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Kristene Quan/ MEDILL

Ulta's State Street store offers customers a wide selection of beauty and fragrance products as well as a salon.

Experts see continued growth for beauty retailer Ulta

by KRISTENE A. QUAN

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Ulta Salon, Cosmetics & Fragrance Inc. has been one of the standout retail success stories of the past two years.

Its formula of offering beauty brands at discount prices has struck a chord with women looking for bargain cosmetics and skincare during the recession. Ulta has been expanding rapidly in the United States, opening 116 stores in the past two years.

"I love Ulta. I always shop there," said Sicura Beal as she exited Ulta's State Street store recently. "I feel like it's the best of both worlds where it has the high-end products like at a Sephora and the low-end products found at a drugstore like Walgreens."

Rapid expansion has been the undoing of many retail chains. It strains financial resources and spreads managerial talent thin.

But so far, experts say Ulta isn't giving off any danger signals yet.

"They haven't lost control, they've been able to attract good people, and it hasn't strained their management or their resources," said Howard Davidowitz, chairman of Davidowitz & Associates Inc., a New York retail consulting and investment banking firm.

So the question is how long can Ulta keep it up?

At the end of October, the Bolingbrook-based company operated 442 stores in the U.S., 35 of them in Illinois. Ulta has identified 1,000 locations in the U.S. for its current 10,000-square-foot prototype store, excluding possible international locations and smaller, urban store formats.

Executives told analysts in early January that they plan to accelerate Ulta's growth to the high end of their 15 to 20 percent long-term target in 2012, which means up to 87 new stores.

Wall Street appears to be on board. Ulta's shares are at an all-time high of more than \$87 and are trading at a lofty price-earnings ratio of about 53.

Of the 11 analysts following Ulta surveyed by Bloomberg LP, seven have a buy recommendation on the retailer's shares. The remaining four analysts recommend holding the retailer's stock. No analyst has a sell on the shares.

"It's growing much faster than the overall economy," said Daniel Hofkin, an analyst at William Blair & Co., one of the analysts with a buy rating.

"If you think about earnings growth overall for the market over time, it's something like 7 to 8 percent. Ulta is growing the next few years probably north of 25 percent. So, it's growing at least three times as fast as the broader U.S. stock market earnings," he stated.

Ulta markets itself as a discount beauty retailer that offers customers the best of both a beauty superstore and a specialty store. The company went public in fall 2007, right as the stock market hit its peak.

When the financial crisis hit, Ulta's sales growth slowed and its earnings declined. But Hofkin said that the chain's falloff was "not worse than the overall consumer spending."

Overall, the beauty business tends to be relatively recession-proof, retail experts say.

"There are discretionary aspects – fragrance is discretionary – meaning that it can be impacted in a bad economy; spending falls. Some things are less discretionary like basic makeup," he said. "Their category did show resilience. There were still the core aspects of their stores during this time, which helped it."

Ulta did slow its store growth down when the economy nosedived, which helped to generate more free cash flow. "They were still opening 10 percent of stores each year, whereas in their peak of 2006 to 2007 – the end of the economic expansion – they were doing 25 percent or more," Hofkin said. "They didn't want to take anything for granted. They slowed things down and now they're picking up."

The beauty retailer has high expectations for its continued growth. Ulta management told investors and analysts in early January that it can achieve 25 to 30 percent annual net income growth over the next several years with an increase of 3 to 5 percent in its annual comparable-store sales – revenues from stores open at least one full year.

Analysts expect Ulta to post sales of \$1.7 billion when it files its 2011 fiscal year results Thursday, a 21.7 percent increase from \$1.5 billion a year ago. They project sales this year will continue rising at nearly the same rapid rate, to \$2.1 billion.

"I think if you were to look across a range of companies that have generated the kind of growth that Ulta has, I would think that very few people are estimating that that same rate of growth would continue, or at least estimate it officially," Hofkin said.

Analysts at William Blair actually believe Ulta will do better than its 2012 earnings projection of \$2.35 per share and have revised their forecast for the retailer's annual earnings per share growth to 25 percent from 20 percent. Ulta earned \$1.16 per share in fiscal 2011. Analysts surveyed by Bloomberg are projecting Ulta will earn \$1.85 per share in 2012.

Despite possible competition from drugstore giant Walgreen Co.'s LOOK boutiques, experts believe Ulta has a competitive advantage that will continue to contribute to the company's growth: salons. Ulta customers can book appointments for everything from haircuts to chip-free manicures.

"Without the salons they're competing head-to-head with a company like Sephora. I think it gives them an edge to have the salons," said Keven Wilder, owner of Chicago retail consulting firm Wilder Inc.

This year, Ulta plans to broaden its marketing efforts in order to drive more traffic to its stores.

"While print media (direct mail, catalogs, newspaper inserts) has been highly effective at driving traffic, the company has begun shifting spending into digital media (paid search and online partnerships), broadcast and email marketing" said Erika K. Maschmeyer, an analyst at Robert W. Baird & Co., in a recent note.

Ulta's President and CEO, Chuck Rubin told analysts in December that the retailer is working to grow its e-commerce site: "We strive for 100 percent up time and that's what we'll work towards. I think as many of our competitors and many other retailers in general experienced, there's some things you can continue to learn through the expansion of the online business."

Ulta management's decision to enhance ULTA.com is to "make it an authority on beauty trends in order to drive traffic to stores, in addition to driving substantial revenue growth," wrote Maschmeyer. However, revenues from Ulta's website has "low single-digit penetration."

Hokin says that Ulta is not "doing a great deal of product sales online." Rather the company is focused on creating a community space for consumers and beauty experts.

Wilder adds that ULTA.com does not set the company up as being a "beauty authority," and says there was a disconnect between Ulta's online presence and its actual stores.

"This site is really promotional. It looks like a drugstore flyer," she commented. "It doesn't appear like it has the same cachet as they have in their stores."

Moving forward, Ulta's challenge will be converting online traffic into actual sales. Although the company plans to focus on enhancing customers' experience with ULTA.com by providing online editorial content as a beauty resource, Wilder believes the retailer should put a greater emphasis on garnering revenue online.

"A customer is going to shop wherever they want to shop. You should be driving sales in both directions," she said.

As for expanding internationally, William Blair's Hofkin does not foresee Ulta heading in that direction within the next few years.

"I don't expect them to do it until it makes sense for them to from the standpoint of really having identified a viable growth opportunity," he said. "For the time being I think there's just so much opportunity to grow in the United States."



