009 and August 3, 2008 | | | |
| | <u>2009</u> | <u>2008</u> | <u>2009</u> | <u>2008</u> |
| | (In thousands) | | (Percentages) | |
| Net revenue | \$97,721 | \$85,484 | 100.0 | 100.0 |
| Cost of goods sold | 52,557 | 41,108 | 53.8 | 48.1 |
| Gross profit | 45,164 | 44,376 | 46.2 | 51.9 |
| Selling, general and administrative expenses | 30,832 | 28,832 | 31.6 | 33.7 |
| Income from operations | 14,332 | 15,544 | 14.7 | 18.2 |
| Other income, net | 23 | 211 | 0.0 | 0.2 |
| Income before income taxes | 14,355 | 15,755 | 14.7 | 18.4 |
| Provision for income taxes | 5,111 | 3,415 | 5.2 | 4.0 |
| Net income from continuing operations | 9,244 | 12,340 | 9.5 | 14.4 |
| Net loss from discontinued operations | — | (1,192) | — | (1.4) |
| Net income | <u>\$ 9,244</u> | <u>\$11,148</u> | <u>9.5</u> | <u>13.0</u> |

Net Revenue

Net revenue increased \$12.2 million, or 14%, to \$97.7 million for the second quarter of fiscal 2009 from \$85.5 million for the second quarter of fiscal 2008. This increase was the result of sales from new stores opened. Assuming the average exchange rate between the Canadian and United States dollars for the second quarter of fiscal 2008 remained constant, our net revenue would have increased \$19.1 million, or 22%, for the second quarter of fiscal 2009.

| | Thirteen Weeks Ended | |
|--------------------------------|--|------------------|
| | August 2, 2009 and August 3, 2008 | |
| | (In thousands) | |
| Net revenue by segment: | | |
| Corporate-owned stores | \$ 85,091 | \$ 78,334 |
| Franchises | 2,989 | 4,267 |
| Other | 9,641 | 2,883 |
| Net revenue | <u>\$ 97,721</u> | <u>\$ 85,484</u> |

Corporate-Owned Stores. Net revenue from our corporate-owned stores segment increased \$6.8 million, or 9%, to \$85.1 million for the second quarter of fiscal 2009 from \$78.3 million for the second quarter of fiscal 2008. The following contributed to the \$6.8 million increase in net revenue from our corporate-owned stores segment:

- Net revenue from corporate-owned stores we opened during the first two quarters of fiscal 2009, and other corporate-owned stores we opened, or reacquired the franchise rights for, subsequent to August 3, 2008 and therefore not included in the comparable store sales growth, contributed \$14.6 million of the increase. Net new store openings since the second quarter of fiscal 2008 included two stores in Canada and 22 stores in the United States; and
- Comparable store sales decline of 2% in the second quarter of fiscal 2009 resulted in a \$1.7 million decrease to net revenue, excluding the effect of foreign currency fluctuations. Including the effect of foreign currency fluctuations, comparable stores sales declined 10%, or \$7.8 million, in the second quarter of fiscal 2009.

Franchises. Net revenue from our franchises segment decreased \$1.3 million, or 30%, to \$3.0 million for the second quarter of fiscal 2009 from \$4.3 million for the second quarter of fiscal 2008. The decrease in net revenue from our franchises segment resulted primarily from our reacquisition of two franchise stores in Victoria, British Columbia and one franchised store in Bellevue, Washington in the third quarter of fiscal 2008.

Other. Net revenue from our other segment increased \$6.8 million, or 234%, to \$9.6 million for the second quarter of fiscal 2009 from \$2.9 million for the second quarter of fiscal 2008. The \$6.8 million increase was primarily the result of an increase in sales from the launch of our e-commerce channel in the first quarter of fiscal 2009 which contributed \$2.8 million in net revenues, as well as increased sales from wholesale, outlet and warehouse sales which contributed \$3.9 million in net revenues.

Gross Profit

Gross profit increased \$0.8 million, or 2%, to \$45.2 million for the second quarter of fiscal 2009 from \$44.4 million for the second quarter of fiscal 2008. The increase in gross profit was driven principally by:

- an increase of \$6.8 million in net revenue from our corporate-owned stores segment related to an increase in corporate-owned stores;
- an increase of \$6.8 million in net revenue from our other segment related primarily to an increase in sales from the launch of our e-commerce channel in the first quarter of fiscal 2009 as well as increased sales from wholesale, outlet and warehouse sales; and
- a decrease in the cost of sales support departments of \$0.9 million related to reduced costs for distribution, design, merchandising and production.

These amounts were partially offset by:

- an increase in product costs of \$6.5 million associated with our sale of goods through corporate-owned stores related primarily to increased revenues and unfavorable foreign exchange differences;
- an increase in product costs of \$3.4 million associated with the increase in the sale of our goods through our other segment including the launch of our e-commerce channel in the first fiscal quarter of 2009 as well as increased sales from outlet and warehouse locations;
- an increase in fixed costs, such as occupancy costs and depreciation, of \$2.7 million related to an increase in corporate-owned stores which has a deleveraging effect on gross profit; and
- a decrease of \$1.2 million in gross profit from our franchise segment related primarily to the reacquisition of franchised stores late in the third quarter of fiscal 2008.

Gross profit as a percentage of net revenue, or gross margin, decreased 5.7%, to 46.2% for the second quarter of fiscal 2009 from 51.9% for the second quarter of fiscal 2008. The decrease in gross margin resulted primarily from:

- strategic pricing initiatives, sourcing initiatives and other of 3.5%;
- unfavorable foreign exchange differences of 2.6%; and

- an increase in fixed costs, such as occupancy costs and depreciation, which has a deleveraging effect on gross profit as a percentage of revenue, which contributed to a decrease in gross margin of 1.4%.

This was offset by expenses related to our production, design, merchandising and distribution departments which had a leveraging effect on gross profit as a percentage of revenue, and contributed to an increase in gross margin of 1.8%.

Our costs of goods sold in the second quarter of fiscal 2009 and the second quarter of fiscal 2008 included \$0.2 million and \$0.4 million, respectively, of stock-based compensation expense.

Selling, General and Administrative Expenses

Selling, general and administrative expenses increased \$2.0 million, or 7%, to \$30.8 million for the second quarter of fiscal 2009 from \$28.8 million for the second quarter of fiscal 2008. As a percentage of net revenue, selling, general and administrative expenses decreased 2.1%, to 31.6% from 33.7%. The \$2.0 million increase in selling, general and administrative expenses was principally comprised of:

- an increase of \$1.0 million primarily related to lease cancellations and employment related legal matters;
- an increase in administrative costs associated with the launch in the first fiscal quarter of 2009 of our new e-commerce channel of \$0.8 million;
- an increase in administrative costs associated with increased net revenue in our other sales channel of \$0.5 million;
- an increase in foreign exchange losses of \$0.5 million related to unfavorable fluctuations in the Canadian-United States dollar exchange rates; and
- an increase in depreciation costs of \$0.4 million primarily related to the retirement of legacy IT systems.

These amounts were partially offset:

- a decrease in costs associated with our corporate store segment of \$0.9 million primarily related to lower employee and distribution costs; and
- a decrease in employee compensation of \$0.3 million related to a decrease in employee head count in our store support center, as part of our efforts to reduce operating expenses.

Our selling, general and administrative expenses in the second quarter of fiscal 2009 and the second quarter of fiscal 2008 included \$1.2 million and \$1.1 million, respectively, of stock-based compensation expense.

Income from Operations

Income from operations decreased \$1.2 million, or 8% to \$14.3 million for the second quarter of fiscal 2009 from \$15.5 million for the second quarter of fiscal 2008. The decrease of \$1.2 million in income from operations for the second quarter of fiscal 2009 was primarily due to a \$2.0 million increase in selling, general and administrative expenses, partially offset by an increase of \$0.8 million in gross profit resulting from increased comparable store sales and additional sales from corporate-owned stores opened.

On a segment basis, we determine income from operations without taking into account our general corporate expenses such as corporate employee costs, travel expenses and corporate rent. For purposes of our management's analysis of our financial results, we have allocated some general product expenses to our corporate-owned stores segment. For example, all expenses related to our production, design, merchandise, and distribution departments have been allocated to this segment.

Income from operations (before general corporate expenses) from:

- our corporate-owned stores segment remained consistent with the second quarter of fiscal 2008 with less than a 1% increase, at \$23.5 million for the second quarter of fiscal 2009. The increase in corporate-owned stores net revenue of \$6.8 million was offset by an increase of \$6.5 million cost of goods sold and a decrease in store operating expenses of \$0.4 million;

- our franchises segment decreased \$1.2 million, or 53%, to \$1.1 million for the second quarter of fiscal 2009 from \$2.3 million for the second quarter of fiscal 2008, primarily as a result of franchises net revenue included in the comparative period shifting to corporate-owned stores income from operations when we reacquired two franchised stores in Victoria, British Columbia and one franchised store in Bellevue, Washington; and
- our other segment increased \$4.4 million, or 635%, to \$5.1 million for the second quarter of fiscal 2009 from \$0.7 million for the second quarter of fiscal 2008, primarily due to the introduction of online sales through our e-commerce channel as well as increased outlet, warehouse and wholesale activity.

Other income, net decreased \$0.2 million to \$nil for the second quarter of fiscal 2009 from \$0.2 million for the second quarter of fiscal 2008. The decrease was primarily due to lower interest rates earned on cash balances.

Provision for Income Taxes

Income tax expense for the second quarter of fiscal 2009 was \$5.1 million compared to \$3.4 million for the corresponding period in fiscal 2008. The Company's financial statement effective tax rate for the thirteen weeks ended August 2, 2009 was 36%. The effective tax rate will vary from the statutory rate because (i) stock-based compensation expense recorded is a permanent difference in certain jurisdictions, (ii) the realization of the benefits of the tax assets recorded prior to the second quarter of fiscal 2008, and (iii) the realization of the benefits of the tax assets related primarily to historical tax differences between financial and tax bases of assets and liabilities prior to February 1, 2009.

During the second quarter of fiscal 2008, after considering a number of factors, including a history of cumulative earnings, utilization of previously generated NOLs and estimated taxable income in future years, we determined we would more likely than not realize substantial future tax benefits from our deferred income tax assets generated in the United States prior to February 1, 2009. As a result of this analysis the Company recorded deferred tax assets of (i) \$1.4 million related primarily to historical tax differences between financial and tax bases of assets and liabilities, (ii) \$0.9 million cumulative tax benefit recorded from stock-based compensation expense prior to the second quarter of fiscal 2008, and (iii) \$2.7 million excess tax benefit from the exercise of stock options during and prior to the second quarter of fiscal 2008.

During the second quarter of fiscal 2009, an adjustment was made to deferred tax assets and additional paid-in capital in the amount of \$12.0 million relating to windfall taxes recorded in the year ended February 1, 2009 in excess of US taxes payable. A similar entry for \$0.2 million was recorded in the same period related to windfall taxes recorded in the first quarter of fiscal 2009. The Company has concluded that the adjustment was not material to the financial statements.

Net Income from Continuing Operations

Net income from continuing operations decreased \$3.1 million, to \$9.2 million for the second quarter of fiscal 2009 from \$12.3 million for the second quarter of fiscal 2008. The decrease in net income of \$3.1 million for the second quarter of fiscal 2009 was a result of a \$2.0 million increase in selling, general and administrative expenses, a \$1.7 million increase in provision for income taxes and a \$0.2 million decrease in other income, net, partially offset by an increase of \$0.8 million in gross profit resulting from additional sales from corporate-owned stores opened.

Discontinued Operations

During the second quarter of fiscal 2009, revenues, expenses and loss from discontinued operations were \$nil. The loss from discontinued operations was \$1.2 million for the second quarter of fiscal 2008, resulting in a reduction of basic and diluted earnings per share of \$0.02. The shut down costs related to the closure of the stores in Japan were fully accrued in the second quarter of fiscal 2008.

Twenty-six Weeks Results

The following table summarizes key components of our results of operations for the twenty-six weeks ended August 2, 2009 and August 3, 2008. The operating results are expressed in dollar amounts as well as relevant percentages, presented as a percentage of net revenue.

| | Twenty-six Weeks Ended | | | |
|--|--|------------------|----------------------|-------------|
| | August 2, 2009 and August 3, 2008 | | | |
| | 2009 | 2008 | 2009 | 2008 |
| | (In thousands) | | (Percentages) | |
| Net revenue | \$179,401 | \$162,424 | 100.0 | 100.0 |
| Cost of goods sold | 99,213 | 76,947 | 55.3 | 47.4 |
| Gross profit | 80,188 | 85,477 | 44.7 | 52.6 |
| Selling, general and administrative expenses | 56,003 | 57,987 | 31.2 | 35.7 |
| Income from operations | 24,185 | 27,490 | 13.5 | 16.9 |
| Other income, net | 101 | 489 | 0.1 | 0.3 |
| Income before income taxes | 24,286 | 27,979 | 13.5 | 17.2 |
| Provision for income taxes | 8,524 | 7,169 | 4.5 | 4.4 |
| Net income from continuing operations | 15,762 | 20,810 | 8.8 | 12.8 |
| Net loss from discontinued operations | — | (1,186) | — | (0.7) |
| Net income | <u>\$ 15,762</u> | <u>\$ 19,624</u> | <u>8.8</u> | <u>12.1</u> |

Net Revenue

Net revenue increased \$17.0 million, or 10%, to \$179.4 million for the first twenty-six weeks of fiscal 2009 from \$162.4 million for the first twenty-six weeks of fiscal 2008. This increase was the result of sales from new stores opened. Assuming the average exchange rate between the Canadian and United States dollars for the first twenty-six weeks of fiscal 2008 remained constant, our net revenue would have increased \$34.7 million, or 21%, for the first twenty-six weeks of fiscal 2009.

| | Twenty-six Weeks Ended | |
|--------------------------------|-------------------------------|-----------------------|
| | August 2, 2009 | August 3, 2008 |
| | (In thousands) | |
| Net revenue by segment: | | |
| Corporate-owned stores | \$ 157,993 | \$ 147,685 |
| Franchises | 5,680 | 8,804 |
| Other | 15,728 | 5,935 |
| Net revenue | <u>\$ 179,401</u> | <u>\$ 162,424</u> |

Corporate-Owned Stores. Net revenue from our corporate-owned stores segment increased \$10.3 million, or 7%, to \$158.0 million for the first twenty-six weeks of fiscal 2009 from \$147.7 million for the first twenty-six weeks of fiscal 2008. The following contributed to the \$10.3 million increase in net revenue from our corporate-owned stores segment:

- Net revenue from corporate-owned stores we opened during the first twenty-six weeks of fiscal 2009, and other corporate-owned stores we opened, or reacquired franchise rights for, subsequent to August 3, 2008 and therefore not included in the comparable store sales growth, contributed \$30.8 million of the increase. Net new store openings from the second quarter of fiscal 2008 included two stores in Canada and 22 stores in the United States;
- Comparable store sales decline of 5% in the first twenty-six weeks of fiscal 2009 resulted in a \$7.0 million decrease to net revenue, excluding the effect of foreign currency fluctuations. Including the effect of foreign currency fluctuations, comparable store sales declined 15%, or \$22.2 million, in the first twenty-six weeks of fiscal 2009; and

- Net revenue related to gift card breakage contributed \$1.6 million of the increase. Based on historical gift card breakage, we recognize into revenue a portion of gift card sales for which we estimate redemption is remote over the estimated period of redemption. In the first quarter of 2009 we recorded a one-time charge of \$1.3 million related to a change in our estimated rate of redemption.

Franchises. Net revenue from our franchises segment decreased \$3.1 million, or 36%, to \$5.7 million for the first twenty-six weeks of fiscal 2009 from \$8.8 million for the first twenty-six weeks of fiscal 2008. The decrease in net revenue from our franchises segment resulted primarily from our reacquisition of two franchise stores in Victoria, British Columbia and one franchised store in Bellevue, Washington in the third quarter of fiscal 2008.

Other. Net revenue from our other segment increased \$9.8 million, or 165%, to \$15.7 million for the first twenty-six weeks of fiscal 2009 from \$5.9 million for the first twenty-six weeks of fiscal 2008. The \$9.8 million increase was primarily the result of an increase in sales from the launch of our e-commerce channel in the first quarter of fiscal 2009 which contributed \$3.2 million in net revenues, as well as increased sales from wholesale, outlet and warehouse sales which contributed \$6.6 million in net revenues.

Gross Profit

Gross profit decreased \$5.3 million, or 6%, to \$80.2 million for the first twenty-six weeks of fiscal 2009 from \$85.5 million for the first twenty-six weeks of fiscal 2008. The decrease in gross profit was driven principally by:

- an increase in product costs of \$11.5 million associated with our sale of goods through corporate-owned stores related primarily to increased revenues and unfavorable foreign exchange differences;
- an increase in fixed costs, such as occupancy costs and depreciation, of \$6.8 million related to an increase in corporate-owned stores which has a deleveraging effect of gross profit; and
- a decrease of \$2.3 million in gross profit from our franchises segment related primarily to the reacquisition of franchised stores in the third quarter of fiscal 2008.

These amounts were partially offset by:

- an increase of \$10.3 million in net revenue from our corporate-owned stores segment related to an increase in corporate-owned stores and a one-time charge related to gift card breakage in the first quarter of fiscal 2009;
- an increase of \$4.2 million in net revenue from our other segment related primarily to increased sales from the launch of our e-commerce channel in the first quarter of fiscal 2009; as well as wholesale, outlet, and warehouse sales; and
- a decrease of \$1.2 million in the cost of our distribution centers related primarily to decreased employee costs as well as other fees we pay to third parties to operate our distribution centers.

Gross profit as a percentage of net revenue, or gross margin, decreased 7.9%, to 44.7% for the first twenty-six weeks of fiscal 2009 from 52.6% for the first twenty-six weeks of fiscal 2008. The decrease in gross margin resulted primarily from:

- strategic pricing initiatives, sourcing initiatives, shrinkage and other of 3.7%;
- an increase in fixed costs, such as occupancy costs and depreciation, which has a deleveraging effect of gross profit as a percentage of revenue, which contributed to a decrease in gross margin of 2.8%; and
- unfavorable foreign exchange differences of 2.7%.

This was offset by expenses related to our production, design, merchandising and distribution departments which had a leveraging effect on gross profit as a percentage of revenue, and contributed to an increase in gross margin of 1.3%.

Our cost of goods sold in the first twenty-six weeks of fiscal 2009 and the first twenty-six weeks of fiscal 2008 included \$0.4 million and \$0.6 million, respectively, of stock-based compensation expense.

Selling, General and Administrative Expenses

Selling, general and administrative expenses decreased \$2.0 million, or 3.5%, to \$56.0 million for the first twenty-six weeks of fiscal 2009 from \$58.0 million for the first twenty-six weeks of fiscal 2008. As a percentage of net revenue, selling, general and administrative expenses decreased 4.5%, to 31.2% from 35.7%. The \$2.0 million decrease in selling, general and administrative expenses was principally comprised of:

- a decrease in employee compensation, including options expense, of \$3.2 million related to a reduction in employee head count in our corporate-owned store locations and store support center, as part of our efforts to reduce operating expenses, as well as a one-time charge in the first quarter of fiscal 2008 related to the acceleration of performance-based awards;
- a decrease in travel and meals and entertainment expense of \$1.1 million related to a reduction in discretionary spending as part of our efforts to reduce operating expenses and improve our income from operations; and
- an increase in foreign exchange gains of \$0.6 million related to favorable fluctuations in the Canadian-United States dollar exchange rates.

These amounts were partially offset by:

- an increase of \$1.6 million primarily related to employment related legal matters;
- an increase in administrative costs associated with the launch in the first fiscal quarter of 2009 of our new e-commerce channel of \$0.9 million; and
- an increase in depreciation costs of \$0.4 million related to the retirement of legacy IT systems.

Our selling, general and administrative expenses in the first twenty-six weeks of fiscal 2009 and the first twenty-six weeks of fiscal 2008 included \$2.4 million and \$3.0 million, respectively, of stock-based compensation expense.

Income from Operations

Income from operations decreased \$3.3 million, or 12%, to \$24.2 million for the first twenty-six weeks of fiscal 2009 from \$27.5 million for the first twenty-six weeks of fiscal 2008. The decrease of \$3.3 million in income from operations for the first twenty-six weeks of fiscal 2009 was primarily due to a \$5.3 million decrease in gross profit resulting from decreased comparable store sales offset by additional sales from corporate-owned stores opened, partially offset by a decrease of \$2.0 million in selling, general and administrative expenses.

On a segment basis, we determine income from operations without taking into account our general corporate expenses such as corporate employee costs, travel expenses and corporate rent. For purposes of our management's analysis of our financial results, we have allocated some general product expenses to our corporate-owned stores segment. For example, all expenses related to our production, design and distribution departments have been allocated to this segment.

Income from operations (before general corporate expenses) from:

- our corporate-owned stores segment decreased \$5.3 million, or 12%, to \$41.6 million for the first twenty-six weeks of fiscal 2009 from \$46.8 million for the first twenty-six weeks of fiscal 2008, primarily due to an increase in corporate-owned stores costs of sales of \$11.5 million and \$4.3 million in store operating expenses such as occupancy and depreciation, offset by an increase of \$10.3 million in net revenues;
- our franchises segment decreased \$2.3 million, or 53%, to \$2.1 million for the first twenty-six weeks of fiscal 2009 from \$4.4 million for the first twenty-six weeks of fiscal 2008 primarily as a result of franchises net revenue included in the comparative period shifting to corporate-owned stores income from operations when we reacquired two franchised stores in Victoria, British Columbia and one franchised store in Bellevue, Washington; and

- our other segment increased \$5.7 million, or 438%, to \$7.0 million for the first twenty-six weeks of fiscal 2009 from \$1.3 million for the first twenty-six weeks of fiscal 2008, primarily due to the introduction of online sales through our e-commerce channel as well as increased outlet, warehouse and wholesale activity.

Other income, net decreased \$0.4 million to \$0.1 million for the first twenty-six weeks of fiscal 2009 from \$0.5 million for the first twenty-six weeks of fiscal 2008. The decrease was primarily due to lower interest rates offered on cash balances.

Provision for Income Taxes

Income tax expense for the twenty-six weeks ended August 2, 2009 was \$8.6 million compared to \$7.2 million for the corresponding period in fiscal 2008. The Company's financial statement effective tax rate for the twenty-six weeks ended August 2, 2009 was 35%. The effective tax rate will vary from the statutory rate because (i) stock-based compensation expense recorded is a permanent difference in certain jurisdictions, (ii) the realization of the benefits of the tax assets recorded prior to the second quarter of fiscal 2008, and (iii) the realization of the benefits of the tax assets related primarily to historical tax differences between financial and tax bases of assets and liabilities prior to February 1, 2009.

During the second quarter of fiscal 2008, after considering a number of factors, including a history of cumulative earnings, utilization of previously generated NOL carryforwards and estimated taxable income in future years, we determined we would more likely than not realize substantial future tax benefits from our deferred income tax assets generated in the United States prior to February 1, 2009. As a result of this analysis the Company recorded deferred tax assets of (i) \$1.4 million related primarily to historical tax differences between financial and tax bases of assets and liabilities, (ii) \$0.9 million cumulative tax benefit recorded from stock-based compensation expense prior to the second quarter of fiscal 2008, and (iii) \$2.7 million excess tax benefit from the exercise of stock options during and prior to the second quarter of fiscal 2008.

During the second quarter of fiscal 2009, an adjustment was made to deferred tax assets and additional paid-in capital in the amount of \$12.0 million relating to windfall taxes recorded in the year ended February 1, 2009 in excess of US taxes payable. A similar entry for \$0.2 million was recorded in the same period related to windfall taxes recorded in the first quarter of fiscal 2009. The Company has concluded that the adjustment was not material to the financial statements.

Net Income from Continuing Operations

Net income from continuing operations decreased \$5.0 million to \$15.8 million for the first twenty-six weeks of fiscal 2009 from \$20.8 million for the first twenty-six weeks of fiscal 2008. The decrease in net income of \$5.0 million for the first twenty-six weeks of fiscal 2009 was a result of a decrease in gross profit of \$5.3 million resulting from decreased comparable store sales offset by additional sales from corporate-owned stores opened, an increase in provision for income taxes of \$1.4 million and a decrease in other income, net of \$0.4, partially offset by a decrease of \$2.0 million in selling, general and administrative expenses.

Discontinued Operations

During the twenty-six weeks ended August 2, 2009, revenues, expenses and loss from discontinued operations were \$nil. The loss from discontinued operations was \$1.2 million for the twenty-six weeks ended August 3, 2008, resulting in a reduction of basic and diluted earnings per share of \$0.02. The shut down costs related to the closure of the stores in Japan were fully accrued in the second quarter of fiscal 2008.

Seasonality

Historically, we have recognized a significant portion of our income from operations in the fourth fiscal quarter of each year as a result of increased sales during the holiday selling season. Despite the fact that we have experienced a significant amount of our net revenue and gross profit in the fourth quarter of each fiscal year, we believe that the true extent of the seasonality or cyclical nature of our business may have been overshadowed by our rapid growth to date.

Liquidity and Capital Resources

Our cash requirements are principally for working capital and capital expenditures, including the build out cost of new stores, renovations of existing stores, and improvements to our distribution facility and corporate infrastructure. Our need for working capital is seasonal, with the greatest requirements from August through the end of November each year as a result of our inventory build-up and concentration of new store openings during this period for our holiday selling season. Historically, our main sources of liquidity have been cash flow from operating activities and borrowings under our existing and previous revolving credit facilities, and our initial public offering that closed on August 2, 2007.

At August 2, 2009, our working capital (excluding cash and cash equivalents) was \$23.7 million and our cash and cash equivalents were \$83.8 million.

The following presents the major components of net cash flows provided by and used in operating, investing and financing activities for the periods indicated:

Operating Activities

Operating Activities consist primarily of net income adjusted for certain non-cash items, including depreciation and amortization, deferred income taxes, realized gains and losses on property and equipment, stock-based compensation expense and the effect of the changes in non-cash working capital items, principally accounts receivable, inventories, accounts payable and accrued expenses.

Cash provided by operating activities increased \$18.0 million, to \$29.1 million for the twenty-six weeks ended August 2, 2009 compared to cash used by operating activities of \$11.1 million for the twenty-six weeks ended August 3, 2008. The \$18.0 million increase was primarily a result of a decrease in inventories and an increase in items not affecting cash and was offset by a decrease in miscellaneous accruals. The net decrease in the change in inventories is a result of selling our on-hand spring inventories we had built up at the end of fiscal 2008 for a larger store base. The net increase in items not affecting cash is primarily a result of increased depreciation and amortization for a larger store base and increased deferred income tax liabilities. The net change in miscellaneous accruals are a result of changes in the timing of receipts and payments of invoices from and to third parties.

Investing Activities

Investing Activities relate entirely to capital expenditures and advances to and investments in franchise.

Cash used in investing activities decreased \$15.8 million to \$6.3 million for the twenty-six weeks ended August 2, 2009 from \$22.1 million for the twenty-six weeks ended August 3, 2008. The \$15.8 million decrease was a result of reduced corporate-owned store openings. In the first twenty-six weeks of fiscal 2009 two new corporate-owned stores were opened compared to nine new corporate-owned stores opened in the first twenty-six weeks of fiscal 2008.

Financing Activities

Financing Activities consist primarily of cash received on the exercise of stock options and excess tax benefits from stock-based competition. Cash provided by financing activities decreased to \$2.7 million for the twenty-six weeks ended August 2, 2009 from \$0.3 million of cash used in financing activities for the twenty-six weeks ended August 3, 2008.

We believe that our cash from operations and borrowings available to us under our revolving credit facility will be adequate to meet our liquidity needs and capital expenditure requirements for at least the next 24 months. Our cash from operations may be negatively impacted by a decrease in demand for our products as well as the other factors described in "Risk Factors" of our Annual Report on Form 10-K for fiscal 2008 filed on March 27, 2009. In addition, we may make discretionary capital improvements with respect to our stores, distribution facility, headquarters, or other systems, which we would expect to fund through the issuance of debt or equity securities or other external financing sources to the extent we were unable to fund such capital expenditures out of our cash from operations.

Revolving Credit Facility

In April 2007, we executed a credit facility with the Royal Bank of Canada that provided for a CDN\$20,000,000 uncommitted demand revolving credit facility to fund our working capital requirements. This agreement cancelled our previous CDN\$8,000,000 credit facility. Borrowings under this uncommitted credit facility are made on a when-and-as-needed basis at our discretion.

Borrowings under the credit facility can be made either as i) *Revolving Loans* — Revolving loan borrowings will bear interest at a rate equal to the Bank's CA\$ or US\$ annual base rate (defined as zero% plus the lender's annual prime rate) per annum, ii) *Offshore Loans* — Offshore rate loan borrowings will bear interest at a rate equal to a base rate based upon LIBOR for the applicable interest period, plus 1.125% per annum, iii) *Bankers Acceptances* — Bankers acceptance borrowings will bear interest at the bankers acceptance rate plus 1.125% per annum, or iv) *Letters of Credit and Letters of Guarantee* — Borrowings drawn down under letters of credit or guarantee issued by the banks will bear a 1.125% per annum fee.

At August 2, 2009, aside from letters of credit and guarantees, there were no borrowings outstanding under this credit facility.

Off-Balance Sheet Arrangements

We enter into documentary letters of credit to facilitate the international purchase of merchandise. We also enter into standby letters of credit to secure certain of our obligations, including insurance programs and duties related to import purchases. As of August 2, 2009, letters of credit and letters of guarantee totaling \$3.4 million have been issued.

Other than these standby letters of credit and guarantee, we do not have any off-balance sheet arrangements, investments in special purpose entities or undisclosed borrowings or debt. In addition, we have not entered into any derivative contracts or synthetic leases.

Critical Accounting Policies

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions. Predicting future events is inherently an imprecise activity and, as such, requires the use of judgment. Actual results may vary from estimates in amounts that may be material to the financial statements. An accounting policy is deemed to be critical if it requires an accounting estimate to be made based on assumptions about matters that are highly uncertain at the time the estimate is made, and if different estimates that reasonably could have been used, or changes in the accounting estimates that are reasonably likely to occur periodically, could materially impact our consolidated financial statements. Our critical accounting policies and estimates are discussed in our Annual Report on Form 10-K for our 2008 fiscal year end filed with the SEC on March 27, 2009 and in Note 2 included in Item 1 of Part 1 of this Quarterly Report on Form 10-Q. We believe that there have been no other significant changes during the twenty-six weeks ended August 2, 2009 to our critical accounting policies.

Operating Locations

Our operating locations by country, state and province as of August 2, 2009 are summarized in the table below.

| | <u>Corporate-Owned Stores</u> | <u>Franchise Stores</u> | <u>Total Stores</u> |
|--|-----------------------------------|-----------------------------|-------------------------|
| Canada | | | |
| Alberta | 8 | — | 8 |
| British Columbia | 11 | — | 11 |
| Manitoba | 1 | — | 1 |
| Nova Scotia | 1 | — | 1 |
| Ontario | 17 | — | 17 |
| Québec | 4 | — | 4 |
| Saskatchewan | — | 1 | 1 |
| Total Canada | <u>42</u> | <u>1</u> | <u>43</u> |
| United States | | | |
| California | 19 | 1 | 20 |
| Colorado | — | 3 | 3 |
| Connecticut | 2 | — | 2 |
| District of Columbia | 2 | — | 2 |
| Florida | 2 | — | 2 |
| Hawaii | 1 | — | 1 |
| Illinois | 6 | — | 6 |
| Maryland | 2 | — | 2 |
| Massachusetts | 4 | — | 4 |
| Michigan | 1 | — | 1 |
| Nevada | 1 | — | 1 |
| New Jersey | 2 | — | 2 |
| New York | 7 | — | 7 |
| Oregon | 1 | — | 1 |
| Pennsylvania | 1 | — | 1 |
| Texas | 6 | — | 6 |
| Virginia | 2 | — | 2 |
| Washington | 3 | — | 3 |
| Total United States | <u>62</u> | <u>4</u> | <u>66</u> |
| International | | | |
| Australia | — | 6 | 6 |
| Total International | <u>—</u> | <u>6</u> | <u>6</u> |
| Overall total, as of August 2, 2009 | <u>104</u> | <u>11</u> | <u>115</u> |
| Overall total, as of February 1, 2009 | <u>103</u> | <u>10</u> | <u>113</u> |

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Market risk represents the risk of loss that may impact our financial position due to adverse changes in financial market prices and rates. Our market risk exposure is primarily a result of fluctuations in interest rates and foreign currency exchange rates. We do not hold or issue financial instruments for trading purposes.

Foreign Currency Exchange Risk. We currently generate a majority of our net revenue in Canada. The reporting currency for our consolidated financial statements is the United States dollar. Historically, our operations were based largely in Canada. As of August 2, 2009, we operated 42 stores in Canada. As a result, we have been impacted by changes in exchange rates and may be impacted materially for the foreseeable future. For example, because we recognize net revenue from sales in Canada in Canadian dollars, if the United States dollar strengthens it would have a negative impact on our Canadian operating results upon translation of those results into United States dollars for the purposes of consolidation. Any hypothetical loss in net revenue could be partially or completely offset by lower cost of sales and lower selling, general and administrative expenses that are generated in Canadian dollars. A 10% appreciation in the relative value of the United States dollar compared to the Canadian dollar would have resulted in lost income from operations of approximately \$5.0 million for the first two quarters of fiscal 2009. To the extent the ratio between our net revenue generated in Canadian dollars increases as compared to our expenses generated in Canadian dollars, we expect that our results of operations will be further impacted by changes in exchange rates. We do not currently hedge foreign currency fluctuations. However, in the future, in an effort to mitigate losses associated with these risks, we may at times enter into derivative financial instruments, although we have not historically done so. These may take the form of forward sales contracts and option contracts. We do not, and do not intend to, engage in the practice of trading derivative securities for profit.

Interest Rate Risk. In April 2007, we entered into an uncommitted senior secured demand revolving credit facility with Royal Bank of Canada which replaced our prior credit facility. Because our revolving credit facility bears interest at a variable rate, we will be exposed to market risks relating to changes in interest rates, if we have a meaningful outstanding balance. At August 2, 2009, we had no outstanding borrowings under our revolving facility. We do not believe we currently are significantly exposed to changes in interest rate risk. We currently do not engage in any interest rate hedging activity and currently have no intention to do so in the foreseeable future. However, in the future, if we have a meaningful outstanding balance, in an effort to mitigate losses associated with these risks, we may at times enter into derivative financial instruments, although we have not historically done so. These may take the form of forward sales contracts, option contracts, and interest rate swaps. We do not, and do not intend to, engage in the practice of trading derivative securities for profit.

ITEM 4. CONTROLS AND PROCEDURES

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed by us in the reports we file or submit under the Securities Exchange Act of 1934, or the Exchange Act, is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer (principal executive officer) and Chief Financial Officer (principal financial officer), to allow timely decisions to be made regarding required disclosure. We have established a Disclosure Committee, consisting of certain members of management, to assist in this evaluation. The Disclosure Committee meets on a regular quarterly basis, and as needed.

Our management, including our Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) promulgated under the Exchange Act), at August 2, 2009. Based on that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that, at August 2, 2009, our disclosure controls and procedures were effective.

There was no change in internal control over financial reporting during the twenty-six weeks ended August 2, 2009 that has materially affected or is reasonably likely to materially affect our internal control over financial reporting.

PART II
OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

The Company is, from time to time, involved in routine legal matters incidental to its business. Management believes that the ultimate resolution of any such current proceedings will not have a material adverse effect on the Company's continued financial position, results of operations or cash flows. Refer to Note 5 included in Item 1 of Part 1 of this Quarterly Report on Form 10-Q for information regarding specific legal proceedings.

ITEM 1A. RISK FACTORS

In addition to other information set forth in this report, you should carefully consider the "Risk Factors" discussed in our Annual Report on Form 10-K for our 2008 fiscal year filed on March 27, 2009. There have been no material changes to the "Risk Factors" previously disclosed in our Annual Report on Form 10-K.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

(c) The following table provides information regarding the Company's purchases of its common stock during the thirteen week period ended August 2, 2009:

| <u>Period(1)</u> | <u>Total Number of Shares Purchased</u> | <u>Average Price Paid per Share</u> | <u>Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs(2)</u> | <u>Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs(2)</u> |
|-------------------------------|---|-------------------------------------|--|--|
| May 4, 2009 — May 31, 2009 | 5,526 | \$ 13.59 | 5,526 | 2,905,057 |
| June 1, 2009 — July 5, 2009 | 4,940 | 14.82 | 4,940 | 2,900,117 |
| July 6, 2009 — August 2, 2009 | 4,867 | 15.20 | 4,867 | 2,895,250 |
| Total | <u>15,333</u> | | <u>15,333</u> | |

(1) Monthly information is presented by reference to our fiscal months during our second quarter of fiscal 2009.

(2) Our Employee Share Purchase Plan (ESPP) was approved by our Board of Directors and stockholders in September 2007. All shares purchased under the ESPP are purchased on the Toronto Stock Exchange or the Nasdaq Global Select Market (or such other stock exchange as we may designate from time to time). Unless our Board of Directors terminates the ESPP earlier, the ESPP will continue until all shares authorized for purchase under the ESPP have been purchased. The maximum number of shares available for issuance under the ESPP is 3,000,000.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

At the Company's Annual Meeting of Stockholders held on June 10, 2009 the stockholders of the Company elected Christine M. Day, Martha A.M. Morfitt and Rhoda M. Pitcher to our Board of Directors as Class II Directors. The following table sets forth the voting results for each Director:

| <u>Directors</u> | <u>Votes For</u> | <u>Votes Against</u> | <u>Votes Withheld/Abstained</u> | <u>Broker Non-votes</u> |
|---------------------|------------------|----------------------|---------------------------------|-------------------------|
| Christine M. Day | 59,376,356 | nil | 95,124 | nil |
| Martha A.M. Morfitt | 59,370,296 | nil | 101,184 | nil |
| Rhoda M. Pitcher | 59,372,936 | nil | 98,544 | nil |

After the meeting, our Board of Directors consisted of Michael Casey, RoAnn Costin, R. Brad Martin, Christine M. Day, Martha A.M. Morfitt, Rhoda M. Pitcher, David M. Mussafer, Thomas G. Stemberg and Dennis J. Wilson. Steven J. Collins' term as a director ended immediately prior to the Annual Meeting of Stockholders on June 10, 2009.

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The stockholders of the Company also ratified the appointment of PricewaterhouseCoopers LLP as the Company's independent auditors for the fiscal year ending January 31, 2010 at the Annual Meeting of Stockholders held on June 10, 2009. The following table sets forth the voting results for the ratification:

| <u>Votes For</u> | <u>Votes Against</u> | <u>Votes Withheld/Abstained</u> | <u>Broker Non-votes</u> |
|------------------|--------------------------|-------------------------------------|-----------------------------|
| 59,430,450 | 34,018 | 7,012 | nil |

ITEM 6. EXHIBITS

| <u>Exhibit No.</u> | <u>Exhibit Title</u> | <u>Filed Herewith</u> | <u>Incorporated by Reference</u> | | |
|--------------------|--|-----------------------|----------------------------------|--------------------|-----------------|
| | | | <u>Form</u> | <u>Exhibit No.</u> | <u>File No.</u> |
| 31.1 | Certification of Chief Executive Officer Pursuant to Exchange Act Rule 13a-14(a) | X | | | |
| 31.2 | Certification of Chief Financial Officer Pursuant to Exchange Act Rule 13a-14(a) | X | | | |
| 32.1 | Certification of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350 as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 | X | | | |

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

lululemon athletica inc.

By: /s/ JOHN E. CURRIE

John E. Currie
Chief Financial Officer
(Principal Financial Officer and
Principal Accounting Officer)

Dated: September 10, 2009

Exhibit Index

| <u>Exhibit No.</u> | <u>Exhibit Title</u> | <u>Filed Herewith</u> | <u>Form</u> | <u>Incorporated by Reference</u> | | |
|--------------------|--|-----------------------|-------------|----------------------------------|-----------------|--------------------|
| | | | | <u>Exhibit No.</u> | <u>File No.</u> | <u>Filing Date</u> |
| 31.1 | Certification of Chief Executive Officer Pursuant to Exchange Act Rule 13a-14(a) | X | | | | |
| 31.2 | Certification of Chief Financial Officer Pursuant to Exchange Act Rule 13a-14(a) | X | | | | |
| 32.1 | Certification of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350 as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 | X | | | | |

I, Christine M. Day, certify that:

1. I have reviewed this quarterly report on Form 10-Q of lululemon athletica inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f))) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

By: /s/ CHRISTINE M. DAY

Christine M. Day
Chief Executive Officer and Director
(Principal Executive Officer)

Date: September 10, 2009

I, John E. Currie, certify that:

1. I have reviewed this quarterly report on Form 10-Q of lululemon athletica inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

By: /s/ JOHN E. CURRIE

John E. Currie
 Chief Financial Officer
 (Principal Financial Officer and
 Principal Accounting Officer)

Date: September 10, 2009

**CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO SECTION 906 OF
THE SARBANES-OXLEY ACT OF 2002**

In connection with the Quarterly Report of lululemon athletica inc (the "Company") on Form 10-Q for the thirteen weeks ended August 2, 2009, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), each of the undersigned officers of the Company certifies, pursuant to 18 U.S.C. § 1350, as adopted pursuant to § 906 of the Sarbanes-Oxley Act of 2002, that, to such officer's knowledge:

- (1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

By: /s/ CHRISTINE M. DAY

Christine M. Day
Chief Executive Officer and Director
(Principal Executive Officer)

Date: September 10, 2009

By: /s/ JOHN E. CURRIE

John E. Currie
Chief Financial Officer
(Principal Financial Officer)

The foregoing certification is being furnished solely pursuant to 18 U.S.C. § 1350 and is not being filed as part of the Report or as a separate disclosure document.