Ulta Cosmetics & Fragrance inc. | ULTA

EMPIRE BUILDING CREATES ILLUSION OF GROWTH: ULTA AT SATURATION POINT

RECOMMENDATION: STRONG SELL | PT :$88/SHARE

Disclaimer

This research report expresses our research opinions, which we have based upon certain facts, all of which are based upon publicly available information, and all of which are set out in this research report. Any investment involves substantial risks, including complete loss of capital. Any forecasts or estimates are for illustrative purpose only and should not be taken as limitations of the maximum possible loss or gain. Any information contained in this report may include forward looking statements, expectations, and projections. You should assume these types of statements, expectations, and projections may turn out to be incorrect for reasons beyond Prescience Point LLC's control. This is not investment advice nor should it be construed as such. Use of Prescience Point LLC's research is at your own risk. You should do your own research and due diligence before making any investment decision with respect to securities covered herein.

You should assume that as of the publication date of any report or letter, Prescience Point LLC (possibly along with or through our members, partners, affiliates, employees, and/or consultants) along with our clients and/or investors has a short position in all stocks (and/or are long puts/short call options of the stock) covered herein, including without limitation ULTA Salon, Cosmetics & Fragrance, Inc. ("ULTA"), and therefore stands to realize significant gains in the event that the price of its stock declines. Following publication of any report or letter, we intend to continue transacting in the securities covered therein, and we may be long, short, or neutral at any time hereafter regardless of our initial recommendation.

This is not an offer to sell or a solicitation of an offer to buy any security, nor shall any security be offered or sold to any person, in any jurisdiction in which such offer would be unlawful under the securities laws of such jurisdiction. Prescience Point LLC is not registered as an investment advisor.

To the best of our ability and belief, as of the date hereof, all information contained herein is accurate and reliable and does not omit to state material facts necessary to make the statements herein not misleading, and all information has been obtained from public sources we believe to be accurate and reliable, and who are not insiders or connected persons of the stock covered herein or who may otherwise owe any fiduciary duty or duty of confidentiality to the issuer, or to any other person or entity that was breached by the transmission of information to Prescience Point LLC. However, Prescience Point LLC recognizes that there may be non-public information in the possession of ULTA Salon, Cosmetics & Fragrance, Inc. or other insiders of ULTA Salon, Cosmetics & Fragrance, Inc. that has not been publicly disclosed by ULTA Salon, Cosmetics & Fragrance, Inc. Therefore, such information contained herein is presented "as is," without warranty of any kind – whether express or implied. Prescience Point LLC makes no other representations, express or implied, as to the accuracy, timeliness, or completeness of any such information or with regard to the results to be obtained from its use.

Table of Contents

I. Report Highlights
II. Conclusive Evidence ULTA at Saturation Point, Store Quality Plummeting
III. Store Cannibalization is Worsening
IV. ULTA Same-Store Sales at Inflection Point, Set to Plunge
V. Ecommerce and Small Format Stores Will Not Be Saviors
VI. ULTA Balance Sheet Flashing Warning Signs
VII. ULTA Management Compensation Incentivizes Over-Expansion/Empire Building
VIII. A Long Way Down from Growth to Value
IX. Appendix

Report Highlights

Introduction

Prescience Point has been following "growth story" retailer ULTA passively for a number of years now. It piqued our interest during the 2012 – 2013 timeframe, when a plethora of red flags surfaced potentially signaling slowing demand and/or market saturation:

- The trend in SSS began deteriorating in Q1'12 and declined rapidly into 2013
- In FY'13, ULTA changed its definition of SSS to include e-commerce sales (which benefits headline SSS)
- Inventory levels appeared unmanageable, growing in excess of guidance and of forward quarter sales growth; DSI was steadily moving higher
- Unusual string of executive-level turnover:
  - 2 CFO resignations in 2012: 1.) 3/8/12: Gregg Bodnar resigns after serving for 6 years; 2.) 10/18/12: Bruce Hartman, who was appointed CFO after an extensive search, resigns after serving for 6 weeks
  - 2/14/13: CEO Chuck Rubin resigns after serving for 2.5 years

It was particularly interesting that on 6/6/2012, ULTA inexplicably increased its store count guidance from 1000 stores to 1200 stores, a move having clear valuation implications. The move was concerning:

- Why would ULTA up its store count guidance as the business showed signs of deterioration?
- The increase seemed very premature –> ULTA was only 47% penetrated on its initial guidance for 1000 potential stores (467 stores at Q1'12)

It was also troubling that, by our estimate, insiders sold ~$60m worth of stock between 6/8/2012 and 10/5/2012, in the period following the announcement, and preceding further reported deterioration in 2013.

Despite the aforementioned red flags, ULTA's stock has doubled since the end of 2013 and currently trades at **~30x NTM P/E**. Paradoxically, the market cap/store has increased nearly 4x since 2010 and is currently close to all-time highs, even though the company will be **97% saturated by FYE'16** (based on the Company's initial guidance).

Introduction (cont'd)

We believe that ULTA's time as a "growth story" is over; the chain is **at saturation right now**. Similar to our prior work on multi-billion dollar companies Chicago Bridge & Iron and LKQ Corp., Prescience Point has uncovered an empire-building case fueling value-destructive growth at the expense of long-term shareholders. Moreover, we believe ULTA was aware of its saturation problems when it increased store potential to 1,200 in 2012 and accelerated store openings to mask weak underlying performance. This burst of new store openings has produced a transitory "demographic dividend" from newer stores ramping up their comparable store sales.

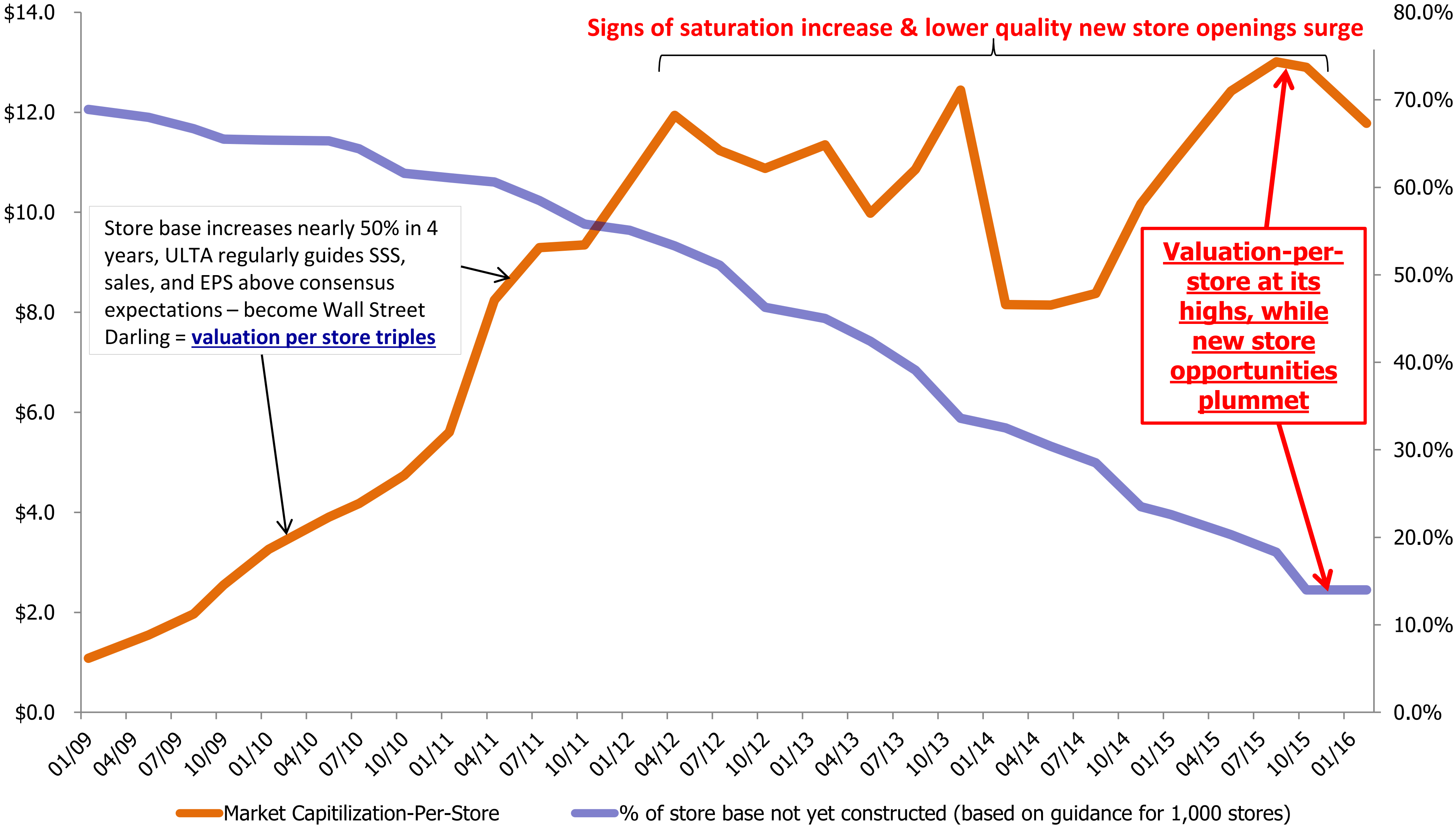
As a part of our investigation, we commissioned an independent research organization to quantitatively analyze ULTA's entire 860-store base including geographic analysis with census data overlay. The results are staggering; stores located within **five miles** of each other **tripled** from 2012 to 2015 (now more than **10% of stores**), stores were increasingly opened in areas where more than 50% of the population had incomes below ULTA's target customer, and store-level gross margins have been weakening. Prescience Point sees a saturated store base that is **undergoing cannibalization**. In addition, transitory items including the "demographic dividend" will soon be cut short, as these stores will never reach the current mature store economics. Lastly, reported same-store sales have been driven by traffic (transaction count) rather than average ticket (dollar value of average transaction). Consequently, we believe this trend suggests higher transaction volume is the results of increased new store openings and weaker average ticket is the result of opening in lower quality locations.

From a working capital standpoint, inventory has continued to increase at a faster rate than revenue growth – a trend we believe will pressure Company margins. Moreover, ULTA has an unusual accounting policy whereby it **capitalizes purchasing costs to inventory**. We believe capitalizing purchasing costs overstates margins as inventory levels build.

What would drive a management team to over-build? Incentivization: management is compensated solely on "adjusted EBT"; there are no considerations given to other metrics (i.e. ROIC). Accordingly, management has been collecting large paychecks for aggressively expanding the store base. However, the executives holds very little ULTA stock and are not heavily impacted by the quality of the stores opened.

We believe Wall Street wants investors to focus on sales growth, while hoping margin expansion follows suit. **Prescience Point believes that with this new data now made available publicly, ULTA will re-rate substantially down to its "true" low multiple competitive set. Based on our analysis: 1.) ULTA is about to hit a brick wall of revenue shortfalls due to saturation/cannibalization and slowing same-store sales, while at the same time face margin pressure from excess inventory; and, 2.) ULTA stock is worth ~$88, 45% below current trading levels.**

Valuation/Store Paradoxically Skyrockets as Store Quality Deteriorates & Growth Approaches Brick Wall



Source: ULTA filings with the SEC; Prescience Point analysis and estimates

Prescience Point Believes:

- ULTA Salon, Cosmetics & Fragrance, Inc. (“ULTA” or “the Company”):
  - Trades at NTM P/E of ~30x
  - Is **grossly overvalued** (huge divergence in stock price vs. underlying performance)
  - “Retail growth story” categorization creates **substantial downside risk**
  - Store base has **hit saturation point**
  - Store quality has **deteriorated dramatically**
  - New stores are **cannibalizing** existing stores
  - **Same-store sales (SSS) are at an inflection point (set to fall off cliff)**
  - Inventory growth & unusual inventory accounting policy **unsustainability** boosted margin
  - Unusual management compensation creates **incentives for empire building / value-destructive growth**

Price Target Range: $84 - $92 per share (42% – 47% Downside)

Source: Prescience Point analysis and estimates

Report Highlights

- Prescience Point analysis of ULTA's geography, census data, & financial reports demonstrate:
  - ULTA's cannot achieve its increased guidance target of 1,200 stores without severe deterioration in store-level economics
  - Store base is already saturated:
    - In less than 12 months, store base will be 97.4% saturated based on initial guidance
    - Store level economics set to roll-over dramatically
  - ULTA's new store openings are getting closer and closer to existing stores:
    - Despite ULTA's representations that customers are willing to travel, stores have been opened right next to each other
    - New stores' distance from existing stores has shrunk by more than 50% since 2010
    - Stores within 5 miles of each other increased 3x in the last 3 years (~10% of store base)
  - Increased store openings in zip codes with average household incomes below ULTA's own stated target of "over $60,000"

Report Highlights

- Prescience Point believes ULTA's "headline" SSS are at an inflection point, set to plunge:
  - SSS have been unsustainably boosted by (1) new store ramp and (2) inclusion of E-Commerce revenue
  - Trend will reverse in the near future as the store base is rapidly maturing
  - Declining store level gross margin and SSS "internals" indicate ongoing cannibalization

- E-Commerce and "small store" pilot program will not be saviors:
  - "Small store" pilot program is inconsistent with Company's differentiation strategy
  - Indicates ULTA is aware of the saturation problem
  - E-Commerce margins will be pressured by larger competitors
  - E-Commerce cannibalizes store traffic

- ULTA's Balance Sheet is flashing warnings signs:
  - Inventory has been growing faster than sales for almost 4 years
  - ULTA has a highly unusual inventory accounting policy: capitalization of purchasing costs
    - Not a policy for ~18 direct public competitors
    - Could be used for assigning period SG&A costs and boosting margins
    - Could be a factor in the observed rampant inventory growth
  - If elevated inventory levels are rationalized due to slower comp sales (which we fully expect), ULTA will be faced with both revenue and margin shortfalls

Report Highlights

- ULTA has an <u>unusual management compensation</u> structure:
  - ULTA removed ROIC metric for compensation targets (eliminated <u>ONLY</u> consideration of store level profitability and efficiency)
  - Management now compensated solely on adjusted earning before taxes
    - Compensation target <u>SOLELY</u> incentivizes absolute growth
    - ULTA has responded with an aggressive store roll-out (including many poor quality stores in recent periods) to achieve these compensation targets
  - Current management team has extremely low ownership interest
    - Long-term health of business is not a primary concern given lower ownership

- <u>ULTA's "growth story" valuation is unforgiving:</u>
  - Trades at NTM P/E of ~30x
  - Based on our analysis, ULTA stock is worth ~$88 per share, ~45% below current trading levels.

Background and Business

Business Description

- ULTA is a retailer of beauty products and salon services. It offers over 20,000 cosmetic products across a variety of price points and categories, including hair care, make-up, fragrances, and nail care. Stores are predominantly located in "off mall" locations, such as local "power centers", and stores are generally around 10,000 square feet.
- As of Q3 15, ULTA operated 860 stores in the US and an e-commerce website
  - Current growth plans are "~100" new stores per year (to 1,200 stores)
- ULTA reports revenue in three segments:
  - Retail stores – sell branded/private label prestige & mass beauty products (~90% of revenue)
  - Salon services – provide haircuts, hair coloring, facials, & waxing (~5.5% of revenue)
  - E-Commerce – sells retail store products via online website (~4.5% of revenue)
- ULTA breaks out same-sales stores into multiple components:
  - Retail sales vs. E-Commerce sales
  - Traffic (transaction count) vs. average ticket (dollar value of average transaction)
  - Stores enter the comp base 14 months after opening
- The Company was founded in 1990, and IPO'ed in 2007

Sources: ULTA most recent 10-Q and 10-K; Prescience Point estimates

PRESCIENCE POINT

Business Description

- ULTA generates majority of revenue from retail sales
- E-Commerce revenue has increased significantly over the last three years

ULTA Revenue by Segment (% of revenue)	FY 12	FY 13	FY 14
Retail Stores	92.7%	91.0%	90.0%
Salon Services	5.5%	5.5%	5.4%
E-Commerce	1.8%	3.6%	4.6%
Total	100.0%	100.0%	100.0%

- Top-five markets account for large amount of stores
  - California, Texas, Florida have the highest concentration

Sources: ULTA most recent 10-Q and 10-K; Prescience Point estimates

Background

CEO of 10 yrs resigns 8/2010; COO Chuck Rubin appointed CEO

Replacement CFO resigns in 6 weeks 9/2012-10/2012

Chuck Rubin resigns to join Michael Stores 2/2013

Acting internal CFO appointed to CFO 3/13 - present

Mary Dillon of US Cellular joins as CEO 6/2013-present

Insider Ownership	2010 Proxy	2011 Proxy	2012 Proxy	2013 Proxy	2014 Proxy	2015 Proxy
	36.30%	25.20%	20.90%	6.70%	6.60%	6.70%

	FYE Jan/Feb 2011	FYE Jan/Feb 2012	FYE Jan/Feb 2013	FYE Jan/Feb 2014	FYE Jan/Feb 2015	FYE Jan/Feb (Est) 2016
Store growth as % of Prior Year	12.4%	15.4%	22.5%	22.7%	14.7%	12.9%
SSS Growth YoY	11.9%	11.5%	9.3%	7.9%	9.9%	11.4% (9 mo)
Inventory growth YoY	6%	12%	48%	27%	27%	25% Q3 YoY

Ecomm inclusion in SSS starting in FY2013

Openings spike right after potential increased, leading to optically great SSS as newer stores conceal cannibalization

Inventory growth a persistent concern

Sources: ULTA filings and PR, Morningstar Professional; press reports, Prescience Point estimates

Key Statistics

Share price (as of Fri, Feb 12, 2016)	$158.49
52-week high	$188.48
52-week low	$120.38
Average target price	$192.44
Shares outstanding (mm)	63.7
Market cap (mm)	$10,096
Enterprise value (mm)	$9,736
LTM P/E	34.2x
NTM P/E	29.6x
Dividend yield	0.00%
LTM sales (mm)	$3,703
LTM EBITDA (mm)	$629
LTM EBIT (mm)	$474
LTM EPS	$4.65
Average daily volume	1.1 mm
Short interest/% of Float	2.2 mm/3.76%
Analyst ratings (Buy/Hold/Sell)	13/9/0
Next reporting date (Q4 2015)	March 10, 2016
Store count as of Q3 2015	860

Sources: Bloomberg as of Friday, Feb 12, 2016; , Morningstar Professional, ULTA most recent 10-Q

Conclusive Evidence ULTA at Saturation Point, Store Quality Plummeting

Prescience Point Conducts Comprehensive Investigation of ULTA Store Location Quality

- Prescience Point hired an independent research firm to analyze ULTA's store base

- The research firm obtained:
  - Stores by location and quarter opened since ULTA's founding in 1990
  - 2010 census data
  - Co-tenant store data

- The research firm analyzed:
  - Concentration of ULTA stores (i.e. the distance between stores)
  - Demographics of ULTA store locations (based on 2010 census data)
  - Concentration of ULTA stores relative to preferred cotenants
  - Data and analysis is available here: LINK

- Prescience Point has concluded based on this analysis that Wall Street is unaware of the level of store saturation, deterioration in new store location demographics, and the decline in stores opened without preferred co-tenants.

Saturation and Store Quality Thesis Outlined

- New store growth has been the primary revenue driver since ULTA's inception

- Store base near complete saturation based on ULTA's initial total addressable market

- Store openings in <u>new</u> markets will hit all-time low, according to ULTA guidance

- Quality of new store openings deteriorates rapidly
  - Stores opening closer and closer to each other (fewer white space opportunities)
  - Stores are being opened in less dense and lower income regions (i.e. poor quality)
  - Stores in certain locations are being built within a <u>few miles</u> of each other

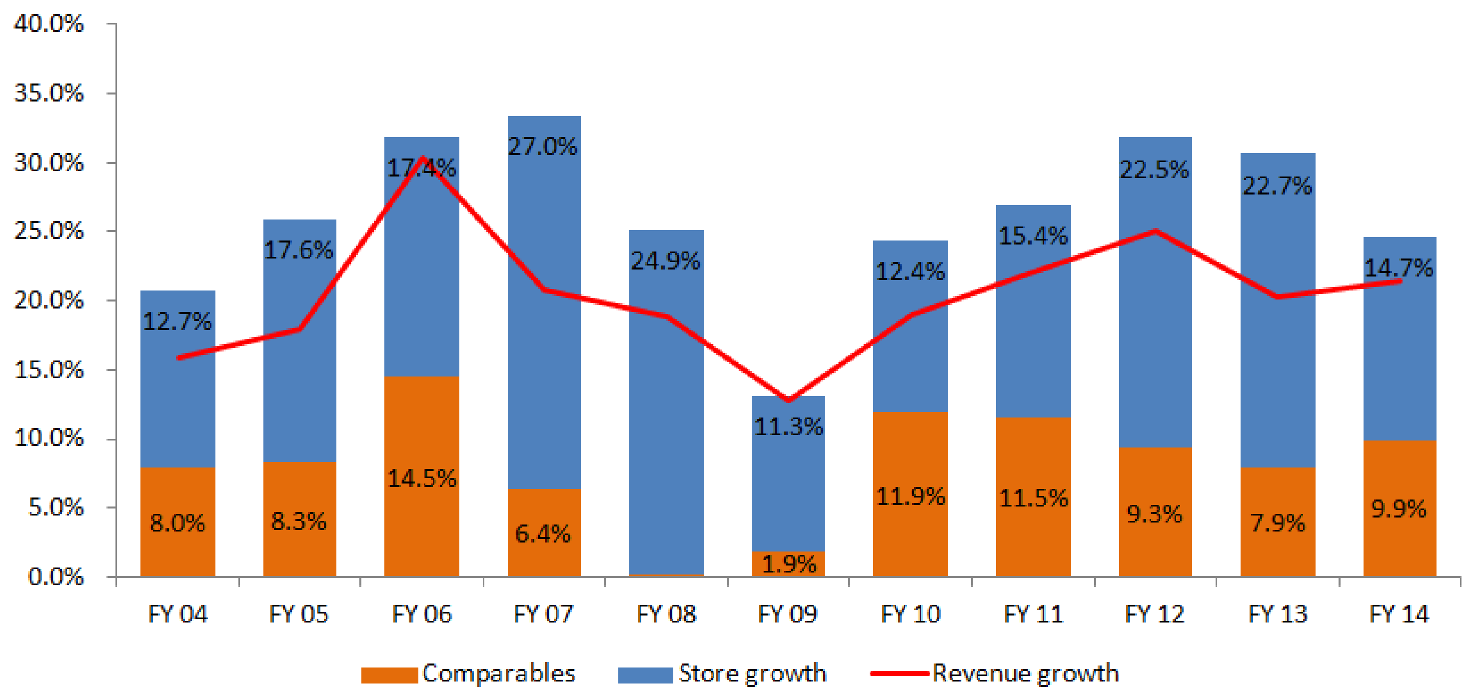
- Strategy shift to small format stores highlights saturation

- <u>**ULTA has been compelled to open stores in lower quality areas within a few miles of each other to maintain its "growth" status with Wall Street. We believe this growth strategy has reached an inflection point wherein unit level economics deteriorate, SSS slow dramatically, and overall revenue growth is pressured.**</u>

Revenue Dependent on Store Growth

- **Since inception, new store growth has been the primary driver of revenue growth**
  - Ability to continue to grow double-digits largely dependent on new store openings
  - Multiple signs suggest the market for ULTA stores is saturated (most notably, the Company's own guidance)

Historic Revenue Growth Contribution



Source: SEC Filings

Store Target Gives Illusion of Long Runway

- ULTA established its 1,000 store guidance target in its IPO prospectus in 2007
  - ULTA had a 17 year operating history (1990 – 2007) to determine the total addressable market
  - ULTA had over 200 stores ~30 states

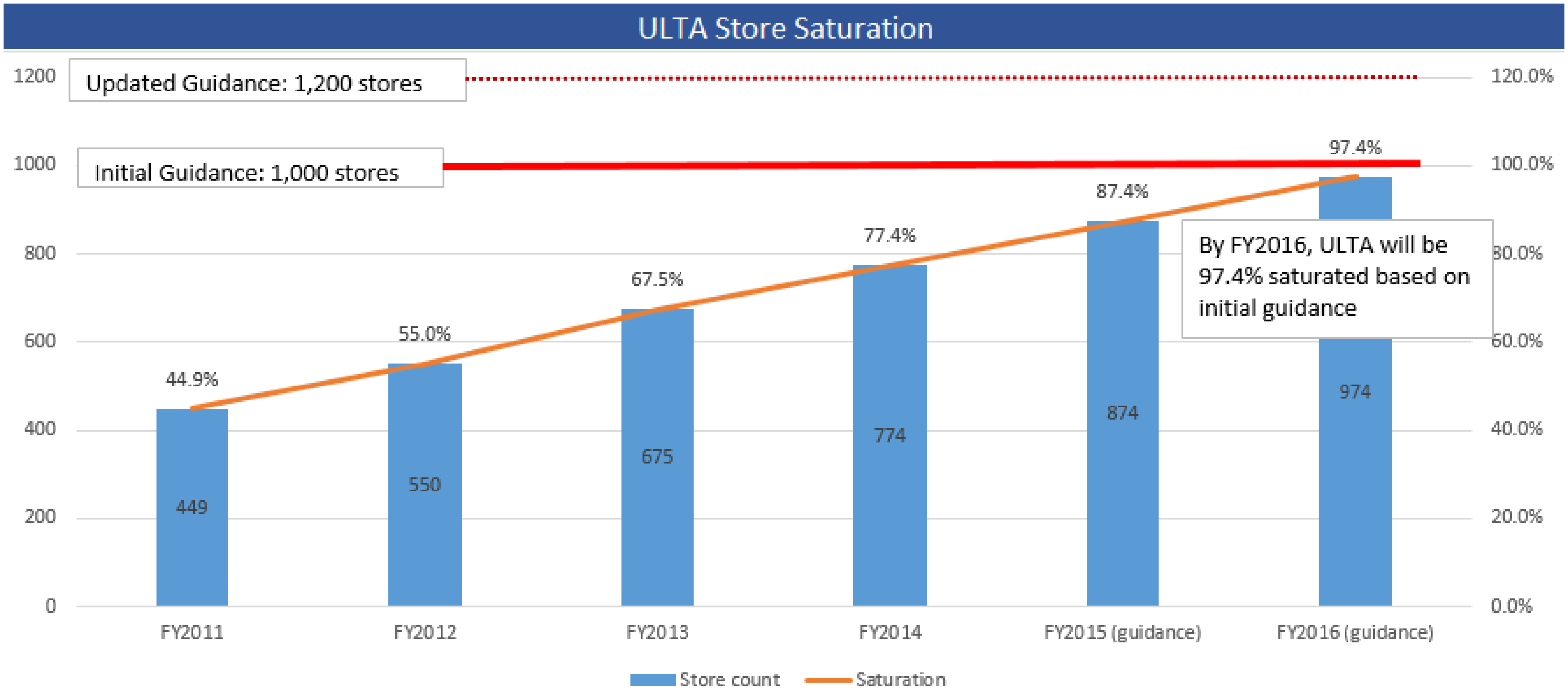
- ULTA reiterated its 1,000 store guidance consistently through May 2012
  - ULTA had ~5 years as a public company + 17 years as private to determine the TAM
  - ULTA had over 430 stores in 43 states at beginning of 2012

- ULTA increased its store guidance to 1,200 stores in June 2012
  - Three weeks prior the largest shareholder had reduced ownership from ~18% to ~5%
  - ULTA reiterated store guidance target of 1,000 at investor day just two weeks earlier
  - Mr. Rubin had been the CEO for less than two years at the time of the guidance raise
  - Multiple executives dumped stock in the months following the guidance raise (4 executives/board members sold nearly $50M in stock!)

- **Prescient Point believes that ULTA knows the true total addressable market is 1,000 stores (it had nearly 22 years to figure it out). We believe ULTA increased the store guidance to 1,200 to (1) promote its "growth" story to Wall Street, (2) provide an opportunity for insiders to sell stock, and (3) assuage investor concerns about its largest shareholder dumping stock.**

Market Saturated Based On Initial Guidance

- In less than twelve months, ULTA will **97.4% saturated based on its initial guidance** (81% saturated on updated)



Source: ULTA filings, Prescience Point estimates

ULTA Indentifies Stores Most Susceptible to Cannibalization And They Are Surging

PRESCIENCE POINT

- ULTA claims that any cannibalization that takes place will take place when opening stores in existing markets

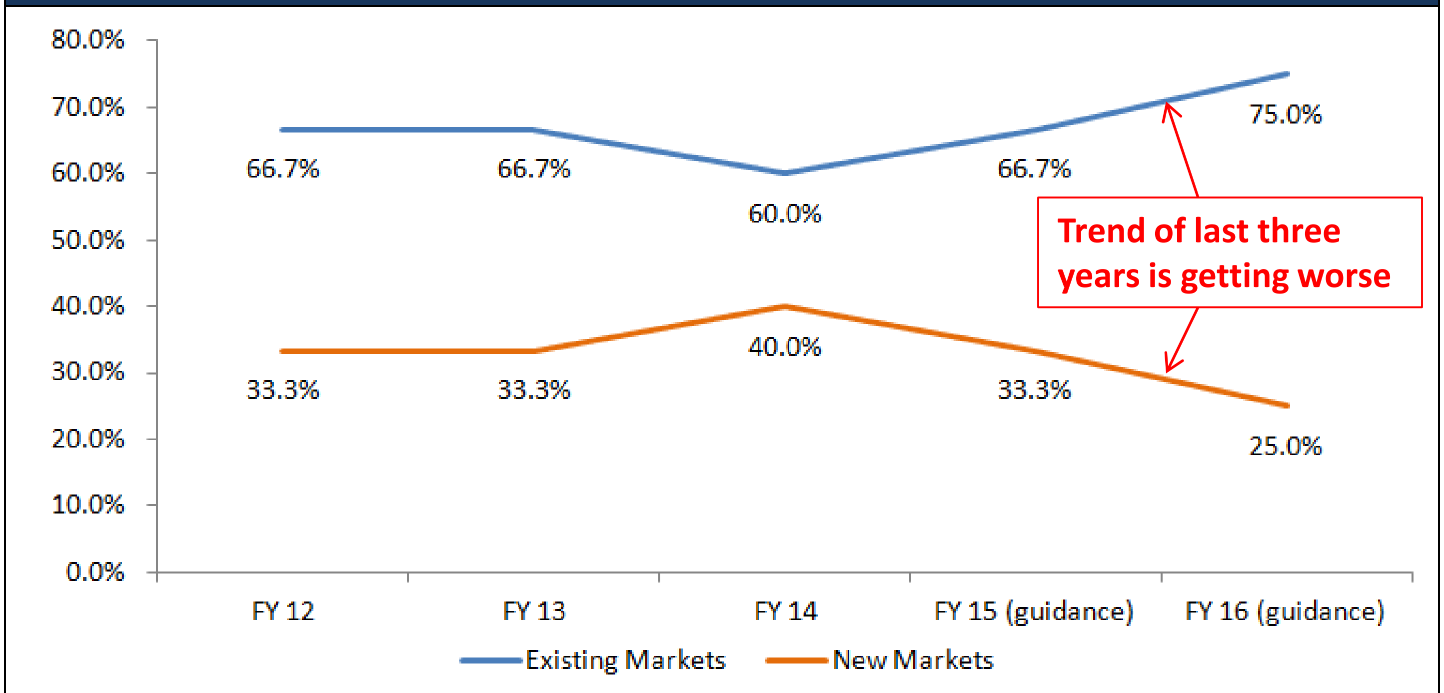
> "We are always opening stores in new markets and existing markets, as well. To a large degree, a lot of the -- ***any of the cannibalization***... ***occurs in the existing markets...***"
>
> – Former CFO Gregg R. Bodnar, September 06, 2012 call

- **On the following slides, we demonstrate a surge in stores most susceptible to cannibalization, which will result in deterioration in store level economics. This is a clear indication ULTA has saturated the market.**

Lack of New Markets Highlights Saturation

- **ULTA guided for only 25% of store openings in 2016 to occur in new markets**
  - **Represents the lowest percentage disclosed in the last five years (possibly ever)**
  - **Demographics of new markets has declined precipitously**
- **Lack of new markets provides further evidence that ULTA has hit a saturation point**

ULTA Guidance for Store Opening in New Vs. Existing Markets



Source: ULTA Quarterly Earnings Conference Calls

PRESCIENCE POINT

Store Concentration Surges

- ULTA claims that its customers are willing to travel

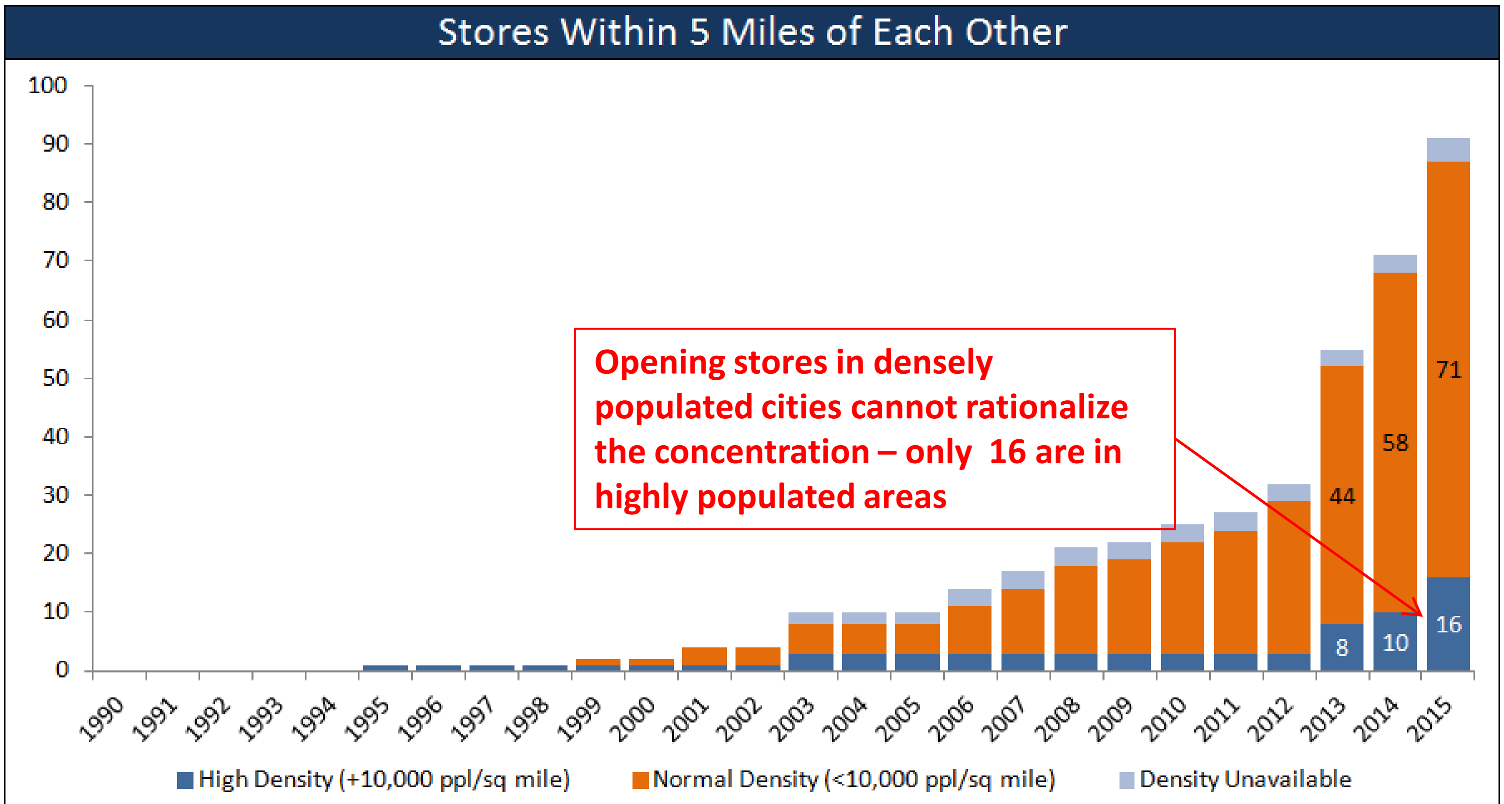
> *We know what our market share is. We color code a map so we know within a five-mile radius because by and large we have loyalty customers everywhere. **She is traveling -- if there is not an Ulta store close by, she is traveling places to shop with us on whatever mission she might be on.** So we do a good job and we have a long history of all that data.*
>
> (CFO Mr. Scott M. Settersten, Oppenheimer Consumer Conference, 06/25/14)

- **Despite its claims that customers are willing to travel, ULTA has accelerated store openings that are right on top of each other (as shown over the next several slides).**

Source: Conference transcript, independent research database (linked previously); Prescience estimates

Stores Opened Right Next To Each Other

- **ULTA stores within 5 miles of each other have tripled in the last three years to 91 stores**
  - Increased store concentration indicates the market is saturated
  - The following slides provide a few examples of highly concentrated stores – notice the quality of location, risk of traffic cannibalization, and co-tenants



Source: *ULTA Store Data, and Prescience Point Estimates*

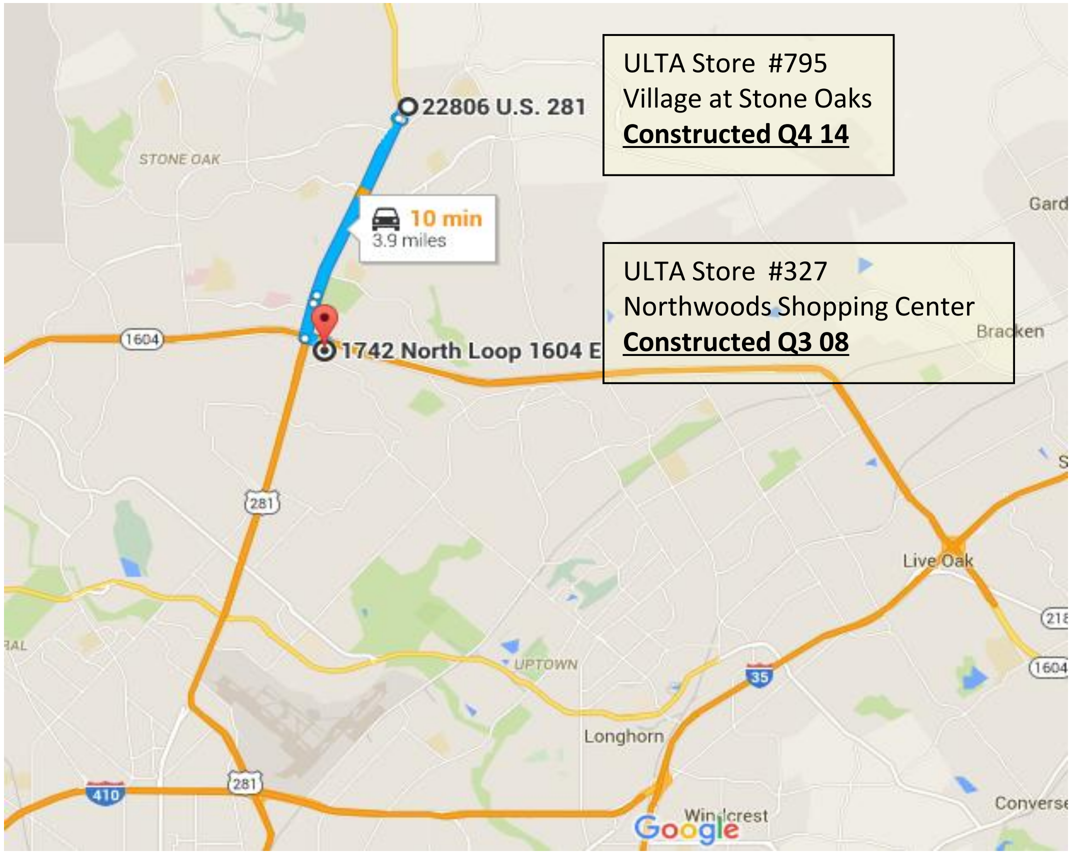
New San Antonio Store In Terrible Location

- <u>In Q4 14</u>, ULTA opened Village at Stone Oaks (Store #795) in Northern San Antonio.
- Store #795 is just a <u>3.9 mile drive</u> from Northwoods Shopping Center (Store #327)

- Store #795 cannibalizes all of Store #327's southbound traffic on SR281

- Store #795 is in a less desirable location, no traffic from northbound SR281, or East/West bound traffic on SR1604

- Traffic dependent on sparsely populated Northern San Antonio



New Oregon Store To Split Traffic With Existing Store

- In Q3 15, ULTA opened Square Too (Store #818) southwest of Portland, OR.
- Store #818 is just a 4.8 mile drive from Cedar Hills Crossing (Store #130).

- ULTA waited 10 years to open a second store in this region. If this was a quality location, why didn't ULTA open a store sooner?

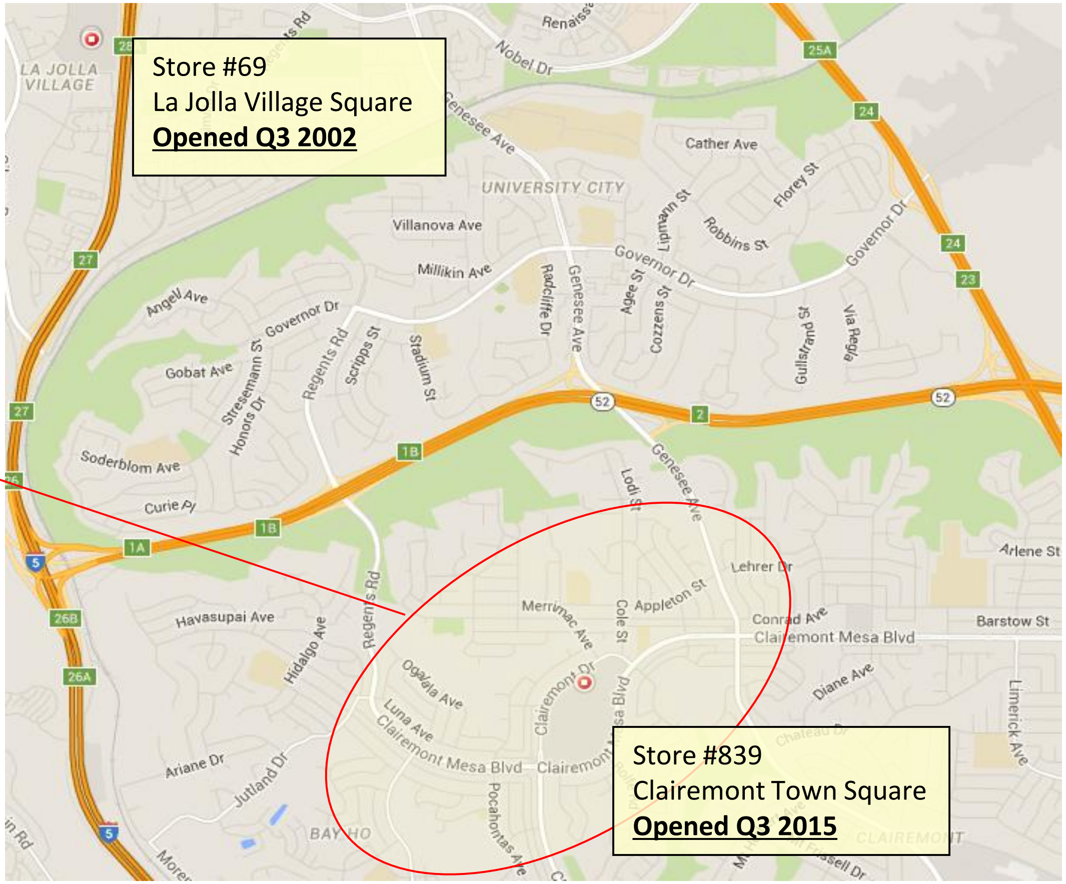
- These stores will now split traffic from customers living along SR217. Twice the fixed costs (two stores, but customers did not double.

New San Diego Store Much Lower Quality Than Nearby Store

- In Q3 15, ULTA opened Clairemont Town Square (Store #839) in central San Diego, CA.
- Store #839 is just over a five mile drive to La Jolla Village Square (Store #69).

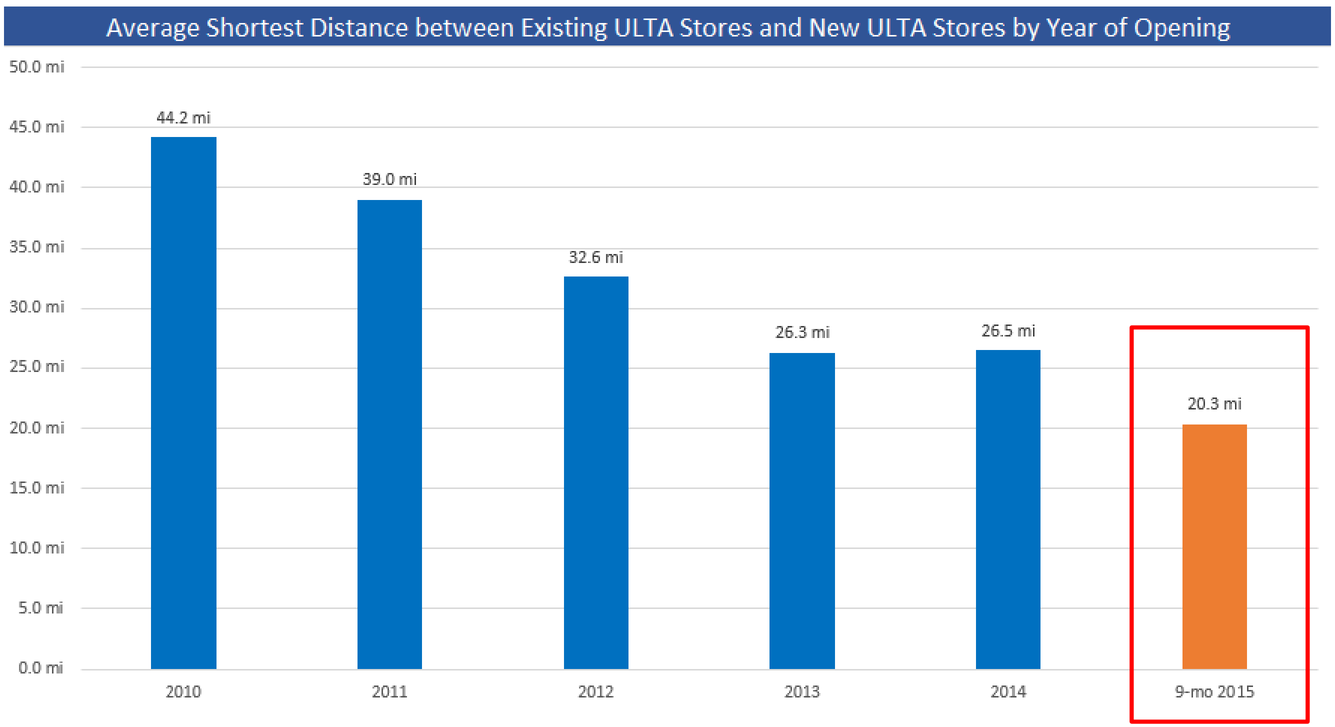
- ULTA waited over a decade to open a second store in this region. Prescience Point believes ULTA had good reason.

- The Clairemont store:
  - Has no highway access
  - All traffic will be local residents
  - +50% of residents earn LESS than $50K a year
  - Cotenants include Burlington Coat Factory, Big Lots, 99 Cent Store. Only preferred cotenant is TJ Maxx



Store Concentration Surges

- The average distance between new and the closest old store <u>has been cut by more than 50% since 2010</u>
  - Negative effects could be visible in the near future as these new stores will likely not reach the volume of the “average” mature store



Source: independent research database (linked previously); Prescience estimates; distances <u>exclude</u> Alaska locations and include relocations

PRESCIENCE POINT

ULTA Promotes Customer & Store Quality

- ULTA devotes considerable effort to convince Wall Street about its customer and store quality
  - Promotes the high average income of its customers +60K a year ("affluent")
  - Promotes in-depth real estate selection process ("power centers" are 83% of stores)
  - Promotes strong co-tenants: BBBY, DSW, TGT, JWN, and TJX
- **Census data shows that store location quality has deteriorated in recent years as the market has been saturated.**

ULTA Store Characteristics

CURRENT PORTFOLIO
CHARACTERISTICS

ULTA

1. Market type: primarily in suburban locations
2. Market density: 80% of stores in trade areas with average household size of 75K - 100K
3. Consumer profile: affluent, average household income >$60K
4. Co-tenants: DSW, Nordstrom Rack, Target, Dick's, Bed Bath & Beyond, Kohl's, TJ Maxx
5. Shopping center type:
   - Power centers and community centers represent 83% of portfolio
   - Enclosed mall stores represent 8% of portfolio (primarily exterior positions)
   - Urban stores represent 1% of portfolio
   - Other (lifestyle, open air malls, neighborhood centers) represent 8% of portfolio

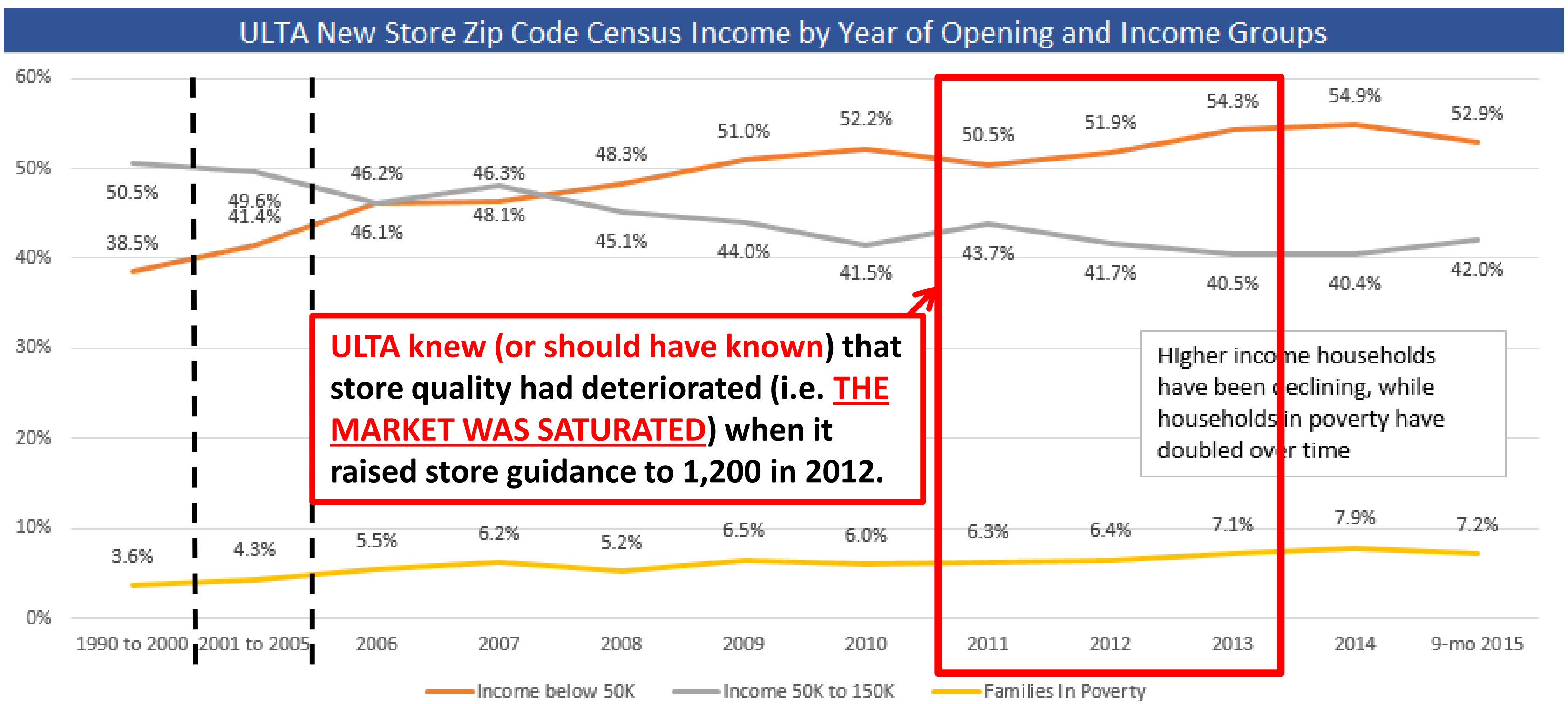
Source: ULTA Investor Presentation, October 2014

PRESCIENCE POINT

Stores Located In Lower Income Areas

- ULTA states that its customers are "affluent" with income +$60K
  - More than 50% of store openings in areas with avg incomes less than $50K (Pre IPO: closer to 40%)
  - Nearly 8% families live in poverty in locations of newly opened stores (Pre IPO: closer to 4%)

- **<u>The deterioration in income statistics indicates the market is saturated and ULTA has moved to lower income areas to open new stores. These stores are unlikely to produce advertised store-level economics.</u>**



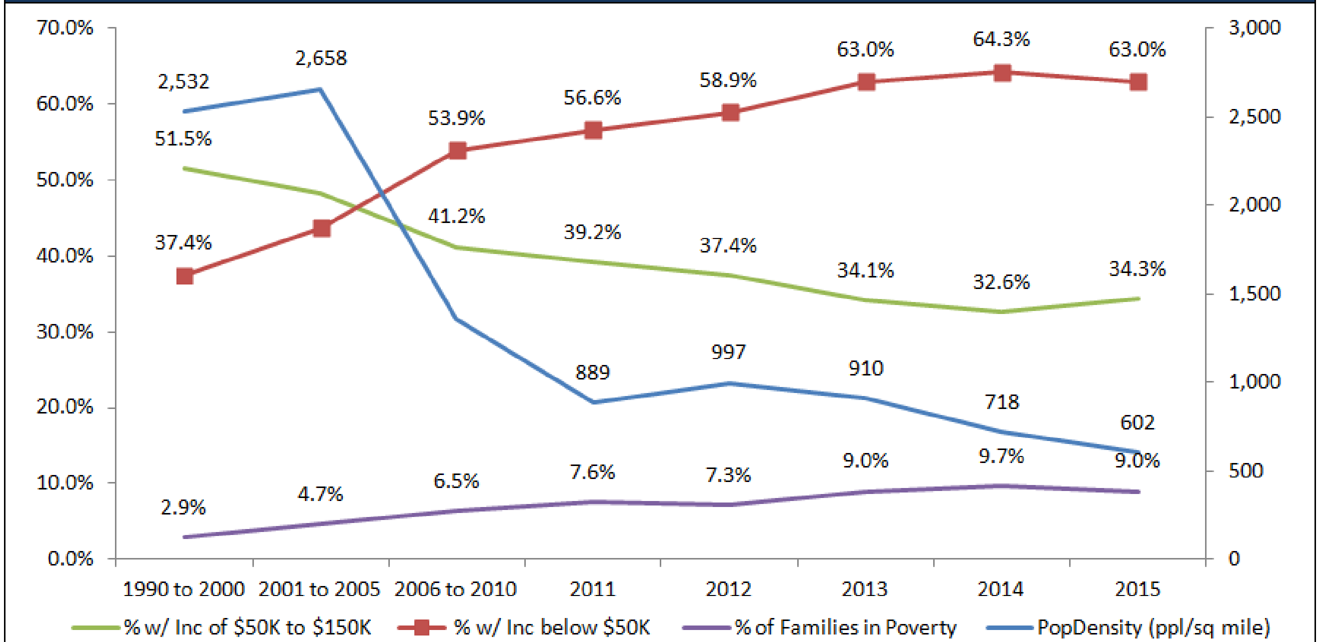
*Income data based on 2010 census data for the zip code where each store was opened.

Demographic Deterioration Even Worse In New Markets

- From 2011 to 2015, ULTA opened 193 stores in 'new markets' (Prescience Point estimated as no stores within 20 miles). The demographics of 'new markets' has deteriorated drastically. Poverty levels and residents making <$50k/year have skyrocketed, while population density has plummeted.

- **Prescience Point believes the deterioration in new markets proves there is limited <u>new</u> opportunities and the market is saturated. As a result, ULTA has constructed stores in increasingly tighter concentrations (in existing markets) that will certainly cause continued cannibalization.**

Demographics of New Markets



Source: 2010 Census Data, ULTA Store Data, and Prescience Point Estimates

ULTA Store Traffic Dependent On Co-tenants

- ULTA devotes considerable effort to convince Wall Street that it opens stores in quality locations
- ULTA represents that it opens stores near certain best of breed big box retailers
  - ULTA indicates these retailers are "are very big drivers of traffic"
  - These retailers include DSW, JWN, TGT, DKS, BBBY, and TJX

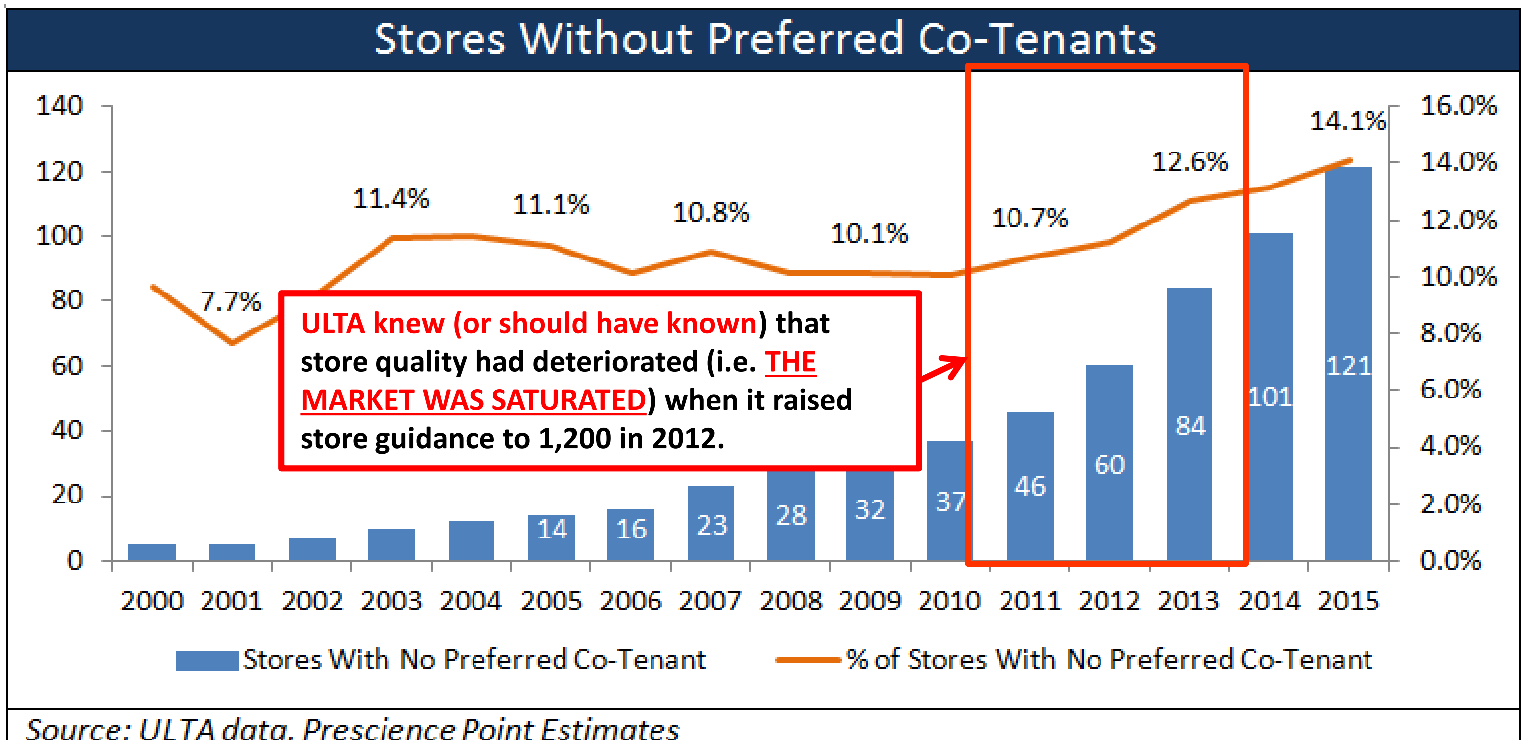
> *Our current store base has several cotenants that we feel most comfortable with. They are usually the best of the breed, big-box cotenants, tenants such as DSW, Nordstrom Rack, Target, Dick's, Bed Bath & Beyond, T.J. Maxx. These big-box tenants are very big drivers of traffic and we like that.*
>
> -Alex Lelli, SVP of Growth and Development, 10/15/14

- Prescience Point hired an independent research firm to analyze preferred co-tenants store locations
  - The research firm purchased store data for each of the six preferred co-tenants
  - These store locations were triangulated against ULTA store locations to determine which ULTA stores had preferred co-tenants
- **ULTA stores opened without preferred co-tenants has skyrocketed. Prescience Point believes this is just another piece of evidence that the market for ULTA stores is saturated. As ULTA over expands, it cannot find co-tenants in these weaker locations.**

Stores Without Preferred Co-tenants Skyrocket

- Since 2012, ULTA stores without a preferred co-tenant doubled to 121 stores (now +14% of stores)
  - This is exactly the same as the trend as stores opened within five miles of each
  - Prescience Point believes management knew the store base was getting saturated in 2012 when it increased its guidance 1,200 stores. **Over 20% of ULTA's stores now (1) have no preferred co-tenant or (2) are located within five miles of another store.**

- The following few slides demonstrate the challenges generating traffic without solid co-tenants.

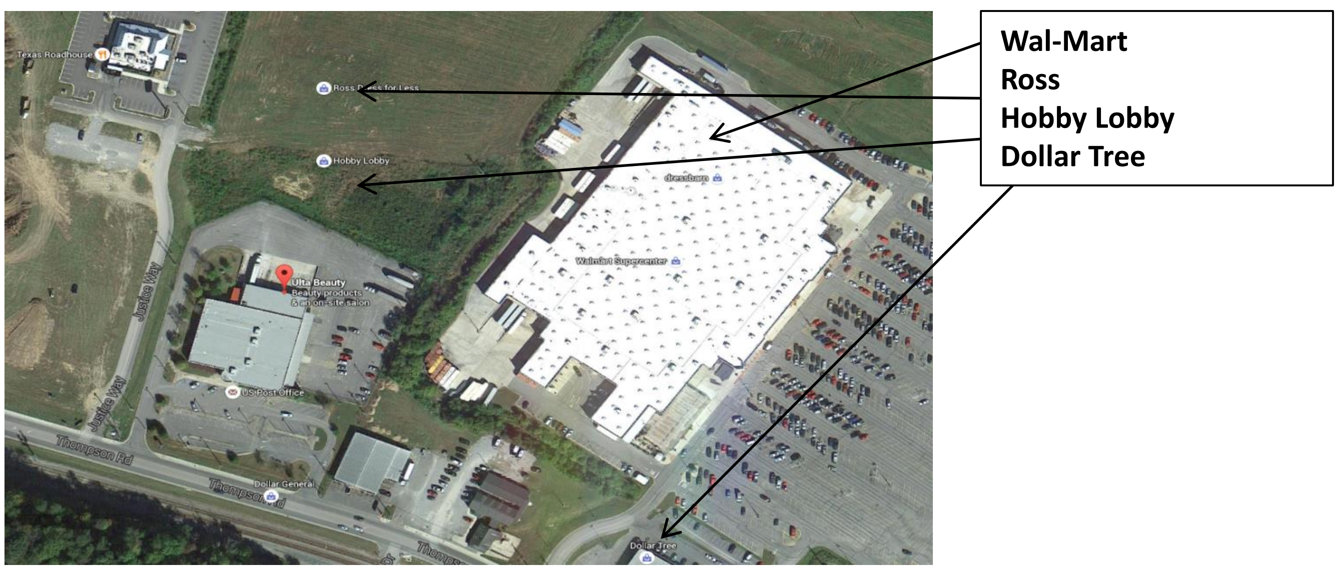


PRESCIENCE
POINT

Lack of Co-tenants Pressures Traffic

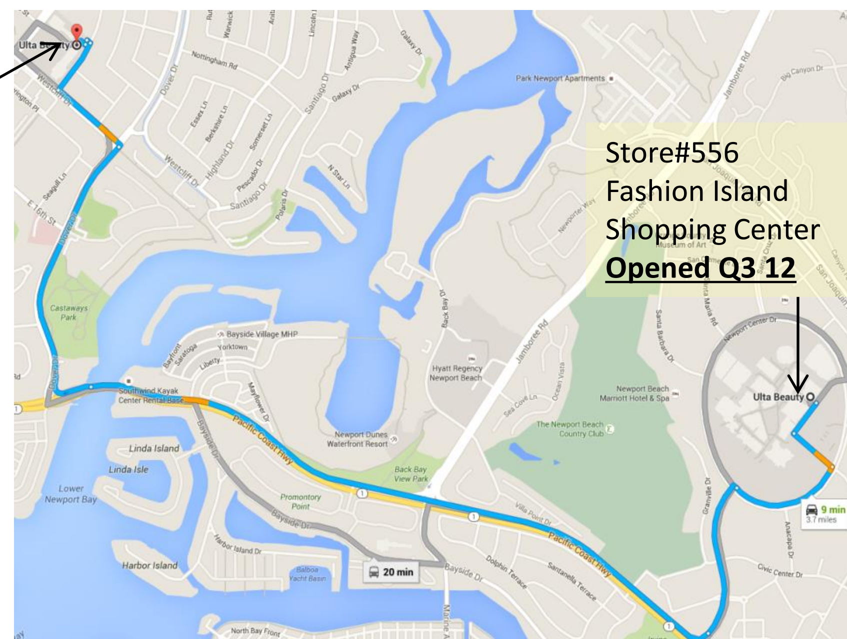
- In Q1 15, ULTA opened Pikeville Commons (Store #755) in Pikeville, Kentucky
  - Pikeville's co-tenants include a Wal-mart, Dollar Tree, Ross Dress for Less, and Hobby Lobby
  - These co-tenants are unlikely to drive "affluent" customers to ULTA
  - In fact, **it will be extremely difficult to find target ULTA customers (i.e. income +$60K) given that more than 3/4ths of households in the area have incomes of <$50K per year**.

- **This is the image of market saturation –ULTA store in low income area with no preferred co-tenants.**



Lack of Co-tenants Pressures Traffic

- In Q1 15, ULTA opened Mesa Center (Store #805) in Costa Mesa, CA.
  - Store 805's co-tenants include Ralphs (a grocery store), CVS Pharmacy, and a Ace Hardware
  - These are convenience type stores that will not drive traffic to this ULTA location.
  - Furthermore, store #805 is just a 3.7 mile drive from Store#556 opened in Q3 2012.
- **Store #805 will not benefit from co-tenant traffic and will also have to compete for traffic with another ULTA store that is just a few miles away. The market for ULTA stores is saturated.**



Small Format Pilot Indicates Saturation

- At recent investor conferences, ULTA discussed its experiments with small format stores (~5,000 sq ft vs. ~10,000 sq ft regular)

- Prescience Point believes that small format tests could be an indication that ULTA, internally, is aware of the saturation problem

- In its latest 10-K, ULTA lists as its #1 business key aspect *“one stop shop”,* offering the wide selection of *“more than 20,000 prestige and mass beauty products… in a bright, open-store environment…We believe we offer the widest selection of categories…”*

- Opening stores with half of the footprint appears to be going against offering wide selection, a key competitive strength listed

Source: ULTA slide deck from GS Sept 09 2015 conference; ULTA latest 10-K

Store Cannibalization is Worsening

Store Cannibalization Worsening

- ULTA warns investors about the risk of cannibalization:

> *A variety of factors affect our comparable sales and quarterly financial performance, including… cannibalization of existing store sales by new store openings.*
>
> \- ULTA Annual 10K Filings

- What is cannibalization?
  - Cannibalization is the decline in store performance caused by the placement of another store in close proximity, preventing *both* stores from reaching their full sales and profitability potential, and <u>lowering gross margin per store</u>
  - <u>Cannibalization can occur while the chain reports sales growth and same store sales growth</u>, predominantly transactions (traffic)
  - Cannibalization is so important in retail that franchisors, who deal with independent franchisees, contractually guarantee a minimum exclusive radius in which no franchise will be sold to another franchisee

- **<u>Prescience Point believes that ULTA's saturation is already leading to store cannibalization</u>**

Wall Street Ceased Questioning ULTA About Cannibalization

- ULTA <u>only</u> discusses cannibalization when asked about it by analysts on conference calls
  - Prescience Point was unable to identify any organic commentary from ULTA about cannibalization (outside of boiler plate language included in its SEC filings)
  - Analysts almost never asked about cannibalization in the early years. Prescience Point believes that ULTA has only responded to seven questions about cannibalization in its entire history.
- The first question about cannibalization in five years occurred on March 8th, 2012
  - ULTA indicated that store openings in "some cases in those existing markets…will create some cannibalization"
  - <u>ULTA raised its total store count guidance just three months later to 1,200 stores</u>
- **<u>Prescience Point believes investors are not focused enough on the impact of cannibalization as evidenced by the lack of questions to management. Prescience believes the negative impacts of cannibalization will be a shock to investors</u>.**

Questions About Cannibalization

Year	2007	2008	2009	2010	2011	2012	2013	2014	2015
Number of Questions	1	0	0	0	0	2	1	3	0
% saturation based 1,000 store guidance	24.9%	31.1%	34.6%	38.9%	44.9%	55.0%	67.5%	77.4%	86.0%

Source: Conference call transcripts and Prescience Point estimates

Store Cannibalization Model

- Prescience Point presents a simplified model of value destruction through cannibalization
- A second store opens near an existing store, and by Year 2, we can see growth in overall sales, transactions, same-store sales (even with flat ticket) but lower gross profit versus Year 0
- Note that the SSS increase is driven entirely by transactions, and not by ticket
- As we'll see on the next slide, this is exactly what is happening with ULTA: transaction growth boosts "headline" SSS while store gross profit margin is dropping

	Year 0		Year 1		Year 2	
	Store 1 existing	Store 2 "just opened"	Store 1 existing	Store 2 first year	Store 1 existing	Store 2 second year
Transactions	1000	0	900	300	925	600
Avg ticket	$ 10	$ -	$ 10	$ 10	$ 10	$ 10
Revenues	$ 10,000	$ -	$ 9,000	$ 3,000	$ 9,250	$ 6,000
Variable Cost per ticket (30%)	$ 3.00	$ 3.00	$ 3.00	$ 3.00	$ 3.00	$ 3.00
Total Variable Costs	$ 3,000	$ -	$ 2,700	$ 900	$ 2,775	$ 1,800
Store fixed costs	$ 5,000	$ -	$ 5,000	$ 5,000	$ 5,000	$ 5,000
Store-level profit	$ 2,000	$ -	$ 1,300	$ (2,900)	$ 1,475	$ (800)
Gross Margin per Store	**20%**	**N/A**	**14%**	**(97)%**	**16%**	**(13)%**
Aggregate Sales	$ 10,000		$ 12,000		$ 15,250	
Aggregate Gross Profit	$ 2,000		$ (1,600)		$ 675	
Aggregate Gross Margin	**20%**		**(13)%**		**4%**	

Source: Prescience Point estimates

Gross Profit Margin Deterioration Indicates Cannibalization Worsening

PRESCIENCE POINT

- In March 2012, ULTA's CFO stated that cannibalization, while an issue here or there, wasn't significant because ULTA was <50% saturated on guidance for 1k stores

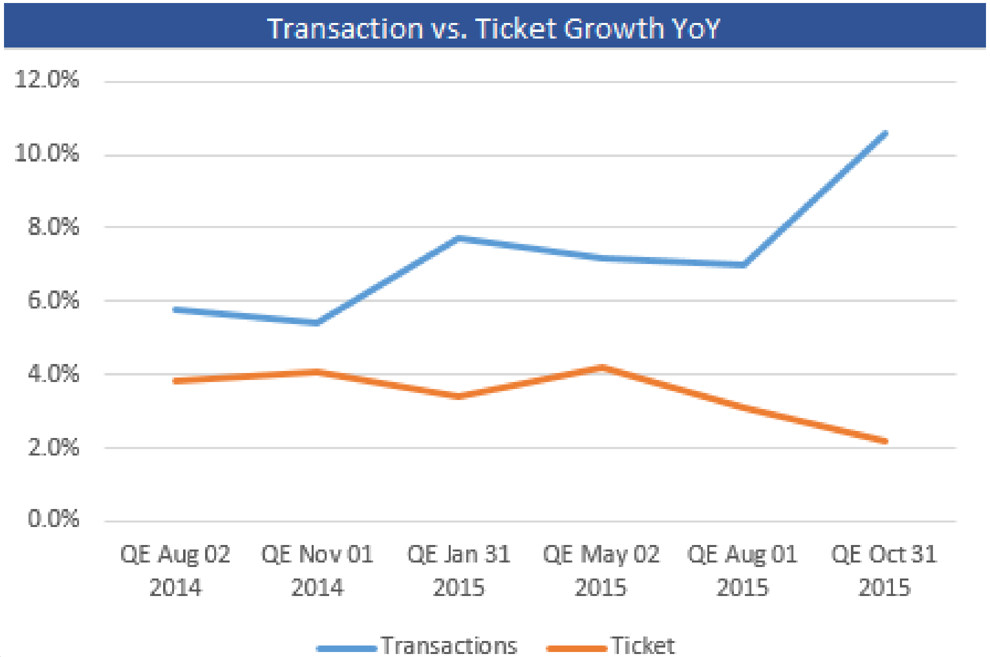
> *I'd also remind you that when you have less than half of your potential store build-out that's up and running, cannibalization will be a factor in some cases, but we have a lot of runway open…"*
>
> -Former CFO Gregg Bodnar, 3/8/2012 conf call

- Today, ULTA is closing on 100% saturation on that guidance; **cannibalization is an issue, and a growing one**
- As shown on the previous slide, a key indicator of cannibalization is reduced gross profit margin per store
- ULTA gross profit margin per store declined to 35.1%
  - The second consecutive period of decline (coincides with saturation)
  - The lowest level in 3 years.

	Per Store Metrics				
	FYE Jan/Feb 2011	FYE Jan/Feb 2012	FYE Jan/Feb 2013	FYE Jan/Feb 2014	FYE Jan/Feb 2015
Sales	$1,454,838	$1,776,151	$2,220,256	$2,670,573	$3,241,369
Gross profit	$484,085	$616,840	$783,674	$941,248	$1,136,787
Average store count estimate	368	419	500	613	725
Net sales per avg store	$3,959	$4,239	$4,445	$4,360	$4,474
Gross profit dollars per avg store	$1,317	$1,472	$1,569	$1,537	$1,569
Gross profit margin per avg store	33.3%	34.7%	35.3%	35.2%	35.1%
Average inventory per avg store	$579	$553	$606	$669	$717

Cannibalization a Growing Problem

- <u>Cannibalization is a growing problem at ULTA</u>; it is evident in increasing sales, increasing same-store sales (predominantly transactions from new stores, not ticket) and declining gross margin per store
  - The Street is focused on the "headline" SSS while <u>missing both ticket vs. transactions dynamic, and the dropping gross margin per store as signs of cannibalization</u>
  - Please note that seasonal fluctuations in working capital prevent valid year-end comparisons to LTM ROIC metrics (LTM ROIC is understated at Q3)



Source: Prescience Point research opinions

ULTA SSS Growth at Inflection Point, Set to Plunge

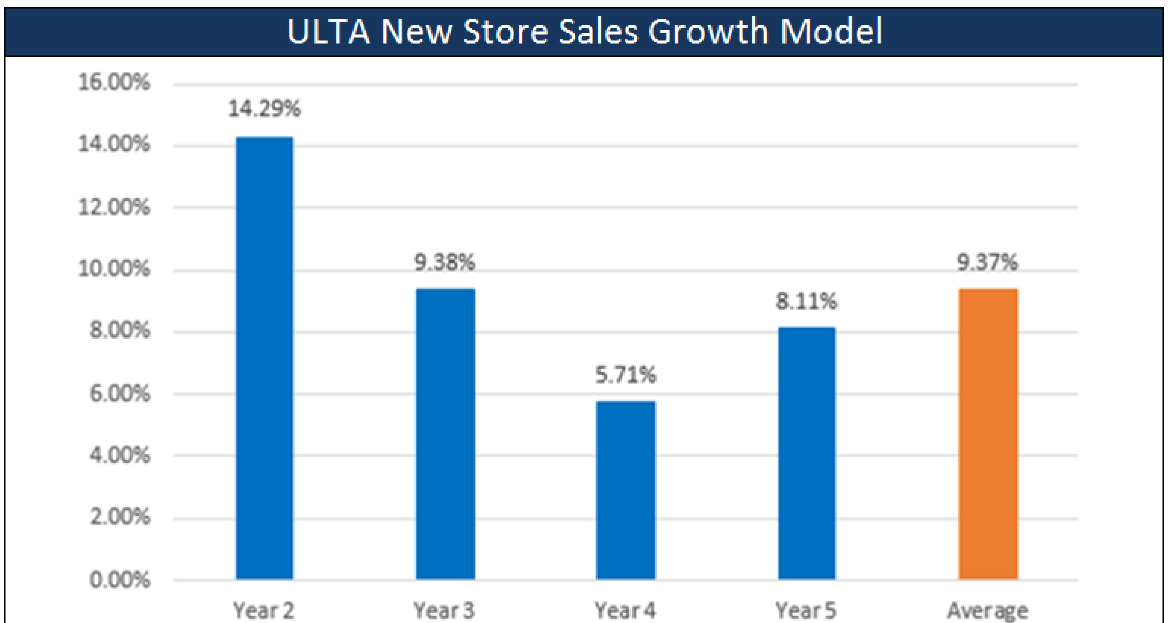
ULTA Same-Store Sales Growth at Inflection Point

- Prescience Point believes that ULTA's <u>**SSS growth is at an inflection point**</u>:
  - a slowdown in "growth story" stocks' SSS could <u>lead to a serious decline in valuation</u>
- ULTA's same-store sales:
  - Ramp of stores between 2-5 years old provided unsustainable "demographic dividend", resulting in 'illusion of growth'
  - Store maturation will pressure SSS growth sustainability
  - Store openings in lower income areas will negatively impact SSS growth
  - Cannibalization will eat into existing stores SSS
  - Current transaction (traffic) boost likely due to new store openings
- Wall Street has focused on good reported "headline" SSS, <u>but under the surface</u>:
  - **Traffic has significantly outpaced average ticket**
    - Traffic and average ticket <u>should be increasing in tandem</u>
    - Traffic outpacing average ticket suggests:
      - Average ticket is dependent on unit growth and/or
      - Traffic is being "bought" by discounting
  - Inclusion of E-Commerce sales created an <u>illusory benefit to "headline" SSS</u>
    - E-Commerce sales growth is <u>decelerating</u>

Source: Prescience Point estimates & research opinions

Unsustainable SSS Boost from Newer Stores

- New store revenue increases at the fastest rate in year 2 (per ULTA's own guidance)
  - Revenue growth of new stores slows over the next few years
  - New stores enter the comparable store base when revenue is growing fastest
  - Revenue growth at new stores is predominately traffic rather than ticket
- New stores entering the comparable base in recent years have provided an unsustainable boost to same store sales. These new stores increase traffic comparables which have been the primary driver of same store sales in recent periods. This phenomena is unsustainable as demonstrated (next slide).



Source: ULTA presentation on 09/09/15, Prescience Point Estimates

Store Base is Maturing Fast

- <u>The “demographic dividend” is a temporary phenomenon</u> due to rapid unit growth in the last three years
  - Slow-growth 5-year+ old store base as a percentage of store mix will only increase in the future
  - The percentage of stores in the comparable base two years old or less peaked in Q4 14

ULTA Store Maturation Model

	FYE Jan/Feb 2011	FYE Jan/Feb 2012	FYE Jan/Feb 2013	FYE Jan/Feb 2014	FYE Jan/Feb 2015	*Projection* FYE Jan/Feb 2016	FYE Jan/Feb 2017	FYE Jan/Feb 2018	FYE Jan/Feb 2019	FYE Jan/Feb 2020
Stores at YE	389	449	550	675	774	874	974	1074	1174	1274
New stores (0-1 yo)	43	60	101	125	99	100	100	100	100	100
Store count age 1-2 yo	35	43	60	101	125	99	100	100	100	100
Store count age 2-3 yo	62	35	43	60	101	125	99	100	100	100
Store count age 3-4 yo	53	62	35	43	60	101	125	99	100	100
Store count age 4-5 yo	29	53	62	35	43	60	101	125	99	100
Store count age 5-6 yo		29	53	62	35	43	60	101	125	99
Store count age 6+ yo		167	196	249	311	346	389	449	550	675
Oldest stores as % of all		37.2%	35.6%	36.9%	40.2%	39.6%	39.9%	41.8%	46.8%	53.0%

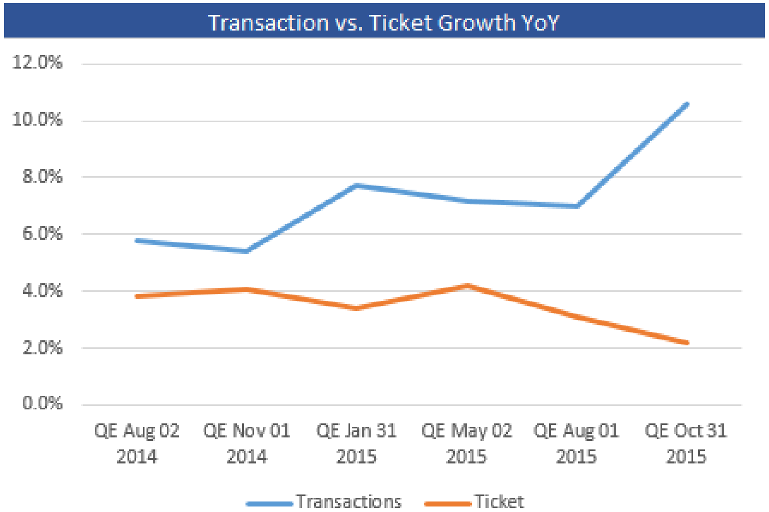
Sample store cohort aging

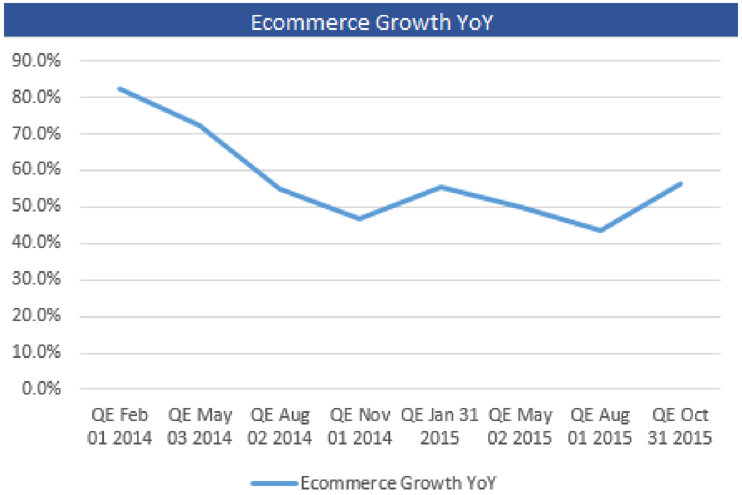
Oldest stores grow dramatically as a % of store base in the near-future

Source: Unit growth target from ULTA slide deck from GS Sept 09 2015 conference ; Prescience Point estimates

ULTA SSS Challenges "Under the Surface"

- ULTA's "good" headline SSS has been driven predominantly by transactions, rather than a balance of transactions and ticket
  - Growth in transactions is driven by new stores ramping up while the underlying business, the ticket, is indicating limited pricing power and lack of uniqueness of the offering
- ULTA's headline SSS is also boosted by the inclusion of ecommerce growth, which is slowing
  - We discuss ULTA's lack of pricing advantages online later; as well as the margin compression seen by traditional retailers growing online sales
  - Additionally, ecommerce could pressure/cannibalize in-store traffic rather than be purely incremental
    - Ecommerce cannibalization was added as a risk factor in the FY13 10-K





Source: ULTA filings, Prescience Point estimates and research opinions

Ecommerce and Small Format Stores
Will Not Be Saviors

PRESCIENCE POINT

ULTA Ecommerce Will Not Be a Savior

- ULTA's tiny but growing ecommerce business will not be a savior
  - <u>ULTA has no apparent price advantage online</u> (identical basket costs 13.4% higher than AMZN) based on a sample basket of 20 diverse items (screenshots of all items side-by-side in Appendix I)

	Category	Item	ULTA price	AMZN price
1	Lip	L'Oreal Infallible Pro-Matte Gloss	$ 9.99	$ 7.99
2	Lip	Laure Geller Iconic Baked Sculpting Lipstick	$ 21.00	$ 21.00
3	Lip	Bareminerals Marvelous Moxie Lipstick	$ 18.00	$ 16.86
4	Eye	Benefit Cosmetics They're Real! Mascara	$ 24.00	$ 22.50
5	Eye	Bareminerals Lash Domination Volumizing Mascara	$ 19.00	$ 17.60
6	Eye	Stila Stay All Day Waterproof Liquid Eye Liner	$ 22.00	$ 20.50
7	Face	Lorac PRO Palette 2	$ 44.00	$ 42.00
8	Face	Maybelline The Rock Nudes Palette	$ 11.99	$ 9.59
9	Face	Bareminerals Original Foundation Broad Spectrum SPF 15	$ 28.50	$ 25.52
10	Face	Lorac Sheer POREfection Foundation	$ 34.00	$ 34.00
11	Face	Laure Geller Baked Gelato Swirl Illuminator	$ 26.00	$ 24.59
12	Hair	Sebastian Drench Moisturizing Shampoo	$ 38.00	$ 21.99
13	Hair	Redken Body Full Shampoo	$ 15.50	$ 15.41
14	Hair	Alterna Caviar Anti-Aging Replenishing Moisture Conditioner	$ 49.00	$ 49.00
15	Hair	OGX Renewing Moroccan Argan Oil Conditioner	$ 7.99	$ 9.99
16	Hair	It's A 10 Silk Express Miracle Silk Conditioner	$ 19.96	$ 11.17
17	Hair	Ouidad Boost Curl Energizing and Refreshing Spray	$ 20.00	$ 16.20
18	Fragrance	D&G Light Blue for Women Eau de Toilette	$ 74.00	$ 51.96
19	Fragrance	Ralph Lauren Romance for Her Eau de Parfum Spray	$ 70.00	$ 70.00
20	Fragrance	Philosophy Amazing Grace Eau De Parfum Spray	$ 56.00	$ 49.00
		Total Basket Cost	**$ 608.93**	**$ 536.87**
		ULTA basket cost disadvantage	13.4%	
		Free shipping?	Over $50	Most are Prime-eligible

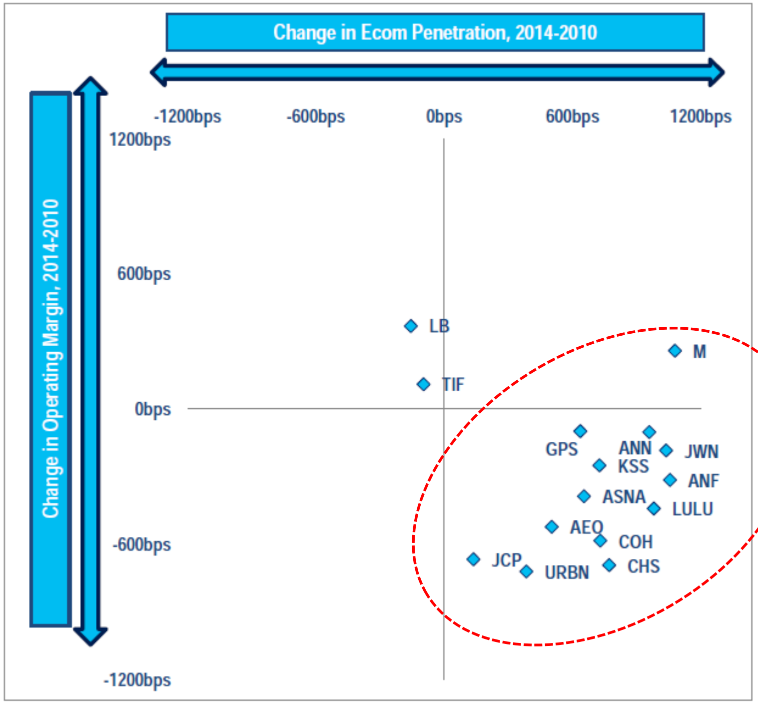
"Your margin is my opportunity"
– Jeff Bezos
Quoted by *Fortune*, Nov 16, 2012

Source: ULTA and AMZN websites, Prescience Point estimates, Fortune Magazine

ULTA Ecommerce Will Not Be a Savior

- ULTA's tiny but growing online business will not be a savior
  - In addition to ULTA lacking a pricing advantage in the transparent online world, <u>growing online sales for traditional retailers has compressed margins</u>
  - Citi Research, in their coverage initiation report on specialty retailers in October 2015, looked at several retailers whose sales mix had more online sales in 2014 versus 2010
    - 13 retailers had grown online as a part of the sales mix (M, JCP, JWN, KSS, GPS, ANN, ANF, LULU, COH, CHS, URBN, AEO, ASNA)
    - <u>12 of these had seen EBIT margin compression</u> during the period, with M being the sole exception
    - Reasons for the margin compression: price transparency, difficulty upselling/adding related items, free shipping on an order that might be fulfilled in two centers, high returns (shipping, processing)

Figure 1. EBIT margins have gone down as Ecom penetration has increased



Source: Company reports, Citi Research

ULTA Small Format Stores Will Not Be a Savior

- As previously discussed, at recent investor conferences, ULTA discussed its experiments with small format store (~5,000 sq ft vs. ~10,000 sq ft regular)
  - Prescience Point believes that this could be an indication that ULTA, internally, is aware of the saturation problem: ULTA itself claims 'one-stop-shop' and the breadth of its product offerings as competitive advantages; **why would ULTA give up what makes it so special if not of desperation to continue expanding at any cost (and expanding Earnings Before Taxes <– refer to the executive compensation section)?**

> *Our competitive advantages are the quality and assortment of merchandise and services, our value proposition, the quality of our guests' shopping experience and the convenience of our stores and website as one-stop destinations for beauty products.*
>
> \- ULTA most recent 10-K

- Two growth-challenged ULTA competitors, Walmart and Target, have tried the small format store strategy; Walmart announced on January 15, 2016, that the experiment will end with all 102 small format stores closed
  - <u>Why would a "growth story" retailer look to do this</u>?

Source: ULTA SEC filings; ULTA slide deck from GS Sept 09 2015 conference; Walmart IR press release from January 15, 2016; Prescience Point research opinions

No Shortage of Places to Buy Cosmetics

PRESCIENCE POINT

- Prescience Point has put together a sample of 18 publicly traded competitors across the different retail formats that ULTA lists as its competition in its latest 10-K (i.e, "department stores, specialty stores, drug stores, mass merchandisers and on-line" retailers)
- With over 44,000 competitor locations, Prescience Point believes that there is little to no "white space" for cosmetics retailers or salons: there is no shortage of places to buy cosmetics or get a haircut
  - US store counts sourced from most recent filings

	Category	Sample Public Competitor	US Store Count	Comment
1	Department Store	Macy's	900	Includes all banners; 10-Q lists "about 900" locations
2	Department Store	Nordstrom	118	Full-line only (excludes Rack)
3	Department Store	Kohl's	1,166	
4	Department Store	Dillard's	297	
5	Department Store	J.C. Penney	1,021	
6	Department Store	Sears Holdings	1,687	Includes Sears and Kmart
7	Department Store	Hudson's Bay	129	Includes only Saks and OFF5th
8	Specialty Store	Sephora	360	N.A. standalone only (excludes J.C. Penny store-in-stores)
9	Specialty Store	Sally Beauty	2,868	
10	Specialty Store	Perfumania	319	Excludes 1,950 store-in-stores
11	Specialty Store	Bath & Body Works	1,573	Excludes other L Brands stores (i.e. Victoria Secret)
12	Specialty Store	Bed, Bath & Beyond	1,022	BBB locations only (excludes several other properties)
13	Drug Store	CVS	7,822	CVS retail only (excludes clinics)
14	Drug Store	Walgreens	8,192	US only (ex-Boots); parent of Duane Reade
15	Mass/Club	Walmart	5,283	US Walmart + Sam's Club
16	Mass/Club	Target	1,805	
17	Mass/Club	Costco	487	US only
18	Salons	Regis	9,008	All salon brands
	Total sample public competitor store count		44,057	

Source: most recent 10-Q or 10-K filings with SEC; SEDAR for HBC.TO and corporate website for Sephora

ULTA Balance Sheet Flashing Warning Signals

ULTA Balance Sheet Flashing Warning Signals

- Inventory warning signs:
  - Inventory is increasing at a significantly faster pace than revenue growth
  - Inventory relative to next-quarter revenue is also increasing
  - COGS-based inventory metrics are growing

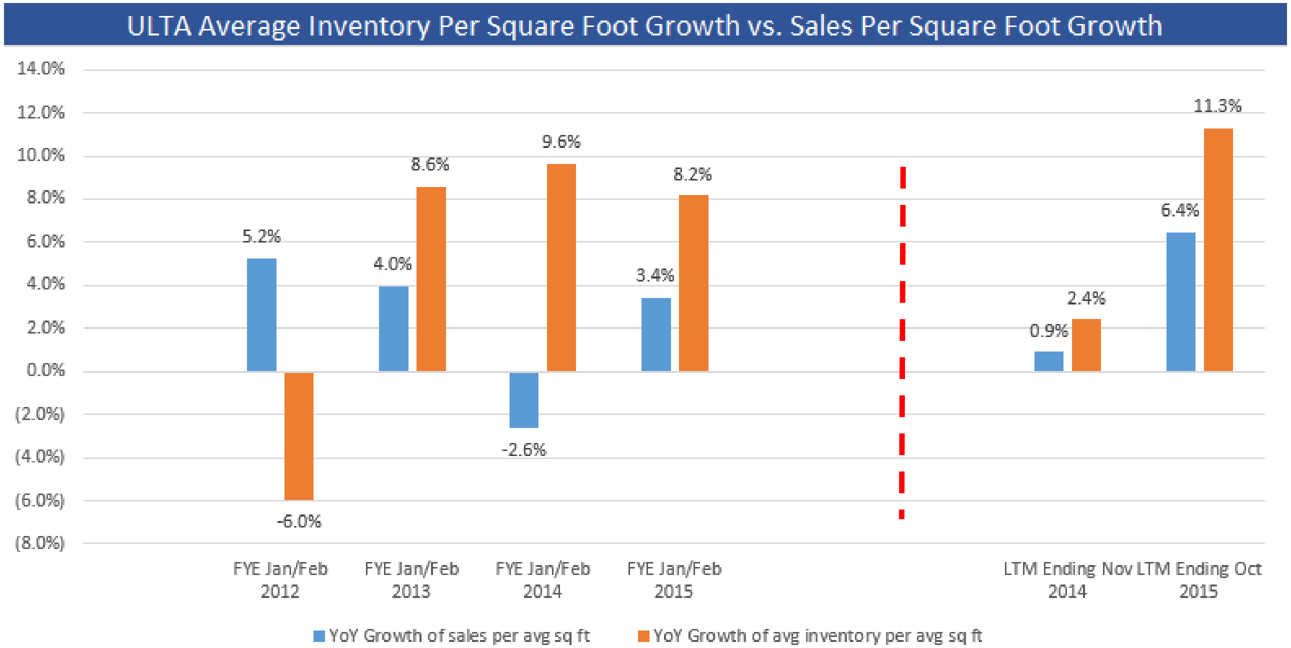
- Prescience Point concerns about inventory:
  - Slowing demand/cannibalization will lead to **top-line and margin pressure**
  - If inventory levels are rationalized due to slower comparable sales (which we fully expect):
    - ULTA will be faced with both **revenue and margin shortfalls**
    - Aggressive discounting to reduce in-store inventory will **negatively impact average ticket**
  - Highly unusual capitalization of SG&A (purchasing) costs into inventory:
    - Is **potentially inflating margins**
    - Capitalization of purchasing costs does not appear to be standard industry practice

- High-valuation "growth story" stocks are expected to show improving margins as they scale-up
  - Margin declines can lead to valuation **multiple compression**

Source: Prescience Point estimates

Inventory Growing Well Ahead of Sales

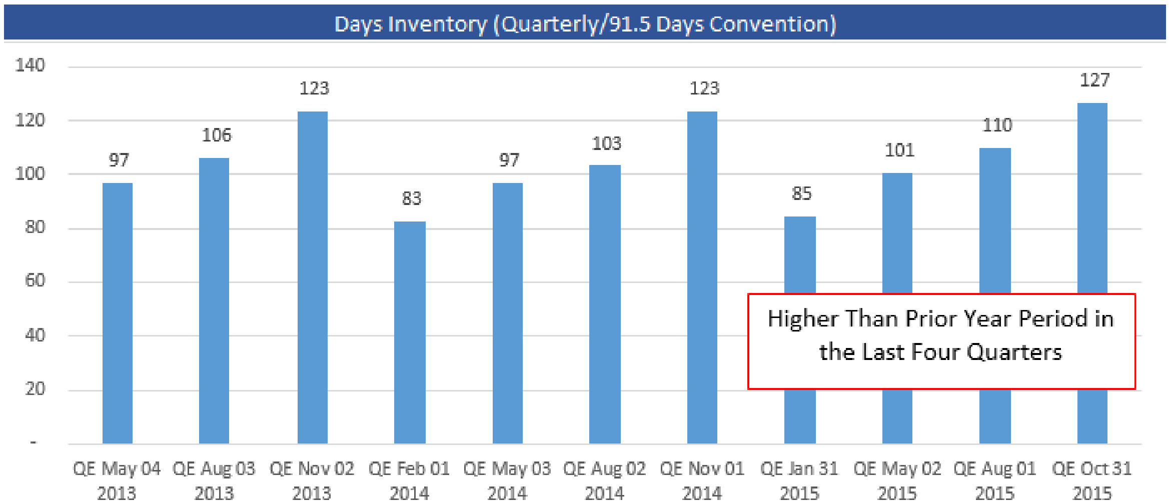
- Some inventory growth is normal for a company growing both units and same-store sales
- ULTA's average inventory growth per avg. sq. ft. has been outpacing sales per sq. ft. growth for almost four years
- The Company attributed some of the latest inventory growth to a new distribution center (Q3 15 call)
  - The distribution center only accounted for $37 million (less than 5% of inventory)
- Significant inventory buildups may indicate weak demand and/or margin pressure from clearance sales, shrink, & waste



Source: ULTA filings and press releases; Q315 call transcript; Prescience Point estimates

Other Inventory Measures Also High

- Days sales in inventory (DSI) continue to grow, increased YoY for the fourth consecutive period



- Inventory growth relative to next-quarter sales growth has increased for four straight periods

	ULTA Inventory YoY Growth vs. Sales YoY Growth Next Quarter							
	QE Feb 01 2014	QE May 03 2014	QE Aug 02 2014	QE Nov 01 2014	QE Jan 31 2015	QE May 02 2015	QE Aug 01 2015	QE Oct 31 2015
Inventory Growth (YoY)	26.8%	20.2%	17.4%	21.9%	26.9%	24.7%	30.3%	24.6%
Forward (+1Q) Sales Growth YoY	22.5%	22.2%	20.5%	20.7%	21.6%	19.4%	22.1%	
Difference:	4.3%	-2.0%	-3.1%	1.2%	5.3%	5.3%	8.2%	

- **Persistent inventory builds could be indicative of forecasting and/or inventory management problems**

Source: ULTA filings and press releases; Prescience Point estimates

Highly Unusual Inventory Accounting

- ULTA's capitalization of purchasing costs to inventory could:
  - Indicate assignment of period SG&A costs to inventory, thus increasing margins
  - Provide **illusory margin improvement** despite growing inventory levels

Inventory valuation

Merchandise inventories are carried at the lower of average cost or market value. Cost is determined using the weighted-average cost method and includes costs incurred to purchase and distribute goods as well as related

43

Table of Contents

vendor allowances including co-op advertising, markdowns and volume discounts. We record valuation adjustments to our inventories if the cost of a specific product on hand exceeds the amount we expect to realize from the ultimate sale or disposal of the inventory. These estimates are based on management's judgment regarding future demand, age of inventory and analysis of historical experience. If actual demand or market conditions are different than those projected by management, future merchandise margin rates may be unfavorably or favorably affected by adjustments to these estimates.

Inventories are adjusted for the results of periodic physical inventory counts at each of our locations. We record a shrink reserve representing management's estimate of inventory losses by location that have occurred since the date of the last physical count. This estimate is based on management's analysis of historical results and operating trends.

We do not believe that there is a reasonable likelihood that there will be a material change in the future estimates or assumptions we use to calculate our lower of cost or market or shrink reserves. Adjustments to earnings resulting from revisions to management's estimates of the lower of cost or market and shrink reserves have been insignificant during fiscal 2014, 2013 and 2012. A change in the lower of cost or market reserve of 10% would have had no material impact on our pre-tax income for fiscal 2014. A change in the shrink rate included in the shrink reserve calculation of 10% would have had no material impact on our pre-tax income for fiscal 2014.

Vendor allowances

Source: ULTA most recent 10-K

ULTA's Inventory Accounting Not Common

- <u>ULTA's capitalization of purchasing costs to inventory is highly unusual</u>:
  - It is <u>not</u> a stated policy for 17 of the 18 competitors listed earlier (unclear on Sephora)

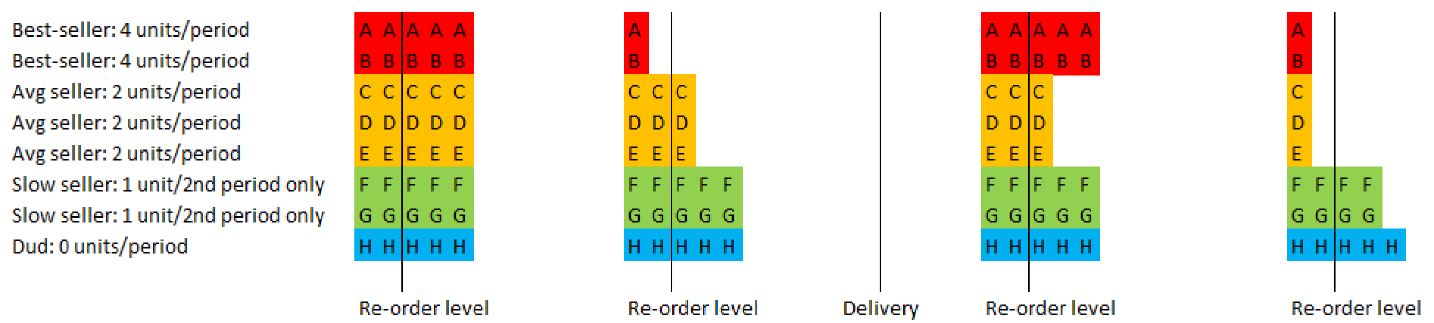
	Category	Sample Public Competitor	Capitalization of purchasing costs in inventory listed?
1	Department Store	Macy's	No
2	Department Store	Nordstrom	No
3	Department Store	Kohl's	No
4	Department Store	Dillard's	No
5	Department Store	J.C. Penney	No
6	Department Store	Sears Holdings	No
7	Department Store	Hudson's Bay	No
8	Specialty Store	Sephora	Not discussed by French conglomerate owner LVMH
9	Specialty Store	Sally Beauty	No
10	Specialty Store	Perfumania	No
11	Specialty Store	Bath & Body Works	No
12	Specialty Store	Bed, Bath & Beyond	No
13	Drug Store	CVS	No
14	Drug Store	Walgreens	No
15	Mass/Club	Walmart	No
16	Mass/Club	Target	No
17	Mass/Club	Costco	No
18	Salons	Regis	No
		ULTA	YES

Source: most recent 10-Ks on file with SEC or SEDAR (for HBC.TO). all accounting policy screenshots in.

Inventory Growth Is Not A "Given"

- While the "prevailing wisdom" is that inventory growth happens with sales growth, we challenge this assumption: inventory growth is not a given
- At the store level, <u>inventory growth below sales growth is entirely possible (and desirable)</u> as discrete items have vastly different velocities
- In the model below, we show how an inventory mix of items with different velocities, combined with a "safety stock" re-order point, can lead to increased same-store sales <u>and</u> lower inventory levels

Period 1 Start	Period 1 End	Period 2 Start	Period 2 End	What happened?
Price: $2 each	Sales: $28		Sales: $32	Same-store sales increased
Cost: $1 each	COGS : $14		COGS: $16	
Inventory: $40	Inventory: $26	Inventory: $34	Inventory: $18	Ending inventory is lower
Inventory: 40 units	Inventory: 26 units	Inventory: 34 units	Inventory: 18 units	



Source: Prescience Point estimates

ULTA Management Compensation Incentivizes Overbuilding

PRESCIENCE POINT

Compensation Structure Incentivizes Overbuilding

- In FY 08, management was compensated on ROIC and EBT
  - FY 08 ROIC misses the target
  - <u>Removed ROIC target in subsequent years</u>

> *In fiscal 2008, our bonus plan paid out based on EBT and return on invested capital (ROIC) targets weighted 70%-30% respectively. The compensation committee decided to change the bonus structure in 2009 based on input from Mr. L'Heureux and confirmed with Towers Perrin as to the trends in setting bonus targets in early 2009, recognizing the difficult economic environment at the time, especially for retail companies.*
>
> (Proxy Statement, 05/07/10)

Ulta ROIC Executive Compensation Target

	FY 08	FY 09	FY 10	FY 11	FY 12	FY 13	FY 14
Target	11.5%	--	--	--	--	--	--
Actual	6.7%	--	--	--	--	--	--
Surprise	(480 bps)	--	--	--	--	--	--

Compensation Structure Incentivizes Overbuilding

PRESCIENCE POINT

- Since FY 08, ULTA management has been compensated <u>solely on: adjusted EBT</u>
  - Peers typically use more than one metric to determine incentive compensation
- Management required to grow EBT at extremely high rates to receive bonus, demanding high rate of store base expansion
  - Compensation is highly dependent on growth while ignoring margins, earnings quality, and return on invested capital
  - Growth dependent compensation incentivizes additional store openings, potentially at detriment of business as a whole
  - Saturated store base will make adjusted EBT growth more difficult

Ulta EBT Executive Compensation Target

	FY 08	FY 09	FY 10	FY 11	FY 12	FY 13	FY 14
Target	69,672,000	47,000,000	94,000,000	167,600,000	271,600,000	360,800,000	384,653,000
Actual	42,358,000	63,700,000	118,000,000	195,600,000	279,800,000	327,700,000	411,300,000
Surprise	(39.2%)	35.5%	25.5%	16.7%	3.0%	(9.2%)	6.9%
Target growth	--	11.0%	47.6%	42.0%	38.9%	28.9%	17.4%

ULTA Has Low Executive Ownership

- ULTA management has <u>very low ownership</u>
  - CEO owns only 44,540 shares
  - CFO owns 23,887
  - Chief Merchandising Officer owns 14,674
  - Chief Human Resources Officer owns 11,446
  - Chief Marketing Officer owns 7,817
- Top five named executive officers own approximately <u>0.2%</u>
  - Based on 64.196 mm diluted shares in the latest 10-Q
- Majority of executive compensation/wealth comes from salary and bonus
  - Bonus dependent on EBT growth

- **<u>Lower ownership levels creates environment wherein management has no vested interest in the long term health of the business.</u>**

Source: ULTA most recent proxy; most recent 10-Q; September 2015 CEO Form 4

Competitors' Managements Are More Broadly Compensated

- ULTA's management comp based on only one metric, while long-standing and shareholder-approved, is <u>very unusual compared to the sample of 18 public competitors</u>

	Category	Sample Public Competitor	Management Compensation Based on a Single Metric?
1	Department Store	Macy's	No
2	Department Store	Nordstrom	No
3	Department Store	Kohl's	No
4	Department Store	Dillard's	No
5	Department Store	J.C. Penney	No
6	Department Store	Sears Holdings	For some NEOs (named executive officers)
7	Department Store	Hudson's Bay	For some NEOs
8	Specialty Store	Sephora	No
9	Specialty Store	Sally Beauty	No
10	Specialty Store	Perfumania	Not disclosed
11	Specialty Store	Bath & Body Works	No
12	Specialty Store	Bed, Bath & Beyond	No
13	Drug Store	CVS	No
14	Drug Store	Walgreens	No
15	Mass/Club	Walmart	No
16	Mass/Club	Target	No
17	Mass/Club	Costco	No
18	Salons	Regis	No
		ULTA	YES

Source: most recent proxies on file with SEC or SEDAR (for HBC.TO); Annual Statement for LVMH (Sephora)

It’s A Long Way Down

from Growth to Value

Analysts Are Completely Wrong on the ULTA "Growth Story"

Wall St. Views of ULTA		Prescience Point Views
"...core growth holding with a multi-year stor that is highly differentiated... unique combination of attractive category growth and favorable industry dynamics... double-digit unit expansion"	→	There is no shortage of options for purchasing cosmetics or hair care services. Management is incentivized for aggressive unit expansion, has already led to apparent saturation and cannibalization.
"These Numbers Are Even Better Than Good" (actual report title)	→	"These numbers" are substantially worse under the surface: SSS driven by cannibalization traffic, not ticket; rampant inventory growth; dropping GM per store
"...multi-year period of momentum exists... we think the multiple is justified..."	→	The multiple is not justified as ULTA is fast approaching even its own store potential guidance. Momentum will reverse as the "demographic dividend" of younger stores matures.
"...a view that EPS growth may be overly conservative..."	→	Near-term EPS growth driven by unsustainable bump in unit openings and inventory growth. Long-term growth in question with saturation and cannibalization.
"...assumptions in the financial model that yield $9+ in EPS power..."	→	Prescience Point does see $9+ in EPS in our "steady state" valuation. We also see it at a "no growth" 13.0x P/E, discounted back 4 years for a 42% downdside.
"...has more work to do in... improving inventory management..."	→	You think?

Source: Various Wall Street reports, Prescience Point research opinions

PRESCIENCE POINT

"Growth Story" Retail is the Wrong Comparable Group

- Wall Street loves ULTA:
  - Valuation-per-store is near all-time peak levels
  - Average price target of $192.44 (20% upside) and 13 BUY/9 HOLD/0 SELL ratings

- ULTA is bundled with a handful of growth retailers
  - These firms are generally much smaller in market cap and store base
  - These firms are growing store base high teens on avg, not just above 10% like ULTA

- ULTA IS NO LONGER A GROWTH COMPANY! In less than twelve months, ULTA will have opened 97.4% of its possible stores location based on its own initial guidance; further, based on our analysis, it has already hit a saturation point.

($ in billions)

				Enterprise Value/						
Name	**Ticker**	**Market Cap**	**Enterprise Value**	**LTM EBITDA**	**EBITDA FY1**	**EBITDA FY2**	**P/E**	**P/E FY1**	**P/E FY2**	**P/FCF**
Tractor Supply	TSCO	$11.2	$11.2	14.4x	12.7x	11.4x	27.8x	24.1x	21.1x	58.6x
Lululemon Athletica	LULU	$8.1	$7.7	17.9x	17.7x	15.3x	32.0x	32.2x	27.2x	242.8x
Cabela's	CAB	$2.9	$7.4	16.6x	15.8x	14.5x	15.2x	14.3x	12.8x	NA
Sprouts	SFM	$3.6	$3.7	13.1x	12.6x	11.0x	29.6x	28.0x	24.4x	44.3x
Five Below	FIVE	$1.9	$1.9	18.6x	16.2x	13.0x	38.0x	32.7x	26.1x	163.7x
Planet Fitness	PLNT	$1.4	$1.8	NA	15.3x	13.2x	NA	27.1x	23.1x	NA
Ollie's Bargain Outlet	OLLI	$1.2	$1.4	NA	16.0x	13.8x	NA	29.7x	27.4x	NA
Median for "Growth Story Comps"				**16.6x**	**15.8x**	**13.2x**	**29.6x**	**28.0x**	**24.4x**	**111.2x**
ULTA	ULTA	$10.1	$9.7	15.5x	14.8x	12.5x	34.2x	32.8x	27.8x	112.7x

Source: Bloomberg as of Friday Feb 12, 2016, Prescience Point estimates

We Believe ULTA has 47% Downside Assessed Against its "True" Comp Group

PRESCIENCE POINT

- ULTA will re-rate to true peer group as investors become aware of:
  - Store saturation, low quality store openings, and increased cannibalization
  - SSS reaches inflection point and revenue growth collapses
  - Inventory problems and reduced fixed cost leverage pressure margins
- **ULTA is not a growth company; we believe re-rate will be quick and PERMANENT**

($ in billions)

Name	Ticker	Market Cap	Enterprise Value	Enterprise Value/ LTM EBITDA	Enterprise Value/ EBITDA FY1	Enterprise Value/ EBITDA FY2	P/E	P/E FY1	P/E FY2	P/FCF
Wal-Mart Stores	WMT	$211.9	$260.4	7.5x	7.6x	8.1x	14.0x	14.5x	16.0x	13.4x
CVS Health	CVS	$105.3	$130.3	10.9x	9.9x	9.2x	19.8x	16.5x	14.6x	17.7x
Walgreens Boots	WBA	$83.2	$95.3	12.5x	10.9x	9.7x	16.9x	17.2x	15.3x	23.3x
Costco	COST	$65.4	$65.5	13.7x	13.1x	11.8x	28.5x	27.2x	24.2x	46.2x
Target	TGT	$43.1	$53.9	7.6x	7.4x	7.1x	15.0x	14.8x	13.5x	9.3x
L Brands (Bath&Body)	LB	$23.7	$28.2	11.2x	10.8x	10.1x	22.0x	21.0x	19.6x	26.1x
Macy's	M	$12.3	$19.8	5.3x	6.0x	6.3x	9.3x	11.2x	10.2x	10.3x
Kohl's	KSS	$7.8	$12.4	4.8x	5.0x	5.0x	9.5x	10.3x	9.6x	9.8x
Nordstrom	JWN	$9.0	$11.0	6.0x	6.3x	6.3x	13.4x	14.5x	13.8x	6.8x
Bed, Bath & Beyond	BBBY	$7.0	$8.0	4.7x	4.8x	5.0x	8.5x	8.5x	8.4x	9.0x
J.C. Penney	JCP	$2.1	$6.8	10.8x	10.4x	7.5x	NA	NA	NA	NA
Sally Beauty	SBH	$4.4	$6.1	10.0x	9.8x	9.4x	18.8x	17.6x	15.7x	25.4x
Hudson's Bay (Saks)	HBC.TO	$2.0	$5.1	9.9x	9.1x	7.8x	27.5x	32.2x	20.8x	NA
Dillard's	DDS	$2.5	$3.3	4.2x	4.5x	4.7x	8.9x	9.7x	9.4x	8.9x
Median for "True Comps"				**8.7x**	**8.3x**	**7.6x**	**15.0x**	**14.8x**	**14.6x**	**11.8x**
ULTA	ULTA	$10.1	$9.7	15.5x	14.8x	12.5x	34.2x	32.8x	27.8x	112.7x

Price Target on FYE Jan 2017 P/E: $84 per share (47% Downside)

Source: Bloomberg, Prescience Point estimates; SHLD not used due to negative metrics; RGS and PERF due to micro cap size and LVMH (Sephora) due to Sephora's small size relative to the conglomerate

Conservative "Steady-State" Model Points to Intrinsic Value Implying 42% Downside

- <u>ULTA has 42% downside at its 1,200 store potential even given generous assumptions</u> about "steady state" sales per store, ecommerce growth, and margins
  - Prescience Point believes that 1,200 stores is unrealistic, while margins will decline from inventory pressures and ecommerce penetration
  - 13.0x "steady state" EPS multiple based on a small discount from the 14.8x F P/E of true comps

ULTA "Steady State" Financials		
	Assumption	Notes
Steady-state year	FYE Jan 2020	
Steady-state store count	1,200	Guidance: 1,200 potential at 100 per year, from 874 est as of Jan 2016
Sales per store (mm)	$5.44	FYE Jan 2015 sales per avg store of $4.47 mm, growing at 4% for 5 years
Store revenues (mm)	$6,532	
Ecommerce revenues (mm)	$726	10% of total sales as LT target
Total revenues (mm)	$7,258	
EBIT Margin	14.0%	Last 3 FY: 12.7%, 12.3%, 12.6%
EBIT (mm)	$1,016	
Tax rate	39.0%	In-line with LT average
Net income (mm)	$620	
Share count (mm)	60	Down from 64 mm last Q
EPS FYE Jan 2020	$10.33	

ULTA "Steady State" Valuation								
		"Steady State" EPS Multiple						
		10.0x	11.0x	12.0x	13.0x	14.0x	15.0x	16.0x
Cost	7.0%	$77.27	$85.00	$92.73	$100.46	$108.18	$115.91	$123.64
of	9.0%	$70.84	$77.92	$85.01	$92.09	$99.17	$106.26	$113.34
Capital	11.0%	$64.81	$71.29	$77.78	$84.26	$90.74	$97.22	$103.70

Price Target on Steady State Valuation: $92 per share (<u>42% Downside</u>)

Source: Prescience Point estimates

Valuation-Per-Store Has Skyrocketed Despite Store Count Closer to Potential, Store Quality Deterioration

- Paradoxically, ULTA's market cap per store has quadrupled since 2010 despite its store base so much closer to saturation

ULTA Market Cap per Store							
	FYE Jan/Feb 2010	FYE Jan/Feb 2011	FYE Jan/Feb 2012	FYE Jan/Feb 2013	FYE Jan/Feb 2014	FYE Jan/Feb 2015	FYE Jan/Feb 2016
Share price on Jan 30/31/Feb 1	$19.57	$36.63	$75.31	$97.82	$85.71	$131.94	$180.57
Diluted share count	59,237	61,288	63,334	64,396	64,461	64,651	64,196 Q3
Market Cap	$1,159,268	$2,244,979	$4,769,684	$6,299,217	$5,524,952	$8,530,053	$11,591,872
Store count	346	389	449	550	675	774	874 est
Market cap/store	$3,350	$5,771	$10,623	$11,453	$8,185	$11,021	$13,263

Source: Prescience Point estimates

Several Recent Major Disappointments from Retail "Growth Story" Stocks

- Similar retail "growth story" stocks have disappointed investors in the recent past when the "growth story" sputters

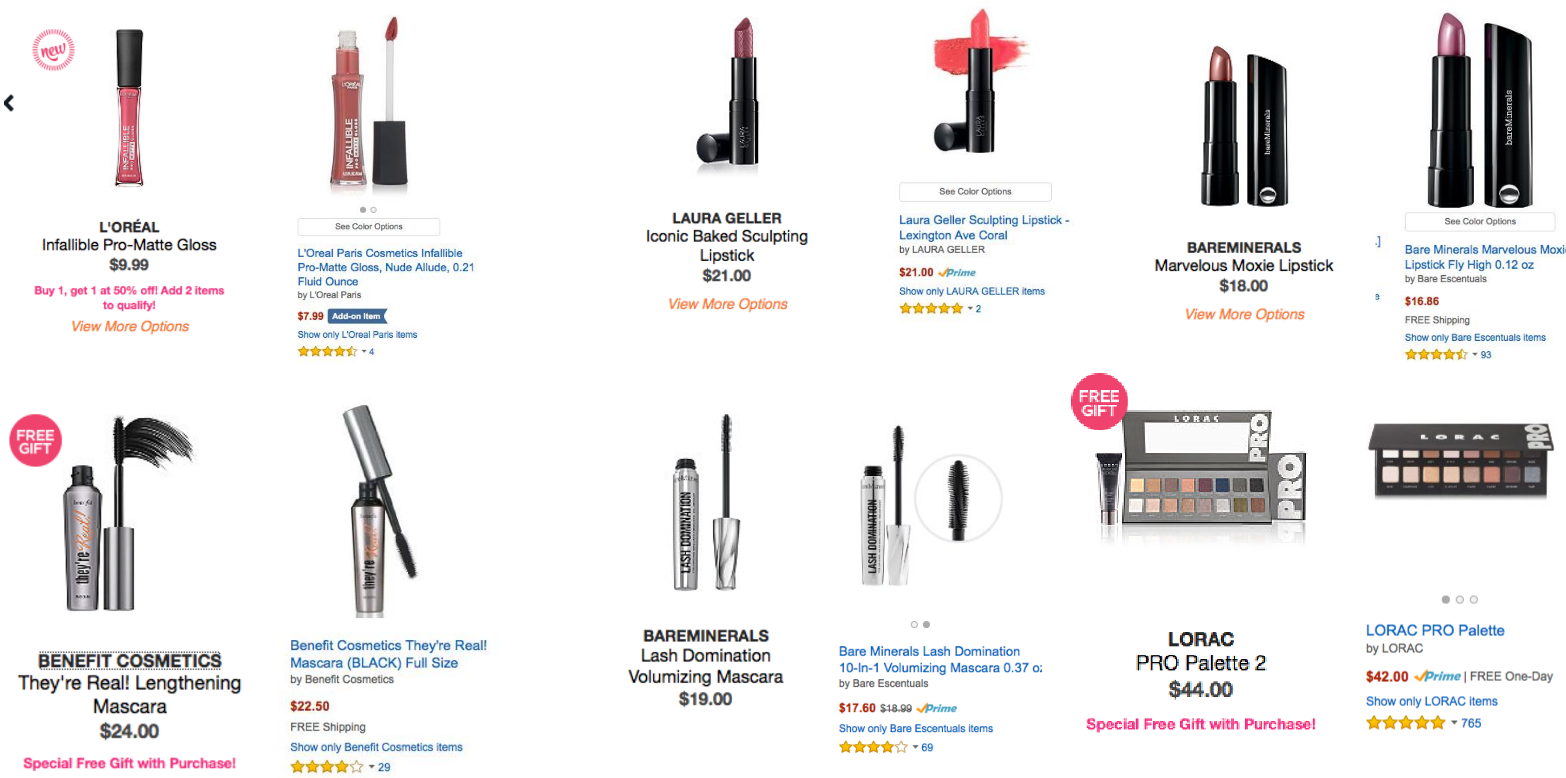
Ticker	Company Name	IPO	Post-IPO High	Month-end Jan 2016	Drop
KORS	Michael Kors Holdings Limited	2012	$101.04	$39.90	(61%)
TCS	The Container Store Group, Inc.	2013	$47.07	$4.32	(91%)
VNCE	Vince Holding Corp	2013	$39.08	$5.17	(87%)
VRA	Vera Bradley, Inc.	2010	$39.48	$14.78	(63%)
DTEA	DAVIDs TEA Inc.	2015	$29.97	$9.30	(69%)
FRPT	Freshpet, Inc.	2014	$25.92	$5.94	(77%)
PBPB	Potbelly Corporation	2013	$33.90	$10.70	(68%)
NDLS	Noodles & Company	2013	$51.97	$12.04	(77%)
LOCO	El Pollo Loco Holdings, Inc.	2014	$41.70	$12.12	(71%)
Median "Growth Story" stock drop from high					**(71%)**

Source: Prescience Point estimates

Appendix

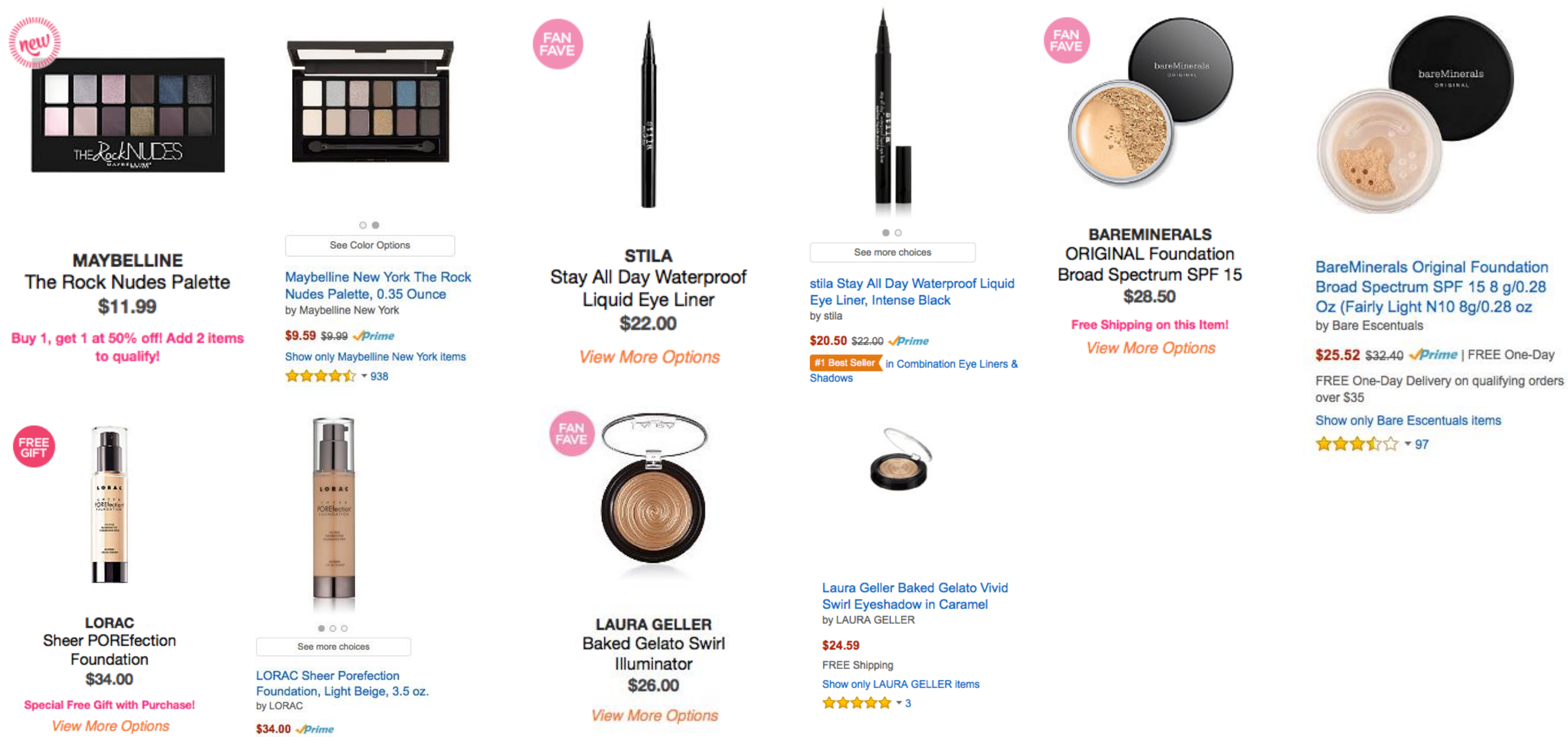
PRESCIENCE POINT

Price comparisons: ULTA vs AMZN



Source: company websites accessed via desktop browser

Price comparisons: ULTA vs AMZN



Source: company websites accessed via desktop browser

Price comparisons: ULTA vs AMZN

SEBASTIAN

Drench Shampoo

33.8 oz

Item #: 2273986

$38.00

Buy 2, get 1 FREE! Add 3 items to qualify!

4.6

Read 88 Reviews | Write a Review

Ask a Question

ADD TO FAVORITES

Qty: 1 ADD TO BAG

Sebastian Drench Moisturizing Shampoo, 33.8-ounce Dec 14, 2010

by Sebastian

$21.99 ($0.65/Ounce) ~~$39.89~~ Prime | FREE One-Day

Get it by Tomorrow, Jan 31

More Buying Choices

$19.60 new (26 offers)

46

FREE One-Day Delivery on qualifying orders over $35

Product Features

... *Drench* Shampoo's rich lather cleanses and provides intensive nourishment ...

Beauty: See all 29 items

REDKEN

Body Full Shampoo

10.1 oz

Item #: 2109239

$15.50

On sale 2 for $25. Excludes Large Sizes. Discount applied in cart!

4.3

Read 294 Reviews | Write a Review

ADD TO FAVORITES

Qty: 1 ADD TO BAG

Redken Body Full Shampoo 10.1 oz Nov 18, 2006

by Redken

$15.41 ($1.53/Fl Oz)

More Buying Choices

$9.98 new (24 offers)

75

FREE Shipping

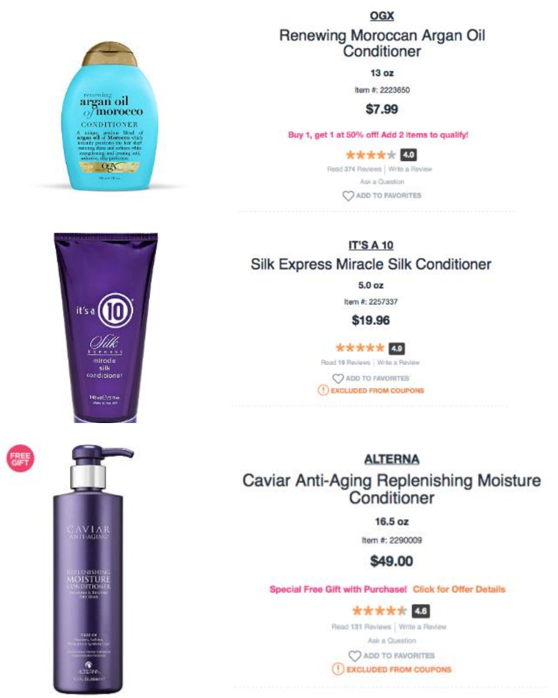
Product Features

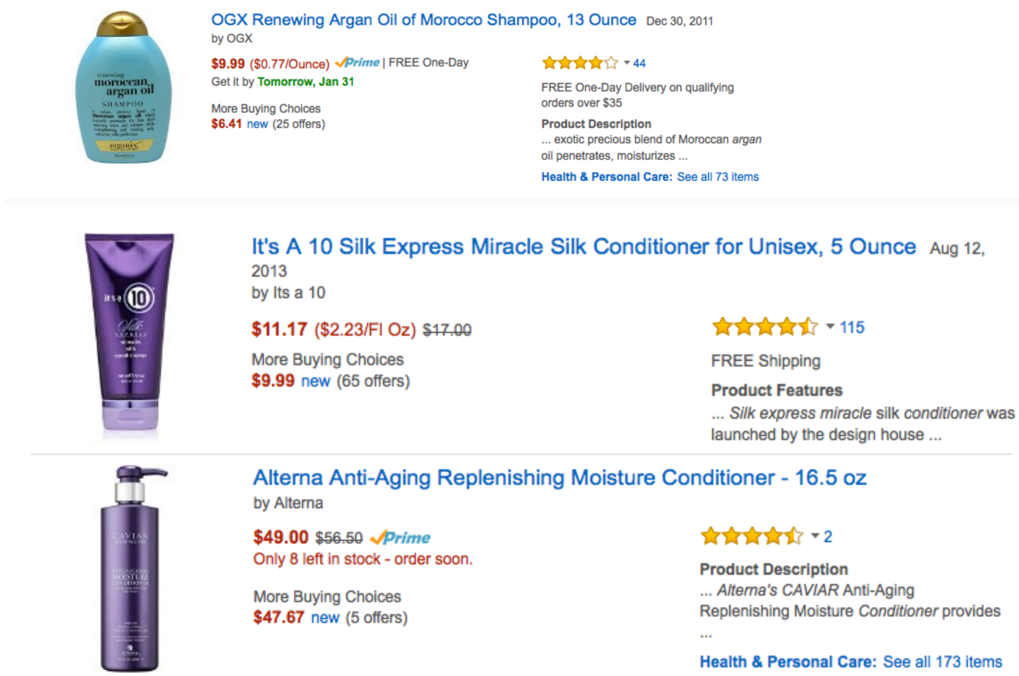
Design House: *Redken*

Health & Personal Care: See all 24 items

Source: company websites accessed via desktop browser

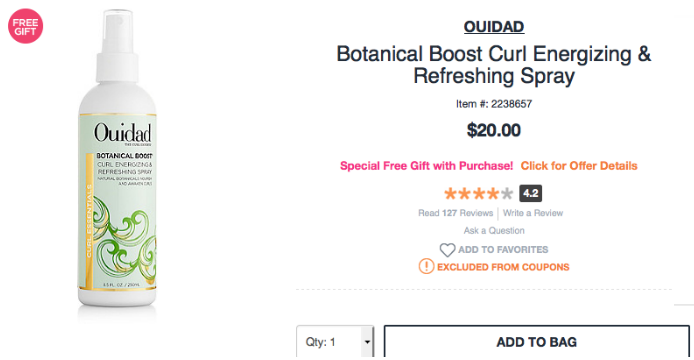
Price comparisons: ULTA vs AMZN

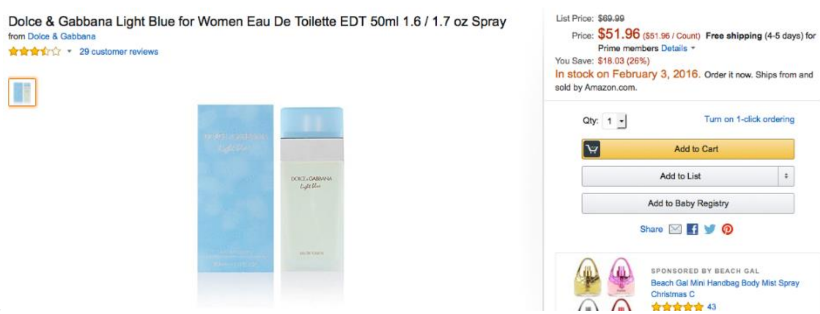




Source: company websites accessed via desktop browser

Price comparisons: ULTA vs AMZN

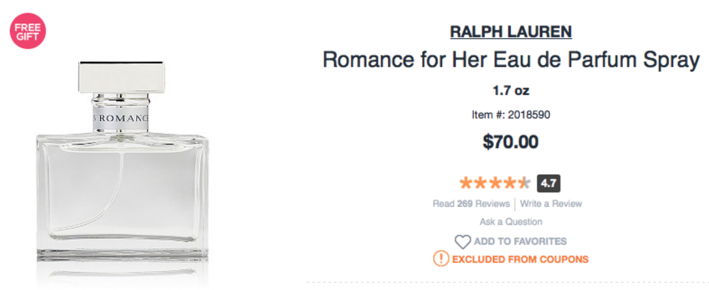


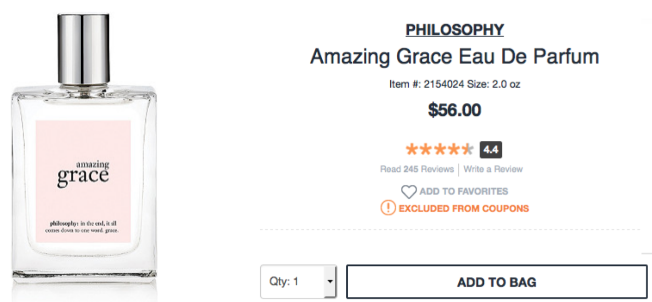


Source: company websites accessed via desktop browser

PRESCIENCE POINT

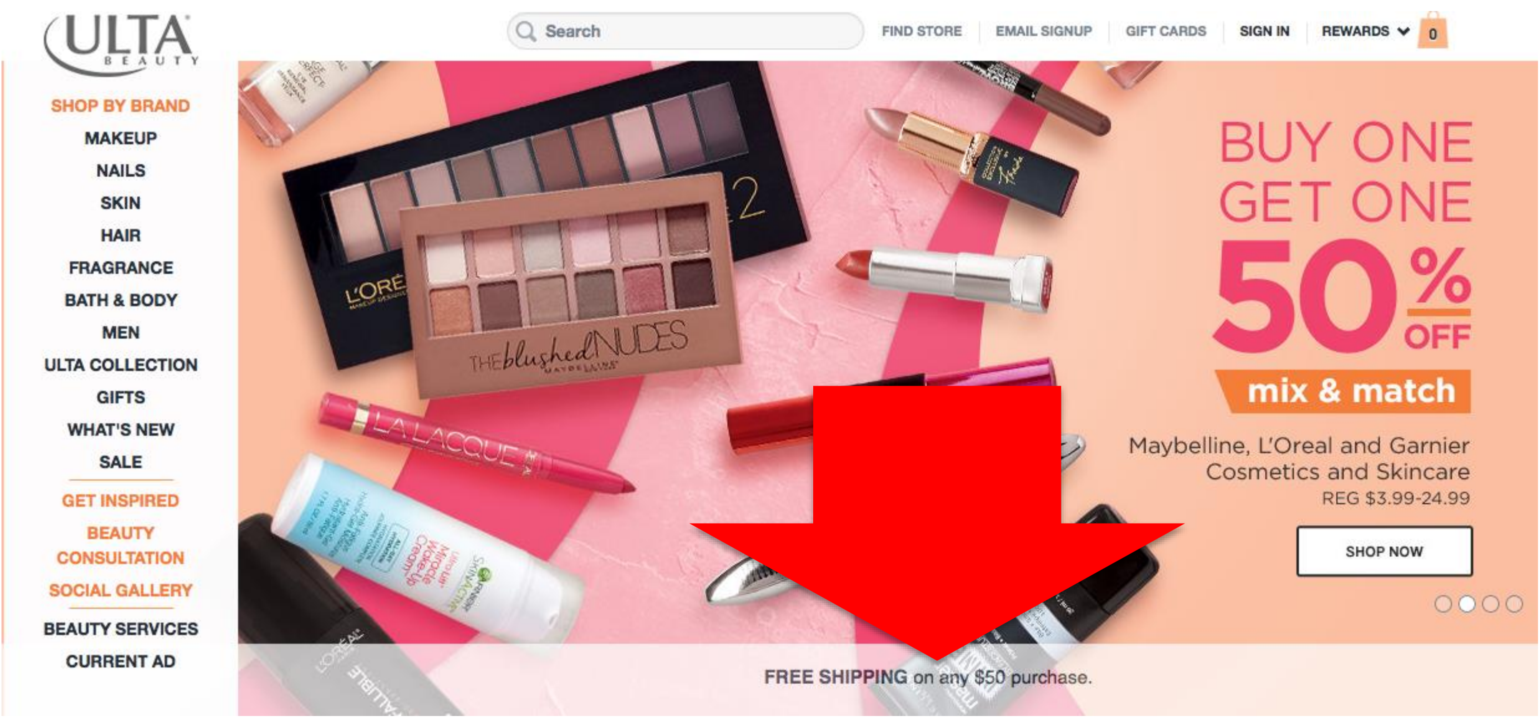
Price comparisons: ULTA vs AMZN





Source: company websites accessed via desktop browser

Price comparisons: ULTA vs AMZN



Source: company website accessed via desktop browser