ANA CRISTINA DE PAZ HASTEDT

Incorporated in 1990, Ulta is an American company that operates exclusively in the United States. It is part of the specialty retail industry, selling products such as cosmetics, fragrance, haircare, and skincare. It also offers salon, makeup, brow, and nail services, within their stores. Products are distributed through their stores, website, and mobile applications. It offers over 25,000 products from more than 600 brands, including its own brand, Ulta Beauty Collection. The diversity of products includes not only prestige but also mass cosmetics, which allows for a variety of price points. In August 2021, Ulta offered some of its products, within Target stores, with whom it made a long-term partnership. As of January 28th, 2023, its products were available in over 350 Target locations. It has acquired two companies, in order to maintain its competitive advantage.

For January 28th, 2023, net sales were attributed to each category:

Category	Percentage of net sales
Cosmetics	42%
Haircare products and styling tools	21%
Skincare	17%
Fragrance and bath	14%
Services	3%
Accessories and other	3%
	100%

The company has a loyalty program: Ultamate Rewards, which enables members to earn points for every dollar spent on products and beauty services, including purchases at Ulta Beauty at Target. It is estimated that 95% of their sales come from members, and 76% of these members purchase in physical stores. This is why it has 1,355 stores across the United States. However, they have also grown the business through their digital platform. Data shows that 17% of their members buy in-store and through the digital platform, but these omnichannel clients spend nearly three times as much as retail-only guests.

It has acquired two companies, in order to maintain its competitive advantage. The first is QM Scientific, which provides an intelligent platform through learning shopping habits, and creating customized shopping lists. It also acquired Glam St, an augmented reality technology for beauty. This allows customers to try the products and see if shades of color match skin color, by only using their camera.

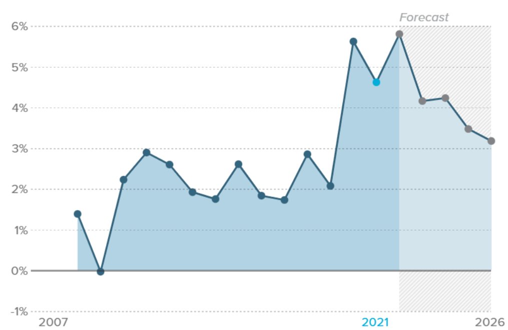
Industry

Ulta Beauty belongs to the Consumer Discretionary sector, selling non-essential products and services, which means it is affected by economic cycles. It is also subject to seasonal fluctuation; thus, significant portions of sales and profits are realized in the fourth quarter of the fiscal year (during the holiday season).

As mentioned above, Ulta has a wide range of products, that include not only premium brands, but also mass beauty and personal care. This is especially beneficial since growth in both types of products behave differently. As shown in Euromonitor, sales performance has been historically different and is expected to continue as such.

Graph 1: Sales Performance of Mass Beauty and Personal Care

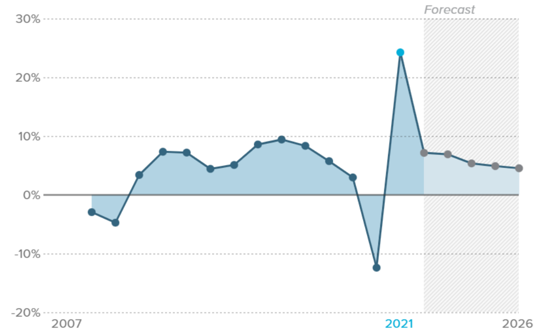
The following graph shows year-over-year retail selling price growth from 2007 to 2021, and a forecast from 2022 to 2026.



As shown in the previous graph, growth was expected to reach its peak in 2022, and then decrease to 3.2% in 2026.

Graph 2: Sales Performance of Premium Beauty and Personal Care

The following graph shows year-over-year retail selling price growth from 2007 to 2021, and a forecast from 2022 to 2026.



As shown in the graph, growth reached its peak in 2021, and is expected to decrease to 4.5% in 2026.

Market Share (U.S.)

The beauty product industry has a market size of about $104 billion in sales, from which Ulta has a share of 9%. Additionally, the salon services industry is about $68 billion in sales, and the company has a 1% share of this market. According to McKinsey, the beauty services market is highly fragmented.

Consumer Preferences

Euromonitor also surveyed North American Respondents on the factors that influenced their most recent skin care purchase. The top five factors were:

- Previous personal experience
- Information/recommendations from friends or extended family
- Online user reviews, communities, or forums
- Dermatologist endorsement
- Social networking site

Intrinsic Valuation

Discounted Cash Flow

A two-stage free cash flow to firm model was used to value Ulta Beauty with an initial high growth period from year 1 to year 5 which gradually decreases to the risk-free rate of the US economy. Below is an analysis of Ulta's competitive advantages that backs up the underlying assumptions used in the valuation.

The main competitive advantage of Ulta is its brand name. As mentioned before, it operates in a highly fragmented (competitive) industry, but clients have shown loyalty towards the brand. This is mainly because:

- **Loyalty Program:** It works as a tier system. This means that the more the client spends on Ulta, it can have a premium membership, with the possibility of earning more points per dollar spent. This works as an incentive for clients to continuously spend more. The second is it lets the client decide on what products it wants to redeem its points on. This is an important differentiator, since other big retailers offer limited options on which to redeem points, or only give away free samples.
- **Omnichannel experience**: It focuses on in-store experience by remodeling and having strategic locations, but also on its website. The acquisitions of QM Scientific, as well as Glam St, has enabled the brand to improve online experience. Both channels and the fact that it has multiple brands (premium and mass) makes Ulta an accessible all-in-one retailer.

Below are some key assumptions regarding the sustainability of the competitive advantages and how this affects the value drivers:

- **Revenue growth:** Ulta grew significantly in 2021, after the recovery of pandemic. That growth rate stabilized during 2022, however, it is considered to be high compared to historical levels. In order to make revenue growth stabilize, industry revenue growth is assumed for next year. CAGR for the last five years was 11.6%, which is why revenue from years 2-5 is expected to be 11%. At year 5, growth rate decreases until risk-free rate is reached in year 10. Growth rates were not high because of the highly competitive market: it is assumed that market share won't have a significant change after 10 years.
- **Operating margin**: Margins have been improving, from 13% to 16% in the last year. These efficiencies are expected to continue for the next year. However, it is expected that for year 5 it will reach again 13%, reflecting the persistence of its competitive advantages (mainly brand name) through time. The reason it is not kept at the 16% level is because of the high competition in the market.
- **ROIC:** Historically, Ulta has shown ROIC above 35%. It is assumed that a high ROIC will be maintained because of a strong brand name, which translates to margins above industry averages. For year 10, ROIC is expected to be around 38.35%. It is also assumed that because of the persistence of its competitive advantages, ROIC in perpetuity is expected to be around 20%, which is more than 5% of its cost of capital in the long-term

Discounted Cash Flow Valuation

Numbers

All figures in USD millions except per share figures

Particulars	Current	Year 10
Revenues	10,208.58	24,042.51
Operating margin	16.06%	13%
Operating income	1,639.50	3,125.53
Tax rate	24.41%	25%
After-tax operating income	1,239.30	2,344.14
Reinvestment (Sales to Capital ratio)	6.00	3.26

<-- decline over time but still in 3rd Quartile of Retail (Special Lines) Industry

Particulars	1	2	3	4	5	6	7	8	9	10
Invested Capital	3,340	3,575	3,837	4,127	4,638	5,110	5,523	5,863	6,112	6,371
Revenues	11,568	12,841	14,253	15,821	17,562	19,230	20,769	22,120	23,228	24,043
EBIT * (1-t)	1,399	1,437	1,530	1,626	1,726	1,887	2,035	2,164	2,268	2,344
Reinvestment	212	235	261	290	511	472	414	339	250	258
FCFF	**1,187**	**1,201**	**1,269**	**1,336**	**1,214**	**1,415**	**1,621**	**1,824**	**2,019**	**2,086**
Cost of capital	9.08%	9.08%	9.08%	9.08%	9.08%	9.05%	9.03%	9.00%	8.97%	8.95%
Cumulative cost of capital	0.92	0.84	0.77	0.71	0.65	0.59	0.54	0.50	0.46	0.42
Present Value	**1,088**	**1,009**	**977**	**944**	**786**	**840**	**883**	**911**	**926**	**878**

Cost of Equity
9.41% *(w=94.69%)*

Cost of Debt
3.15% *(w=5.31%)*

Risk-free rate
3.51%

Beta
1.24

Unlevered Beta 1.19

Equity Risk Premium
4.77%

Rating	AAA
Risk-free rate	3.51%
Default spread	0.69%
Tax rate	25%
Pre-tax cost of debt	4.20%

Stable growth	
Growth	3.51%
Return on Capital	20%
Reinvestment rate	17.54%
FCFF	2,000.79
Cost of capital	8.95%
Terminal Value	36,779

Valuation	
PV of high growth	9,243
PV of terminal value	15,479
Value of operating assets	24,722
Cash	738
Debt	1,903
Value of Options	117
Value of Equity	23,440
No. of shares	50.2
Value per share	466.97

Stock Price: $513.61
Strike Price: $260.34
No. Of options: 324,000
Maturity: 7 years
St. Dev.: 49%
Risk free rate: 3.51%

This analysis gives a value of USD 466.97 per share as against the current market price of USD 513.61. Thus, the equity shares are overvalued by 9.98%. Since it is not highly overvalued the recommendation is to **HOLD.**

It is important to assess how sensitive is Ulta's value to changes in inputs, especially in revenue growth and operating margin.

Operating margin	Revenue growth				
	5%	**7%**	**9%**	**11%**	**13%**
10%	279.72	303.38	329.14	357.17	387.64
12%	333.65	363.16	395.34	430.37	**468.49**
14%	387.59	422.95	**461.53**	**503.57**	549.34
16%	441.52	482.74	**527.72**	576.77	630.19

It can be concluded that the market price implies higher margins, and not necessarily higher revenue growth rates. This is especially interesting since the median operating margins from the Retail (Special lines) industry is 6.08%.

In my view, sustaining such high margins through time is improbable, especially for the competitive market it operates in.

Relative Valuation

14 companies were shortlisted as comparable using data from S&P Capital IQ. The criteria used was:

- Industry Classifications: Online Personal Care Product Retail or Personal Care Product Stores
- Geographic locations: United States of America
- Company Type: Public Company

Given the importance of operating margins in this industry, EV/Sales was chosen as the multiple of analysis.

Variables selected for the regression were:

- EBIT Margin
- Beta
- Payout ratio
- Expected growth (next 5 years)

The regression equation and the relevant statistics are provided below:

$$EV/Sales = 1.46 + 0.10(EBIT\ margin) - 1.24(Beta) + 4.31(Payout\ ratio) + 7.94(Exp.\ growth)$$

Regression Statistics	
Multiple R	**81.08%**
R Square	**65.75%**
Adjusted R Square	**50.52%**
Standard Error	**1.00**
Observations	**14.00**

	Coefficients	Standard Error	t Stat	P-value	Lower 95%	Upper 95%	Lower 95.0%	Upper 95.0%
Intercept	1.46	1.16	1.26	0.24	(1.16)	4.08	(1.16)	4.08
EBIT margin	0.10	0.07	1.52	0.16	(0.05)	0.25	(0.05)	0.25
Beta	(1.24)	0.66	(1.87)	0.09	(2.73)	0.26	(2.73)	0.26
Payout	4.31	1.23	3.51	0.01	1.53	7.08	1.53	7.08
Exp growth	7.94	3.69	2.15	0.06	(0.41)	16.29	(0.41)	16.29

The T-stat suggests that payout and expected growth are significant variables, and EBIT margin and Beta were close to being significant.

Plugging Ulta's numbers in the regression gives a predicted EV/Sales ratio of 2.43 as against an actual EV/Sales ratio of 2.42. This suggests that Ulta is fairly priced.

The regression yields an equity value of USD 468.62 per share, after adjusting for debt, cash and value of options. The slight overvaluation of 9.6% is not significant, which is why it is recommended to treat the shares as fairly priced (relative to companies in the sample).

Thus, the recommendation is to **HOLD.**

Recommendation

Both the intrinsic valuation and pricing metric suggest that Ulta is a HOLD. The discounted cash flow value of Ulta is USD 466.97 vs a current market price of USD 513.61. Based on this, it is recommended to **HOLD**. This means that the assumptions used in the valuation do not differ significantly from what the market is assuming, the most important ones being operating margin and revenue growth.