

2014

Case Studies in Sustainability Management - The Oikos Collection Vol. 3

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Recommended Citation

Gabriel, Jordi Vives; Bass, A. Erin; and Morris, R. J., "Case Studies in Sustainability Management - The Oikos Collection Vol. 3" (2014).
Faculty Books and Monographs. Book 281.

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Lululemon's commitment to the environment

A tangle of seaweed, suppliers, and social
responsibility

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Bass, A.E. & Morris, R.J. 2014. Lululemon's commitment to the environment: A tangle of seaweed, suppliers & social responsibility. In J. Vives Gabriel (Ed.), *Case studies in sustainability management - The oikos collection (vol. 3)*. Sheffield: Greenleaf Publishing.

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A. Erin Bass and Rebecca J. Morris

It was the morning of Wednesday, November 14, 2007. The article on the front page of the *New York Times* Business Section read “‘Seaweed’ clothing has none, tests show.’ The story asserted that one of Lululemon’s product lines, Vitasea®, which purported to contain a seaweed fiber designed to release marine amino acids, minerals, and vitamins into the skin upon contact with moisture, contained no such element. Both Chip Wilson, Chairman and Founder of athletic wear retailer Lululemon, and Robert Meers, Lululemon’s CEO, were about to embark on their first damage-control mission since the company’s Initial Public Offering in July. This was the most widespread negative press Lululemon had received since going public, and the aftermath of the article would question Lululemon’s product integrity, marketing and strategy, suppliers, and ethics. Lululemon’s next move would be crucial to both its survival and reputation.

Lululemon's background

Lululemon Athletica Inc. (Lululemon), a yoga-inspired athletic apparel and accessories manufacturer and retailer, was founded in 1998 in Vancouver, Canada. In 2007, the company owned or franchised 81 stores internationally. See Exhibit 1 for store locations. Lululemon’s mission was – to create components for people to live longer, healthier, and more fun lives, based on core values of quality, product, integrity, balance, entrepreneurship, greatness, and fun.

Lululemon produced high-quality, innovative products meant to inspire physical activity in yogis and athletes. The company created a manifesto to capture the essence of the Lululemon culture and inspire customers to consider changes to improve their own lifestyle. Ideas like ‘a daily hit of athletic-induced endorphins gives you the power to make better decisions, helps you be at peace with yourself, and offsets stress’; ‘that which matters the most should never give way to that which matters the least’; and ‘successful people replace the words “wish”, “should” and “try” with “I will”’ were part of the manifesto and part of the Lululemon brand religion. The company targeted ‘super Girls’; the daughters of the 1980s ‘Power Women’. These educated, hard-working women lived healthy lifestyles by working out, eating

right, and taking care of themselves. Lululemon opened lines of men's clothing and accessories, but still remained highly dedicated to its core market of 'super Girls'.

Lululemon's founder, Dennis 'Chip' Wilson, graduated with a Bachelor of Arts in Economics from the University of Calgary in 1980. He founded the surf/skate/snowboard company Westbeach Sports in the early 1990s, and sold it in 1997. At the age of 41, Chip started taking yoga classes and a year later, in 1998, he opened Lululemon's first store in Vancouver's trendy, upscale neighborhood, Kitsilano Beach. Wilson described his leadership style as 'run and let it be run', desiring a culture of autonomy and accountability among employees. Robert 'Bob' Meers joined Lululemon initially as a consultant in 2005 before accepting the role of CEO. The reorganization allowed Wilson to retain his positions as company Chairman and Chief Product Designer, while relinquishing his duties as CEO. Meers had a seasoned background in retail; serving as President of Reebok International and President and CEO of home décor designer, Syratech Corp.

Lululemon designed and produced technical athletic apparel for yoga, running, and dancing. The company initially became popular for its well-fitting black workout pants. In addition to workout pants, the company sold workout bras and tanks, shorts, capri pants, t-shirts, sweatshirts, jackets, and other pieces of apparel for men and women. The company also produced a line of accessories including water bottles, headgear, yoga mats and accessories, and yoga and gym bags. Lululemon took pride in using innovative materials to manufacture its products. The company's most well-known and often-used fabric was Luon®, a moisture wicking fabric that was used for most of its pants, shorts, tanks, and bras. A more innovative fabric the company used was Silverescent™, a fabric made with silver yarn, designed to eliminate bacteria and remove odor from the fabric. The average price for a pair of Lululemon pants was US\$99, bra was US\$48, tank was US\$5USD, and jacket was UD\$98. Lululemon's line of accessories ranged from water bottles sold for US\$25 to bags as expensive as US\$88.

2007 proved to be a financially stellar year for Lululemon. Total assets had more than doubled, from US\$48,492,745 at the beginning of 2007 to US\$97,906,418 by the end of the 2007 fiscal year. Net revenue had increased during the same time period by 45.8%, while net income posted a 75.1% increase. A financial analysis for the company can be viewed in Exhibit 2. The company continued an aggressive expansion strategy, focused on development of the Canadian and US markets. Lululemon went public on the Toronto Stock Exchange on July 26, 2007 and was first listed on the NASDAQ on September 4, 2007 at US\$36.87 per share. Stock information can be viewed in Exhibit 3.

Lululemon's plan for sustainability and corporate social responsibility

From its inception, Lululemon had extensive plans for incorporating sustainability into the overall strategy of the organization. Corporate social responsibility was at the heart of Lululemon. The company named its corporate social responsibility strategy 'Community Legacy', and Lululemon's business processes were centered on the five elements described in the Community Legacy initiative: community, people, sourcing and manufacturing, efficiency and waste reduction, and green building and spaces. Lululemon specifically focused on three elements of the Community Legacy initiative as it related to sustainability: sourcing and manufacturing, efficiency and waste reduction, and green building and spaces.

Sourcing and manufacturing was developed around a three-year strategy aimed at working with suppliers that not only shared Lululemon's vision and values, but that complied with Lululemon's Workplace Code of Conduct, developed internally by Lululemon executives. Lululemon was committed to only work with suppliers that were as

concerned about the environment and human health as Lululemon. The company set a high level of expectations; therefore suppliers that wanted to work with Lululemon had to meet specific requirements, and were continuously audited by Lululemon to identify areas of weakness and opportunity. Lululemon created a Social Responsibility Compliance ranking to assess suppliers and manufacturing partners, and evaluated each partner out of a possible score of 100. The scorecard was broken down into three sections: labor practices, environmental responsibility, and health and safety.

Efficiency and waste reduction was also at the core of Lululemon's Community Legacy initiative and overall strategy. The five-year vision for this plan included a high level of product and process innovation to reduce environmental pollutants in garment manufacturing and retailing. The company worked on implementing an internal environmental guide and clause in the Workplace Code of Conduct for compliance by both Lululemon and its suppliers. In addition to constant innovation of design, packaging and shipping processes were constantly scrutinized in order to find the best possible way to decrease the company's environmental impact. Lululemon also implemented measurement tactics and benchmarks as indicators of the company's environmental footprint, and to identify areas where improvements could be made. Finally, Lululemon set up networks between itself and environmental experts and NGOs to facilitate idea sharing about process and product improvements, and to foster ongoing conversations about corporate social responsibility and environmental impact.

Green Buildings and Spaces was the final component of Lululemon's Community Legacy initiative. The company had a five-year vision for LEED (Leadership in Energy and Environmental Design) designed buildings and spaces for new construction, and motivated existing departments and retail locations to aim for zero waste and emissions through the implementation of an internal building guide and the Building Code of Conduct; which encouraged paperless communication along with recycling and paper reduction programs, natural building and maintenance materials sourcing, and existing facility retrofitting for improved energy efficiency. Lululemon set a corporate goal of 95% zero waste efficiency in operations by 2010.

Lululemon declared 'social responsibility is our DNA' and felt responsible to all stakeholders: employees, customers, vendors, suppliers, stockholders, and the environment. Lululemon further supported its commitment to social responsibility on its website: 'It is who we are and what we do and we will continue to further our mission of creating components for people to live longer, healthier and more fun lives... both for our guests, our employees, and our manufacturing partners.'

Smartfiber AG, SeaCell®, and Vitasea®

Smartfiber AG was a small, privately held German company based in Rudolstadt, Germany, with fewer than 30 employees. In July 2007, Smartfiber AG took over SeaCell®, a competitor, to expand its research, production, and marketing potential. Smartfiber AG developed, produced, and distributed the SeaCell® Lyocell fabric used in Lululemon's Vitasea® products.

Based on the Lyocell system of combining SeaCell® with cellulose material, SeaCell® contained a skin protective and anti-inflammatory seaweed additive. Lyocell was the seaweed fiber that was part of the SeaCell® fabric. Smartfiber AG claimed that SeaCell® caused an active exchange between the seaweed fiber and the skin, which activated wellbeing in those exposed to the fiber. The partnership between Lululemon and Smartfiber AG commenced in 2006 and the Vitasea® product line was born; made with 23% SeaCell®Pure, Smartfiber AG's purest form of the product. Smartfiber AG complied with Lululemon's Workplace Code of Conduct and had potential to offer a new, exiting relationship between the two companies: one built on environmental awareness, innovation, and trust.

Smartfiber AG provided Lululemon with every piece of information it needed about the SeaCell® fabric. The German company gave Lululemon information on the composition of SeaCell®, and the benefits of producing the Vitasea® product line with the SeaCell® fabric. The clothing line, mainly shirts and some undergarments, was sold with a product claim created by Lululemon and Smartfiber AG certifying that Vitasea® products release amino acids, minerals and vitamins directly into the skin. Lululemon further marketed the product, with knowledge relayed by Smartfiber AG, indicating that the vitamins and minerals released from Vitasea® products' contact with skin would:

- keep skin firm and smooth
- prevent the skin from drying out
- enhance blood supply to skin
- activate cell metabolism
- promote skin cell regeneration
- contain anti-viral or anti-bacterial properties
- sooth skin rashes
- reduce stress
- detoxify the skin

Lululemon employed its grassroots marketing efforts to communicate the benefits of Vitasea® products to customers. Through company spokespersons, termed 'Lululemon Ambassadors', store employees termed 'Educators', and corporate marketing efforts, Vitasea®'s product benefits were made known to all Lululemon customers. Vitasea® products were priced at a premium compared to other Lululemon products. Vitasea® t-shirts were sold at an average US\$58, whereas other Lululemon t-shirts were priced at an average of US\$48 per shirt. Vitasea® products represented 3% of Lululemon's total product line, and accounted for approximately 1% of sales.

The investor's tip

In late 2007, *The New York Times*, one of the largest newspapers in the world, received a tip about one of the NASDAQ's star performers: Lululemon. An anonymous investor, poised to short-sell the stock, tipped the newspaper of Lululemon's false Vitasea® product claims, and even had verification of the company's dishonesty through independent product testing. The investor explained that Chemir, an analytical lab specializing in investigational analytical chemistry, tested the product and found no trace of seaweed in the product's composition. Louise Story, a hedge-fund manager assigned to business and finance articles for *The New York Times* was appointed to get to the bottom of both the investor's and Lululemon's product claims.

The New York Times testing

Story researched Lululemon, Chemir, and Vitasea®. Her conversation with Carolyn J. Otten, director for specialized services at Chemir Analytical Services, solidified the need to investigate the trendy, yoga-wear retailer. 'seaweeds have known vitamins and minerals, and we searched specifically for those vitamins, and we didn't see them,' stated Otten.

With Chemir's findings in its back corner, *The New York Times* ordered an independent test of Lululemon's Vitasea® fabric by the McCrone Group, a premier microscopy resource base in Westmont, IL. The newspaper arranged a lab test of a blue Lululemon Vitasea® racer-back tank top composed of 70% cotton, 6% spandex, and 24% seaweed fiber to be tested alongside a gray J. Crew t-shirt. The McCrone Group's findings were less decisive than those of Chemir; the laboratory could not rule out seaweed as part of the composition of the tank top, but also could not substantiate Lululemon's claims that seaweed was in fact part of the tank top's composition.

The New York Times publication

The New York Times published the article, "'Seaweed' clothing has none, tests show," on the front page of the newspaper's business section on Wednesday, November 14, 2007. Story's article saw immediate attention from investors, analysts, fashion enthusiasts, and businesses alike. Prior to this date, Lululemon had been the poster-child for social responsibility, community involvement, and hip, trendy clothing. The article's publishing caused speculation around Lululemon's integrity and reputation. Some critics felt that *The New York Times* acted unethically, publishing the article even though the tip came from an investor planning on shorting Lululemon's stock. Others questioned Lululemon's ethics and product quality.

NASDAQ: LULU, TSX: LLL

The New York Times article sent shockwaves through investor circles. Since Lululemon's initial public offering (IPO) on the NASDAQ, the stock had seemed unstoppable. The stock climbed from US\$36.87 to US\$58.00 in just seven weeks. Lululemon had also experienced similar increases in stock price on the Toronto Stock Exchange. The release of *The New York Times* article had a negative effect on Lululemon's stock. The stock price decreased 8% on November 14, 2007, and continued to decline for the next several weeks.

Lululemon's rebuttal

Before the article was published, Story spoke to Lululemon's founder, Chip Wilson, about the Vitasea® fabric. 'If you actually put it on and wear it, it is different from cotton,' Wilson stated. 'That's my only test of it.' Wilson was confident in the Vitasea® fabric, the supplier SmartFiber, and Lululemon's brand name. Wilson's and Lululemon's strategy was to ignore *The New York Times* article; however, a few short hours after publication, Lululemon executives and investors watched the stock tumble, an unseen occurrence since Lululemon's initial public offering a few months earlier. Shortly after, Wilson and Meers quickly arranged for Lululemon to conduct an impromptu Vitasea® product test of their own.

Lululemon's tests

Lululemon contacted its partner, SGS Group (SGS), an independent, Switzerland-based inspection, verification, testing, and certification company to conduct a special test on its Vitasea® products. An SGS lab in Hong Kong conducted the test on the night of November 14, 2007, and came to the same result this time as it had when the previous Vitasea® product testing was conducted in June 2007: the product contained Lyocell fibers consistent with Lululemon's product labels, based on special tests required to confirm the fiber's existence. Smartfiber AG also provided Lululemon with a statement supporting Lululemon's product labels and the contents of the Vitasea® fabric: 'SeaCell® is permanently incorporated in the spun fiber we provide to Lululemon and is of the highest quality. In addition, we conduct our own quality assurance procedures, including regular visits to production facilities, to ensure the manufacturer is producing products in strict compliance with our specifications as well as Lululemon's,' declared Gerhard Neudorfer, Sales and Marketing Director SeaCell® Fibers.

Lululemon announced on Thursday, November 15, 2007 at 9:00 pm ET via a press release that the content of the Vitasea® product line was consistent with independent laboratory tests. The press release outlined the results of SGS Groups' tests on Vitasea® conducted in December 2006, June 2007, and November 2007, and included statements from Lululemon supporting its Vitasea® clothing line and product claims. Meers further defended Lululemon's findings and brand: 'Product quality and authenticity are of the utmost importance to Lululemon. Integrity goes to the core of everything we do and is at the heart of our relationship with our guests. For this reason, we test our products for content using a leading testing facility. We absolutely stand behind our products, our processes and refute any claims in recent press reports to the contrary. Innovation and integrity are at the heart of Lululemon. We pride ourselves on innovative and technical design. We are committed to continually bringing new and cutting edge products to the marketplace.'

Lululemon's public relations tactic was received with mixed reviews. The press release earned the company headlines such as 'Lululemon says tests verify fabric's properties' and 'Lululemon CEO says new seaweed clothing tests should clear company's name,' but others were not as confident in Lululemon's claims. Investors, media, and industry critics concluded that Lululemon played with semantics in its press release, arguing that Lululemon, while contending that the clothing did contain a fiber derived from seaweed, remained quiet about the truth regarding the Vitasea® product claim: that the clothing releases amino acids, minerals, and vitamins directly into the skin.

Some Lululemon customers stood behind the brand's products. Toronto shopper Irene Nava stated 'I personally do not care – I just love the pants. I wear them all the time. I have ones for running, ones for yoga, ones for outside.' David Wilkinson echoed Nava's comments, 'I couldn't care less, because it is so comfortable.' Others felt that Lululemon had gone too far. Student Kristie Furlong, said 'I would probably still buy the regular [products], but [the Vitasea®] ones are more expensive, and I don't know that I would pay more anyway just for seaweed.'

The Lululemon brand name and reputation was now in question. The company had been known for its sustainability practices, respect to the environment, and innovative processes, but was now the center of an international controversy. Critics argued that the company should have just told the truth as it knew it, admitted that it made a mistake, and notified the public of corrective action, rather than creating a press release to defend its product.

Canada's government intervenes

After the article was published, the Competition Bureau of Canada, an independent Canadian law enforcement agency that investigated complaints and monitored businesses for fair practices, contacted Lululemon's corporate offices in

Vancouver. On Friday, November 16, 2007, the Competition Bureau of Canada released a statement that Lululemon had agreed to remove all therapeutic claims from its Vitasea® clothing line sold in all Canadian Lululemon stores. ‘The Bureau acted quickly to resolve this issue of significant consumer and marketplace interest,’ said Andrea Rosen, Deputy Commissioner of Competition. ‘Canadians are entitled to receive accurate information from businesses in order to make informed purchasing choices.’

The Bureau outlined that Lululemon had to eliminate the following product attribute claims from its Vitasea® clothing line:

- remove all tags and/or representations on tags that contain unsubstantiated therapeutic and/or performance claims of the Vitasea® technology from all stores across Canada;
- remove all references to the Vitasea® technology from its website and any in-store advertising;
- immediately inform all store managers and employees that they should not provide information on therapeutic benefits and performance claims of the Vitasea® technology to customers; and
- undertake a review of all promotional and marketing materials to ensure they comply with relevant legal requirements.

Lululemon’s removal of the Vitasea® label

With pressure from the Competition Bureau of Canada, a falling stock price, and potential backlash from consumers, Lululemon removed the label storewide. This included not only the Canadian stores over which the Competition Bureau of Canada had jurisdiction, but Lululemon stores in the US, Japan, and Australia. The company was forced to remove all of the current Vitasea® merchandise, re-educate the store employees and ambassadors about the change in the Vitasea® product claims, redesign a new label, and manufacture all new Vitasea® products with the new claimless label.

How would those few days in November 2007 affect Lululemon’s strategy going forward? For a company like Lululemon, fostered in creating a positive change in those that wear its clothing, the Vitasea® debacle was a huge setback. Did *The New York Times* act unethically by publishing the Vitasea® article? Did Lululemon perform due diligence in testing SmartFiber AG’s claims? With the myriad of suppliers Lululemon currently employed – how many of them were also providing the company with false information that had not been checked? Would Lululemon have to implement a random testing process to ensure the truth of its claims? Should Lululemon continue to carry the Vitasea® line?

Lululemon had a huge mess to clean up: many stakeholders wanted explanations about both Lululemon’s inadequate testing and Chip Wilson’s original comments to Louise Story of *The New York Times*. The holiday sales season was right around the corner – how would Lululemon repair its tarnished image? Lululemon’s grassroots marketing strategy focused on conveying a message of health, happiness, and environmental awareness through its clothing to customers needed to be re-vamped – but how?

Exhibit 1

Lululemon stores and locations

LULULEMON ATHLETICA INC.			
LULULEMON STORES AND LOCATIONS			
	Corporate-Owned Stores	Franchise Stores	Total Stores
Canada	37	3	40
United States	30	4	34
Total International	4	3	7
Overall total, as of January 31, 2007	41	10	51
Overall total, as of February 3, 2008	71	10	81

Exhibit 2

Financial analysis, Lululemon Athletica, Inc.

	2/3/2008	1/31/2007	Variance		COMMON SIZE	1/31/2007	1/31/2006	Variance		COMMON SIZE
	USD	USD	USD	%		USD	USD	USD	%	
INCOME STATEMENT										
Revenues	274,713,328	148,884,834	125,828,494	84.5%	100.0%	148,884,834	84,129,093	64,755,741	77.0%	100.0%
Cost of goods sold	128,411,175	72,903,112	55,508,063	76.1%	46.7%	72,903,112	41,176,981	31,726,131	77.0%	49.0%
Gross Profit	146,302,153	75,981,722	70,320,431	92.5%	53.3%	75,981,722	42,952,112	33,029,610	76.9%	51.0%
Selling, general & administrative expenses	96,177,348	52,539,998	43,637,350	83.1%	35.0%	52,539,998	26,416,262	26,123,736	98.9%	35.3%
Income (loss) from operations	50,124,805	16,213,414	33,911,391	209.2%	18.2%	16,213,414	3,726,708	12,486,706	335.1%	10.9%
Net income (loss)	30,842,439	7,666,331	23,176,108	302.3%	11.2%	7,666,331	1,394,104	6,272,227	449.9%	5.1%
	2/3/2008	1/31/2007	Variance		COMMON SIZE	1/31/2007	1/31/2006	Variance		COMMON SIZE
	USD	USD	USD	%		USD	USD	USD	%	
BALANCE SHEET										
Cash & Equivalents	53,339,326	16,028,534	37,310,792	232.8%	34.4%	16,028,534	-	-	-	22.2%
Receivables (ST)	4,431,556	2,290,665	2,140,891	93.5%	2.9%	2,290,665	-	-	-	3.2%
Inventories	39,092,208	26,628,113	12,464,095	46.8%	25.2%	26,628,113	-	-	-	36.8%
Current Assets	97,906,418	48,492,743	49,413,675	101.9%	63.1%	48,492,743	-	-	-	67.1%

Net Property Plant & Equip	44,038,565	18,175,944	25,862,621	142.3%	28.4%	18,175,944	-	-	-	25.1%
Total Assets	155,092,142	72,293,109	82,799,033	114.5%	100.0%	72,293,109	-	-	-	100.0%
Accounts Payable	5,199,604	4,935,037	264,567	5.4%	12.2%	4,935,037	-	-	-	14.4%
Current Liabilities	35,821,551	31,938,590	3,882,961	12.2%	83.8%	31,938,590	-	-	-	93.0%
Total Liabilities	42,739,309	34,346,612	8,392,697	24.4%	100.0%	34,346,612	-	-	-	100.0%
Common stock	466,847	442,908	23,939	5.4%	0.4%	442,908	-	-	-	1.2%
Total Equity	112,034,009	37,378,798	74,655,211	199.7%	100.0%	37,378,798	-	-	-	100.0%
RATIO ANALYSIS										
Profitability Ratios	2/3/2008	1/31/2007	Variance	%		1/31/2007	1/31/2006	Variance	%	
ROA % (Net)	26.91	-	-	-		-	-	-	-	
ROE % (Net)	40.95	41.02	-0.07	-0.2%		41.02	-	-	-	
ROI % (Operating)	66.55	-	-	-		-	-	-	-	
EBITDA Margin %	21.28	13.99	7.29	52.1%		13.99	7.36	6.63	90.1%	
Calculated Tax Rate %	40.16	53.68	-13.52	-25.2%		53.68	62.63	-8.95	-14.3%	
Revenue per Employee	101,556	-	-	-		-	-	-	-	
Liquidity Indicators	2/3/2008	1/31/2007	Variance	%		1/31/2007	1/31/2006	Variance	%	
Quick Ratio	1.61	0.57	1.04	182.5%		0.57	-	-	-	
Current Ratio	2.73	1.52	1.21	79.6%		1.52	-	-	-	
Net Current Assets % TA	40.03	22.9	17.13	74.8%		22.9	-	-	-	
Asset Management	2/3/2008	1/31/2007	Variance	%		1/31/2007	1/31/2006	Variance	%	
Total Asset Turnover	2.4	-	-	-		-	-	-	-	
Receivables Turnover	81.07	-	-	-		-	-	-	-	
Inventory Turnover	8.29	-	-	-		-	-	-	-	
Accounts Payable Turnover	53.77	-	-	-		-	-	-	-	
Accrued Expenses Turnover	18.19	-	-	-		-	-	-	-	

Property Plant & Equip Turnover	8.76	-	-	-	-	-	-	-
Cash & Equivalents Turnover	7.86	-	-	-	-	-	-	-
Per Share	2/3/2008	1/31/2007	Variance	%	1/31/2007	1/31/2006	Variance	%
Cash Flow per Share	0.57	0.39	0.18	46.2%	0.39	-	-	-
Book Value per Share	1.66	0.57	1.09	191.2%	0.57	-	-	-

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Exhibit 3

Market information and dividends

LULULEMON ATHLETICA INC.

MARKET INFORMATION AND DIVIDENDS

Period End: Feb 03, 2008

Our common stock is quoted on the Nasdaq Global Select Market under the symbol "LULU" and on the Toronto Stock Exchange under the symbol "LLL". Prior to July 27, 2007, there was no public market for our common stock. The following tables sets forth, for the periods indicated, the high and low sales prices of our common stock reported by the Nasdaq Global Select Market.

	Common Stock Price (Nasdaq Global Select Market)	
	High	Low
Fiscal Year Ending February 3, 2008		
Second Quarter (from July 27, 2007)	\$34.17	\$24.92
Third Quarter	\$60.70	\$28.70
Fourth Quarter	\$51.94	\$25.00

SOURCES

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