

The Business Case for Diversity

ULTA BEAUTY BROKE INTO THE FORTUNE 500 THIS YEAR THANKS TO A DIFFERENTIATED BUSINESS MODEL AND A RARE APPROACH TO GENDER DIVERSITY. > By Mike Troy

In her nearly five years as President and CEO of Ulta Beauty Mary Dillon has led her company to some impressive accomplishments. On her watch, Ulta's store count has more than doubled to nearly 1,100 units, sales have nearly tripled to \$5.9 billion and e-commerce sales have grown from \$96 million to \$569 million. The growth has been profitable too with net income up 221 percent to \$555 million compared to the fiscal year ended prior to Dillon's arrival as CEO in July 2013. Shareholders have rewarded Ulta's financial performance with a stock price that has increased roughly 160 percent — triple the S&P 500 return during the comparable period — even after Ulta shares pulled back about \$50 after topping \$300 last summer.

The success is due to a differentiated business model that promises “all things beauty, all in one place,” a nationwide network of stores located off the mall and well-positioned to gain share in a fragmented market, and a popular loyalty program that will surpass 30 million members this year. However, no assessment of Ulta's success is complete without recognizing that the company is a true outlier in the retail industry and larger business world.

For starters, Dillon entered an exclusive club this year when she became one of the approximately 5 percent of female executives to lead a Fortune 500 company. In addition, more than 90 percent of Ulta's 37,000 employees are women and during the past five years the company's growth has enabled it to promote 6,000 women to management roles. The predominance of women in store associate positions is understandable given Ulta's merchandise assortment, salon services offering and mostly female customer base. More noteworthy then is the composition of Ulta's board and C-suite. Sixty percent of Ulta's corporate officers are women, 50 percent of Dillon's 55 person senior leadership team is female and 50 percent of the retailer's 12 member board are women.

If ever there were a case study for gender diversity, Ulta Beauty is it. However, having a female CEO and gender parity among the board and senior executives doesn't guarantee success. Ulta has a rock solid strategy

and highly differentiated approach to serving the U.S. beauty market.

“We use the phrase all things beauty all in one place for a reason. We have the largest collection of beauty categories, brands, products and price points that you can get anywhere,” Dillon said earlier this year during a presentation at Shoptalk. “Beauty is a great place to be and we are in an industry that is always going to be important to peoples' lives.”

Ulta could be just getting started despite its impressive performance to date. The company contends it has only about a 4 percent share of a highly fragmented market valued at \$138 billion. Ulta's share of the \$82 billion beauty products segment is 6 percent and in the \$56 billion salon services segment that is even more fragmented it has only a 1 percent share, according to the company.

FOUNDATION FOR GROWTH

Ulta was founded in 1990 as a discount beauty retailer at a time when prestige, mass and salon products were sold through distinct channels. Nine years later, Ulta got its first female CEO when Lyn

Kirby joined the company and began executing the “all things beauty, all in one place,” strategy, although it was not called that at the time. When Kirby left Ulta in 2010, former Office Depot executive Chuck Rubin was named CEO in September 2010. He was in the role for only 18 months before leaving to become CEO of Michaels Stores. That led Ulta to Mary Dillon who was serving as CEO of U.S. Cellular at the time. Hiring an executive from a wireless carrier might have seemed an odd choice, but the bulk of Dillon's career previously had been spent in retail and consumer goods roles. Prior to U.S. Cellular, she was global chief marketing officer for McDonalds and prior to that was president of PepsiCo's Quaker Foods division. She had also served on the Target board beginning in 2007.

Dillon may not have conceived of the “all things beauty, all in one place,” strategy, but she has taken execution of the distinctive value proposition



< Mary Dillon, CEO of Ulta Beauty

FRAGMENTED MARKET = GROWTH OPPORTUNITY

Ulta Beauty plays in the specialty beauty segment and currently has a 4% share of market valued at \$138 billion.



SOURCE: Euromonitor International. "Beauty and Personal Care in the US." April 2017

to a new level. Ulta routinely adds new brands — including its own — at the low end and the high end to deepen its appeal to core customers referred to as beauty enthusiasts. With such a wide-ranging product offering the company is never overexposed to weakness in any particular area or hot trend.

Dillon has pushed Ulta aggressively into digital as well and like many retailers reports that omnichannel customers are its most valuable, spending the most and staying sticky to the brand. Last year was Ulta's best ever digital performance with sales up 65 percent to \$569 million accounting for roughly 10 percent of total company sales. Those sales are largely incremental too, according to the company.

The biggest advantage in Ulta's arsenal is a loyalty program called Ultimate Rewards. The year prior to Dillon's arrival the program had 10 million members, but has since exploded to more than 30 million this year. Ulta makes signing up easy since anyone who makes a purchase can join without having to open a credit account, although that option is available. Late last year, a new "diamond" tier was added to recognize customers who spend more than \$1,200 annually — which isn't hard to do in the beauty category — who then earn rewards at a higher rate similar to how most airline and hotel programs reward their most loyal customers.

"We have a great loyalty program that provides tremendous opportunity. The customer expects you to use the data they provide to develop very personalized interactions and experiences with them. The customer is happy giving the data if they get value in return," said Eric Messerschmidt, Ulta's Senior Vice President Strategic Marketing, CRM and Loyalty who also spoke at Shoptalk. "If you want to have a relationship, you better recognize the guest's birthday, her anniversary with the program and when a new product comes out that you think she might be interested in you want to tell her about it and also put the right samples in her bag to surprise and delight."

THE NEXT FIVE YEARS

It is conceivable that Ulta could double its store base over time, although the company has provided no such direction. Ulta declined Retail Leader's request to speak with Dillon or respond to written questions, but more details on the company's long term vision will come this fall when Ulta hosts an annual investor conference. The company's current projections, shared with investors in 2016, envision a range of between 1,400 and 1,700 stores. However, Ulta ended last year with nearly 1,100 locations and with plans to add another 100 stores this year it will soon hit the low end of its store expansion range.

Although Ulta expects greater growth in e-commerce, that doesn't negate the need for more stores. One look at its store location map reveals opportunities to increase penetration in existing markets and enter new ones. Stores are vital to Ulta's future due to the offering of salon services that generate invaluable traffic and provide an experience that can't be replicated online.

There are also abundant real estate opportunities for the typical 10,000 square foot Ulta Store and the retailer's solid financial footing makes it a desirable tenant for shopping centers. A new store requires a net investment of about \$1.6 million and within five years annual sales of the typical store are approaching \$5 million.

Of course, competitors are sitting still and Ulta isn't sneaking up on anyone these days, with some of the easy market share gains already had. For example, Ulta's ascent has corresponded to weakness in the department store channel and Macy's in particular. Macy's spent the past five years rightsizing its department store fleet, which now numbers about 650 locations compared to nearly 800 five years ago. During that time, its sales declined to \$24.8 billion from \$27.9 billion. Roughly \$3 billion in revenue went to competitors, including Ulta Beauty, since Macy's generates 38 percent of its sales from the broad categories of women's accessories, intimate apparel, shoes and cosmetics.

However, Macy's remains a formidable player that understands beauty is an enduring category, which is why in the midst of deteriorating fundamentals at its core business it acquired the upstart Bluemercury beauty chain in 2015. Macy's has since expanded the concept's freestanding locations, adding 37 new locations last year to end with 137 total.

Ulta's future share gains from mass merchants could also be under pressure. Food, drug and mass retailers account for roughly half of the \$82 billion beauty products market where Ulta figures its share is about 6 percent. Retailers such as Walmart, Target, Walgreens and CVS Health operate a combined 25,000 stores that may not offer Ulta's breadth of assortment but are certainly more convenient and routinely being refreshed with fixtures and lighting to improve the experience and assortments optimized to reflect the latest trends.

Ulta also faces a challenge on the high end from Sephora, the beauty retailer supported by the resources and prestige of its \$50.9 billion parent company and leading global luxury goods purveyor LVMH Moët Hennessy Louis Vuitton. Sephora currently operates 370 U.S. stores and 590 locations inside J.C. Penney stores. Specifics about Sephora's growth plans are hard to come by, but the brand falls into the second largest of LVMH's five divisions known as "selective retailing," which generated 39 percent of its 2017 revenues of \$15.9 billion from the U.S.

Perhaps more concerning about Sephora is its status as the preferred destination for younger shoppers. In its semi-annual spring survey called Taking Stock With Teens, Piper Jaffray research showed Ulta was the second most popular beauty destination after Sephora. The good news for all beauty retailers is that the survey of 6,000 teens showed beauty spending hit a new high for females at \$368 per year led by skin care, up 18% year-over-year.

INNOVATION AHEAD

Future generations of shoppers will have very different expectations of a retailer like Ulta, which is why Dillon says, “We are never done with innovation and there is a lot more to come.”

The company is an early adopter of digital innovations and its app features a functionality called Glam Lab that allows for the virtual try on of make-up. Next up is a partnership with Spruce Labs, makers of a digital assistant device that give employees Internet access and simplifies checking in for and scheduling salon appointments. Ulta also works with Google Express to make sure online orders to 95 percent of the nation are fulfilled in as little as two days.

Despite all that Ulta has going for it, 2018 is shaping up to be Dillon’s most challenging year. Same store sales are forecast to be weak relative to Ulta’s three year string of double digit gains. And the company faces all the same headwinds as other retailers related to cost pressures of an omnichannel business model, continuous reinvestment in stores and technology and rising wage rates. The most positive development of 2018 is the impact of federal tax reform, which Dillon regards as a game changer and gives the company a unique opportunity to deploy the benefits received to improve its long term posture.

TOP BEAUTY DESTINATIONS

1	Sephora	44%
2	Ulta	28%
3	Target	11%
4	CVS	3%
5	Walmart	3%

SOURCE: Piper Jaffray Companies 35th semi-annual Taking Stock with Teens survey.

“(Tax reform) enables us to accelerate certain investments to drive growth and innovation,” Dillon said during Ulta’s fourth quarter earnings call. In addition to employee training, wages and store experience upgrades, Ulta also plans investments in AI and data capabilities to increase personalization for loyalty members. “We’ll increase investments in digital innovation to drive guest experience enhancement designed to drive engagement and education, as well as increase sales through our e-commerce business,” Dillon said. “We’ll also enhance our capabilities to both identify and incubate new brand opportunities that will further evolve our assortment and take full advantage of the changing landscape of brand creation, and we’ll accelerate our services strategy with the continued rollout of the new salon model and the addition of a new skin services model.”

Such investments will take time to impact sales and profits, but don’t be surprised to see Dillon and Ulta many notches higher on the Fortune 500 list in the years to come. **RL**

SAME STORE SALES PRESSURE LOOMS

Ulta Beauty’s same store sales are forecast to decelerate to a range of 6% to 8% in 2018 as the retailer laps an impressive string of 12 consecutive quarters of double digit increases.



SOURCE: Company Reports