- **PEC** Research -

Yale SCHOOL OF MANAGEMENT

US Branded Retail Apparel Industry | Industry Report | September 16th, 2012

US BRANDED RETAIL APPAREL INDUSTRY

Rating: NEUTRAL

The **US Branded Retail Apparel Industry** ("Branded Apparel") is currently **fairly valued**. Our DCF analysis **values the equity of the industry at $37.7Bn**, compared to the **current market value of $35.3Bn**. This implies that the **industry is undervalued by 6%, which we still consider in the range of fairly valued.**

Our multiples approach yields a **Price to LTM Earnings multiple of 22.5**. This is **close to the median of 20.1,** observed over the past 12 years.

We forecast US sales for this mature industry continuing to grow in line with GDP. International growth will remain significantly higher than domestic growth. In our analysis, this adds up to an **aggregate annualized growth rate of 4.1% over the next 5 years.**

The two main pillars for future value creation in the industry are a) an opportunity for **increased operating margins due to a favorable sales mix shift towards the online channel** and b) the opportunity to **expand in international, less mature markets.** However, at the current market value, we believe both of these opportunities are already reflected in the market price.

There is also an **offsetting threat of lower gross margins due to increased input prices for cotton,** caused by an ever increasing worldwide demand.

The low level of differentiation between the individual firms in the industry and the fragmented nature of the industry results in a **very competitive environment**, which will **make it difficult for the industry to outperform the overall market**.

US Branded Apparel Industry

Enrique Baranda Enrique.baranda-gonzalez@yale.edu

PEC Research, USA

Christian Heck Christian.heck@yale.edu

PEC Research, USA

Industry Rating	Neutral

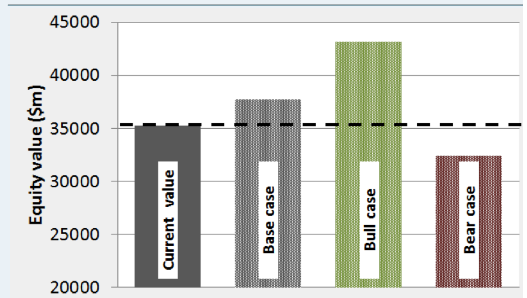
Upside case **18% upside**

We see the key upside potential in an operating margin expansion, caused by a favourable sales mix shift from store sales towards online sales. In order for the sales mix shift to impact margins, the industry will also have to undergo domestic store closures.

Downside case **9% downside**

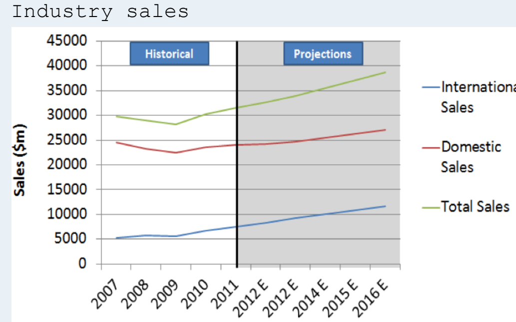
We see the main downside risks as lower international growth due to a prolonged depressed economic environment. Furthermore, there is a risk of higher cotton prices going forward, caused by increased demand for the commodity from emerging markets.

Upside/downside scenarios



Source: PEC Research

Industry sales



Source: Company reports, PEC research

Key Figures

Enterprise value($m)	37,034
Equity value($m)	35,299
Sales($m)	32,365
Gross Profit LTM($m)	14,173
EBIT margin LTM	12.6%

Source: Company reports, Capital IQ

Industry Overview

*Although currently tempered by the economic recession, world market for branded apparel is expected to recover poise and gain momentum over the next few years to reach **US $600 billion** by the year 2015*[1]

The branded apparel industry has benefited from demographic shifts and changes in consumer preferences over time due to globalization and a rise in brand awareness. With fashion emerging as a means of self-expression, consumers are increasingly choosing apparel with brand images or logos over private label. The **United States** represents the world's largest branded apparel market having an estimated **share of 29.26%**[2], followed by Europe and Asia. However, growth in emerging markets such as Asia-Pacific is very encouraging for the branded apparel industry.

Coverage Universe

We are initiating coverage of the US Branded Retail Apparel industry focusing on firms with the following characteristics:

- US based firms that design their own clothes and accessories.
- Sell through diversified channels (single brand retail stores mainly, as well as direct online sales)
- Wholesale/Licensed operations less than 10% sales in US and less than 50% internationally

Our coverage universe includes 7 firms with combined annual revenues of $31.5 billion (2011), which we consider sufficiently representative of the industry: **Abercrombie & Fitch, Aeropostale, American Eagle Outfitters, ANN Inc., The Gap, Guess, and Urban Outfitters**.

Industry Specifics and Key Metrics

Some of the specificities that define this industry include:

- **Highly fragmented** – Branded apparel markets across the globe are extremely fragmented. No player in the industry has more than 3.0% market share[3] in their respective region.
- **Consolidation** –To increase profit margins, apparel companies are making acquisitions and diversifying their revenue base with new product lines. Some retailers are also integrating backward and are developing their own brands.
- **Outsourcing** – The majority of US Branded retailers are now using foreign contractors to manufacture goods. In these arrangements the retailer may have onsite quality control personnel in the factories of the contractor. Design work may also be done onsite, in close consultation with the contractor.
- **Seasonality** – The business is highly cyclical, with peak times around the back-to-school (fiscal third quarter) and holiday seasons (fiscal fourth quarter). The business varies greatly during the year due to the seasonal nature of apparel retailing. Quarterly operating results may fluctuate based upon such factors as the timing of certain holiday seasons, the number and timing of new store openings, the acceptability of seasonal merchandise offerings, the timing and level of markdowns,

[1] According to Global Industry Analysts Inc.
[2] According to Global Industry Analysts Inc.
[3] Morgan Stanley – Retail, Branding Apparel (October 3, 2011)

store closings and remodels, competitive factors, weather, and general economic conditions.

- **Key Metrics**
  - **Same Store Sales –** is more accurate than net sales growth when determining a company's performance as in order to grow sales in existing stores a company needs to drive foot traffic and brand loyalty. Only looking at net sales is a poor indicator of a company's performance as growing net sales can be achieved by simply opening new stores. Industry same store sales have been declining due to the current economic environment.
  - **Inventory Levels –** Apparel retailers must predict demand months in advance and invest in inventory in order to meet seasonal fashion trends. Holding too much inventory at quarter end indicates the company will need to reduce prices to unload the merchandise to make room for new fashions. As this eats into the margins, strong performing companies have to manage inventory levels throughout the year. Overall, the industry average of days of inventory held has jumped from 80 days in 2009 to 89 days in 2011 – this is mainly due to the increase in cotton prices, but can be seen in the lower operating margins of 2011 (more than 400bps decline in 2011 from 2010).[4]

The prolonged **instability in the world economy has taken its toll on the Branded Apparel market**. Slowing economic growth, reduction in household wealth, falling consumer confidence, frugal discretionary spending patterns, and shifting consumer demand to value for money bargains have all eroded sales growth over the last 5 years (-0.5% CAGR domestically and 1.4% CAGR overall). The decline in consumer spending has also battered down retailers' operating margins. With consumers changing to lower price points, cheaper private label brands have been offering tough competition to premium brands.

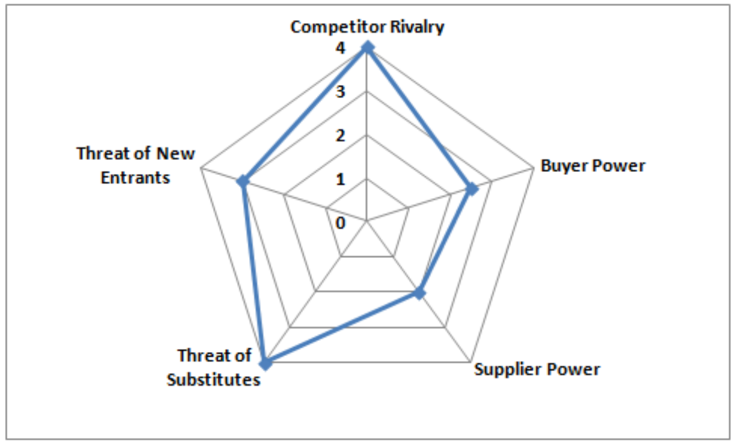
Primary factors that will contribute to **future market growth** include rebuilding lost consumer confidence in the overall economy. This will lead to an improvement in consumer purchasing power and discretionary spending, and the revival of preferences for branded apparel. Rapidly increasing demand from **developing markets**, especially Asia-Pacific, and sustained growth in the **e-commerce channel** are also expected to drive growth.

Competitive Landscape

*The retail apparel industry, including retail stores and e-commerce, is **highly competitive**.*

Companies compete on the following key points: timeliness of fashions, trendiness, breadth of merchandise, brand recognition, pricing, quality, and overall shopping experience and environment. Despite some potential for companies to create competitive advantages, the **industry has relatively low barriers to entry and is highly competitive**.

[3] Company reports, PEC Research



In this fragmented market, buyers refer to European department stores and individual retail customers, suppliers are the apparel manufacturers, and substitutes can be US department stores, discount retailers or foreign branded apparel firms.

- **Buyers** in this market vary in size from the international department stores to the individual retail customer. Due to the majority of sales coming from the company retail stores the large department stores have very little power over the branded apparel players. Their sales contributions are not large enough to have a significant impact on the players' annual sales. The individual retail customer has very little financial power compared to any branded apparel player. However, individual customers are prone to switching due to the many undifferentiated products offered by players and low costs involved (difficult to maintain brand loyalty). The sheer number of consumers in the market decreases the impact from consumer switching to make the power arguably evenly split between apparel retailers and consumers. Therefore, these two different buyer types – department stores and individual retail customers - experience similar levels of buying power.

- Due to the nature of the end product and inexpensive shipping costs, **suppliers** are sourced from around the globe. The large number of suppliers available then weakens their power. Players in this industry also make it their strategy to have no more than 10% of their manufacturing coming from any one supplier in order to decrease the suppliers' power even more.5

- The threat of **substitutes** is high as large national department stores are much larger than any player in the industry (ex. Macy's has $26.4 billion in 2011 sales compared to the largest player's, The Gap, $11.3 billion domestic sales). Also, discount retailers and supercenters like Wal-Mart pose a threat to the industry, especially during economic recessions when consumers have less disposable income. Finally, foreign branded apparel firms (H&M, ZARA, etc.) pose a threat US branded apparel firm both in store and online sales.

- Potential **new entrants** to the branded apparel industry face very low barriers. Requirements include an apparel manufacturing partner and a retail store with sales staff. Even the retail store is becoming increasingly less important. Many people have noticed the increased sales being generated by players' direct-to-consumer operations and new players are beginning to enter the market using online sales as

[4] Company reports, PEC Research

their only point of customer contact – Frank & Oak is an example of such a new player making headlines.[6]

- The high fragmentation of the industry leads to increased **competitor rivalry**. The seasonality of the business is another reason for increased rivalry as players are fighting for customers during short periods of time throughout the year. As many apparel products lack major differentiation between competitors, price becomes an increasingly important factor**.**

This **fierce competition**, with little brand loyalty, low barriers to entry, constant pricing pressure from competitors and a critical need to be fashion-right turn to be one of the main **investment negatives** for the US branded apparel industry. Having strong brand equity enables a retailer to price merchandise higher than commoditized retailers who compete solely on price. The coverage universe does not offer the lowest price points, but it attempts to "value price" its goods, offering solid-quality, trend-right merchandise with a desirable brand name

Coverage Universe – Companies description

Abercrombie & Fitch Co.

Symbol: *ANF*
Current Price: *$39.36*
Market Cap: *$3.2 billion*
PE Ratio: *38.91*

EPS				
2Q2012	**2Q2011**	**Mgmt FY2012**	**FY2011 Actual**	**Consensus**
$0.19	$0.35	$2.50 to $2.75	$2.31	$2.56

ANF is a specialty apparel retailer with over $4.1 billion in sales (2011), operating more than 936 stores in the US and 119 stores internationally. Their flagship brand is *Abercrombie & Fitch*, targeting affluent teens and young adults for an East Coast, Ivy League preppy style (40% of 2011 sales). *Abercrombie Kids* directly follows in the footsteps of *Abercrombie & Fitch*, targeting 7 to 14 year olds (10% of 2011 sales). *Hollister* is their West Coast style, designed for teens and priced lower than the *A&F* line (50% of 2011 sales). Their online direct-to-consumer operations have broadened their reach both domestically and internationally, representing 13% of 2011 sales (36% y-o-y growth).

Management recently reported Q2 results in which trends deteriorated in both their US and international markets. Due to the company working to reduce its high inventory levels, slowing international expansion plans, and comparable store sales down 10% with a similar trend planned for second half of 2012, we believe business will remain difficult for next six months.

Aeropostale Inc.

Symbol: *ARO*
Current Price: *$14.84*
Market Cap: *$1.2 billion*
PE Ratio: *19.84*

EPS				
2Q2012	**2Q2011**	**Mgmt FY2012**	**FY2011 Actual**	**Consensus**
$0.00	$(0.02)	n/a	$0.87	$0.96

ARO is a branded apparel retailer with more than $2.3 billion in 2011 sales, operating more than 1000 retail stores in the US and Canada with 20 licensee stores in UAE, Singapore and Bahrain. The main brand is *Aeropostale*, targeting both men and women aged 14 to 17 years old. Launched in 2009, *PS from Aeropostale* targets kids aged 4 to

[6] TechCrunch, frankandoak.com, PEC Research

12 years old with 71 stores in 20 states. A differentiator between *Aeropostale* and its competitors is their promotional business model, generally pricing lower than their competitors' merchandise. Their online business continues to add value showing a 2Q growth of 27% versus 20% growth last year.

Management is pursuing further licensing agreements for international growth but their main focus is still in the US market. Despite a same store sales growth decline of 1% in Q2, they are still on target to meet their expected 18 *Aeropostale* and *30 PS from Aeropostale* store openings planned for fiscal 2012.

American Eagle Outfitters

Symbol: AEO
Current Price: $23.61
Market Cap: $4.6 billion
PE Ratio: 24.41

EPS				
2Q2012	2Q2011	Mgmt FY2012	FY2011 Actual	Consensus
$0.21	$0.13	$1.33 to $1.36	$0.97	$1.34

AEO is a specialty apparel retailer with $3.1 billion in 2011 sales, operating more than 1,000 retail stores in the US and Canada with 40 franchised stores in 13 countries. Their primary brand is *American Eagle*, targeting 15 to 25 year old men and women with 911 stores, "priced to be worn by everyone, everyday". In fall of 2006 they launched *aerie by American Eagle,* a womens' intimates collection in stand-alone stores with 158 stores. The online business segment, AEO Direct, has shown continuous improvement over the years with a 2Q growth of 28% versus 17% growth last year.

Q2 was a solid quarter for AEO: margins, comparable store sales and inventory levels all improved over this time last year, leading to a 65% increase in EPS. Comparable store sales have increased in Q2 by 9%, compared to 1% in the same period last year. We believe Management's plan for international expansion could boost earnings significantly over the next decade. Also, with AEOs zero debt structure, it could become the target of an LBO – similar to J. Crew.

ANN Inc.

Symbol: ANN
Current Price: $39.06
Market Cap: $1.9 billion
PE Ratio: 20.97

EPS				
2Q2012	2Q2011	Mgmt FY2012	FY2011 Actual	Consensus
$0.63	$0.47	$2.10 to $2.20	$1.64	$2.20

ANN Inc. is a leading specialty retailer of women's apparel, shoes and accessories sold under the *Ann Taylor* and *LOFT* brands with over $2.2 billion in 2011 sales. Their retail store operations are currently comprised of 377 *Ann Taylor* stores and 585 *LOFT* stores throughout the US.

Management has a strong focus on national expansion of retail stores with plans to open 65 new stores in the US in fiscal 2012. With strong Q2 sales growth (7% over last year), management is on target to meet their national store expansion plans. With ANN only just tapping into their online business, and beginning their international expansion (with 2 stores in Canada in Q4 2012) we believe the market has not quite captured their growth potential in their current PE multiple.

The Gap Inc.

Symbol: *GPS*
Current Price: *$35.20*
Market Cap: *$16.9 billion*
PE Ratio: *19.64*

EPS				
2Q2012	2Q2011	Mgmt FY2012	FY2011 Actual	Consensus
$0.49	$0.35	$1.95 to $2.00	$1.56	$2.03

GAP is a global specialty apparel company with over $14.5 billion in sales (2011), offering apparel and accessories to men, women, children and babies through *the Gap, Old Navy, Banana Republic, Piperlime* and *Athleta* brands. All brands combined have over 3,200 stores operating in the US, Canada, United Kingdom, France, Ireland, Japan, China and Italy. They also have 250 franchised store agreements throughout Asia, Australia, Eastern Europe, Latin America, the Middle East and Africa. Gap Direct (their online channel) has grown to represent 10% of 2011 sales posting a 20% y-o-y growth rate.

Management is focussed on improving same store sales growth and closing underperforming stores to improve their declining sales since 2005, while targeting China as their international growth market. Overall comparable store sales growth was up 4% in Q2, despite a 5% decline in international stores. We remain concerned that the damage done to the brand over the past years may take time to repair.

GUESS Inc.

Symbol: *GES*
Current Price: *$27.81*
Market Cap: *$2.4 billion*
PE Ratio: *10.94*

EPS				
2Q2012	2Q2011	Mgmt FY2012	FY2011 Actual	Consensus
$0.49	$0.65	$2.15 to $2.30	$2.86	$2.59

GUESS is a specialty apparel company with $2.6 billion in 2011 sales, offering European-style fashion and accessories to men, women and children through their *GUESS*, *GUESS Kids* and *MARCIANO* brands. These brands are sold in over 500 stores in the US and Canada and more than 1,000 stores internationally, each region accounting for approximately 50% of 2011 sales. Q2 sales decreased 6.2% primarily due to their reliance on European sales – showing a decline of 14.5%.

Management sees significant opportunities in Asia and have planned to open 150 retail stores in Asia during fiscal 2012. This has led to an increase in Q2 sales in Asia of 26%. With Guess' dependence on Europe (currently represents ~30% of sales) we are reluctant to give a buy rating given the still uncertain economic outlook in Europe.

Urban Outfitters Inc.

Symbol: *URBN*
Current Price: *$39.71*
Market Cap: *$5.8 billion*
PE Ratio: *31.66*

EPS				
2Q2012	2Q2011	Mgmt FY2012	FY2011 Actual	Consensus
$0.42	$0.35	n/a	$1.60	$1.58

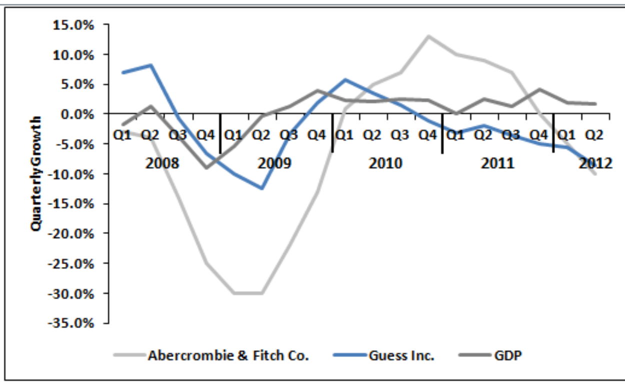
URBN is a specialty apparel and accessories retailer with $2.4 billion in 2011 sales, operating under the *Urban Outfitters* and *Anthropologie* brands. The *Urban Outfitters* brand targets young adults aged 18 to 28 with over 200 stores in North America and Europe. *Anthropologie* focuses on women aged 28 to 45 with over 170 stores in North America and Europe. The direct-to-consumer online business has grown over the years to represent over 20% of fiscal 2011 revenues. Although comparable store sales decreased 1%, comparable store inventory levels decreased 5% in Q2 compared to last year.

Business Model

Revenues

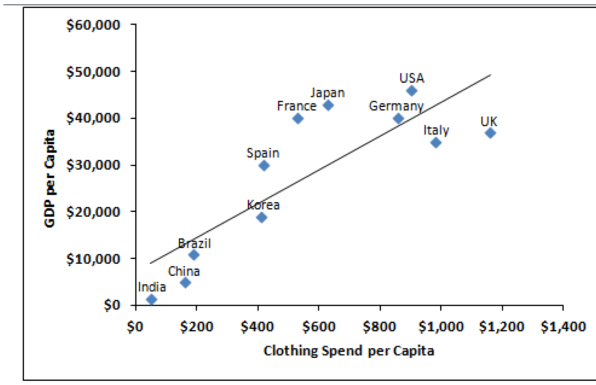
Apparel spending is highly correlated with GDP per capita. Changes in the economic environment may positively or negatively affect industry growth.

Figure 1: US GDP growth vs. Company same-store sales growth



Source: US Bureau of Economic Analysis; Company reports; PEC Research

Figure 2: GDP per Capita vs. Clothing Spending per Capita



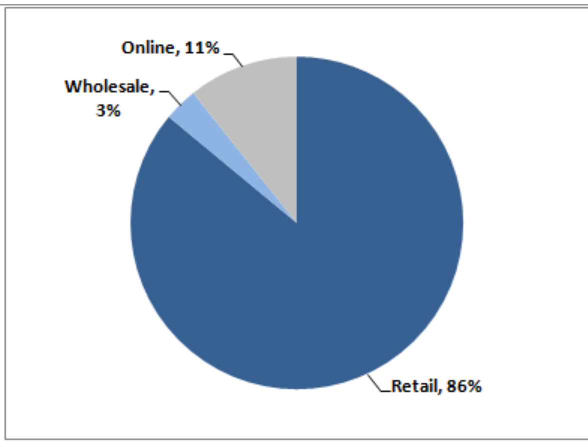
Source: Euromonitor; Morgan Stanley Research; PEC Research

Branded retail apparel companies generally recognize revenue from three major business segments:

- **Retail** – Revenues associated with the sale of merchandise to the individual consumer through specialty retail and outlet stores (usually operated by the firm). This represented on average 86% of sales in 2011 for the top apparel retailers. Contribution to overall profits by this segment was slightly over 76%.
- **Direct (On-line) sales**[7] – The online channel, which has high margins and solid growth prospects, is being leveraged to broaden customer reach, especially in cities and countries where a physical presence is not likely to be productive. This represented on average 11% of sales in 2011. Contribution to overall profits by this segment was slightly over 17%.
- **Wholesale (including licensing)** – Revenues associated with the sale of merchandise to wholesale customers (ex. Department stores). Additionally, major apparel brands also license the right to manufacture market and sell selected products (at wholesale) to third parties. Usually, the licensing agreement allows for the payment to the brand owner a percentage of the licensee's sales. This channel is primarily used for international markets. US operations represented on average less than 3% of sales and contributed 6% to profit margin.

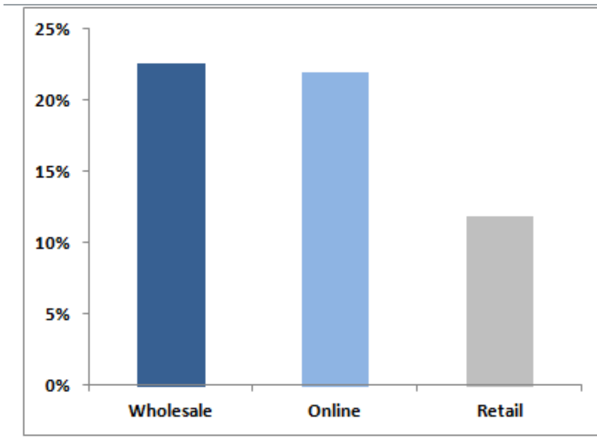
[7] Coverage Universe are not allowed to take advantage of the tax loophole, which allows pure online retailers to aggressively compete with traditional brick-and-mortar stores. The tax loophole essentially allows pure online retailers to charge discounted prices because they are not required to charge sales tax on out-of-state purchases. Up to date, applicable sales tax for the coverage universe is calculated according to the state to where the merchandise is being shipped. International orders are excused from US sales tax but recipients are responsible for all duties and taxes assessed by their country's customs.

Figure 3: Revenue split by channel (%)



Source: GAP, Guess, Urban Outfitters Company reports, PEC Research

Figure 4: Operating margin split by channel (%)



Source: GAP, Guess, Urban Outfitters Company reports, PEC Research

Cost structure and Margin Analysis

Gross Margin

Cost of goods sold for the US Branded Retail Apparel Industry include merchandise costs, markdowns, occupancy costs, shipping for direct-to-consumer orders, inbound and outbound freight, taxes and duties, purchasing costs, and other inventory acquisition-related costs.

*A sharp spike in Cotton prices of more than 300% in 2011 led to a **decrease in margin** of about **350bps** for the industry. This spike was due to apparel manufacturers overreacting to a decrease in cotton supply from flooding in Australia, India and China.*[8]

Cost cutting measures, such as changing overseas sourcing partners, have been employed by major retailers in the last decade in an attempt to improve margins. Nevertheless, apparel companies have been faced with higher input costs (**raw material and manufacturing costs**) during the last years due to the increase in cotton prices, other materials, as well as wage inflation.

While investors were concerned by the above mentioned issues, branded apparel retailers have generally adapted well. Given the high level of competition in the industry, we would also have expected that input prices will eventually be passed through to customers. With cotton prices having decreased to normal levels by the end of 2011, we expect retailers to benefit from this drop in prices during the second half of 2012 as company profitability tends to lag cotton price changes by about 9 to 12 months due to differences in production and sales cycles.[9] However, the competitive nature of the industry works both ways. Hence, any profitability increases due to lower input costs will be short-lived.

Inventory Levels

Industry inventory levels have been steadily increasing over the last 5 years from approximately 12% of sales in 2008 to 14% of sales in 2011. This can be attributed to retailers having a difficult time unloading the merchandise in this price-sensitive economy, as well as the increased cotton prices of 2010/2011 affecting the overall pricing of inventory. As a result, market analysts predict inventory levels to decrease in the second

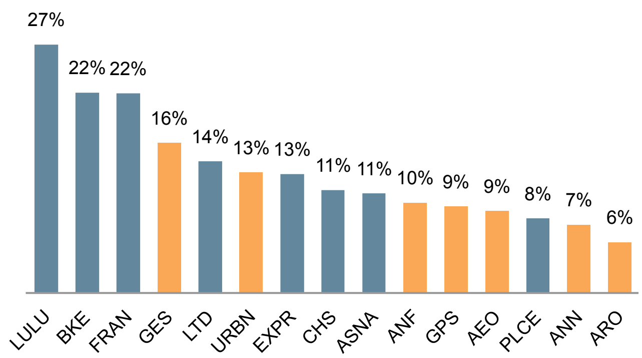
[8] The Daily Telegraph – Cotton price causes 'panic buying' as hits 150-year high
[9] S&P Credit Rating Report – US Apparel Companies

half of 2012 due to the lower cotton prices, leading to an increase in cash flows as a result of the lower working capital requirements.[10]

Operating Margin

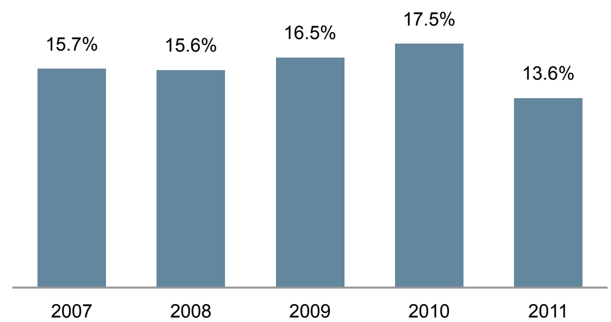
US Branded Apparel Industry operating margin has been **growing slowly since 2008**. As mentioned before, data for 2011 is not representative for the industry due to the spike in cotton prices.

Figure 5: Industry Operating Margin benchmark (2011)



Source: Company Reports; FactSet ; Wells Fargo Securities; PEC Research

Figure 6: Operating margin evolution (% over sales; 2007 – 2011)



Source: Company data; PEC Research

[10] S&P Credit Rating Report – US Apparel Companies

Industry Outlook

We are initiating coverage of the US Branded Retail Apparel industry with a **Neutral** view; given the long term growth opportunities (especially abroad) coupled with the near term risks of higher apparel prices in an uncertain demand environment.

We have confidence that management is taking a rational approach to managing the mature domestic business. While we expect North America business to maintain flat to slightly positive comparable store growth and maintain margins and cash flow, we are excited by continued growth of the high-margin e-commerce platform (most recently in Emerging countries) and international expansion using an asset-light franchise model.

Industry Investment Positives

- **Fragmented markets provide growth in a low growth environment** – Apparel markets are extremely fragmented, allowing opportunities for branded apparel companies to grow even during periods of slower growth.
- **Long Term Trends Should Support Operating Margin Expansion** – With faster international and direct to consumer (own retail and on-line) growth, companies should benefit from higher gross margins over the long term.

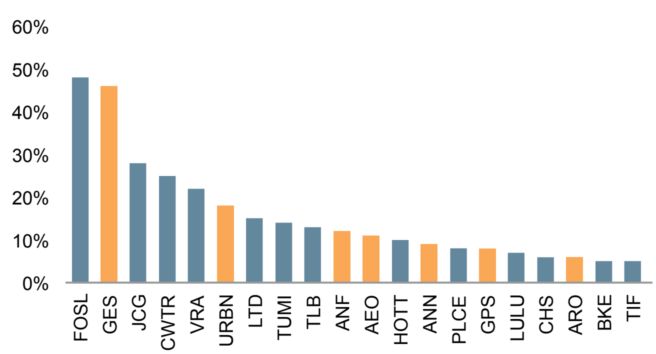
The online channel

***Online** sales of retailers generally have higher **operating margin**, often **2x** that of the retail channel*

The online channel, with its high margins and strong growth prospects, is being leveraged to broaden customer reach, especially in cities and countries where a physical presence is not likely to be productive.

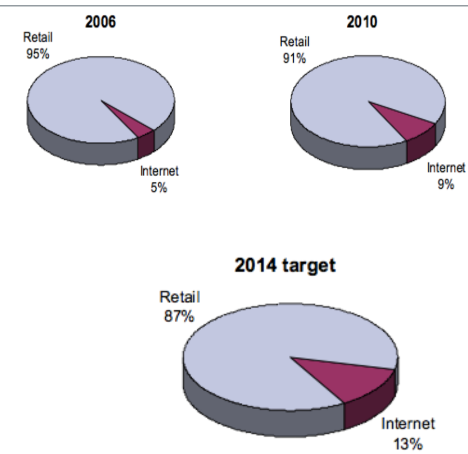
Only 11% of revenues (on average) are currently coming from online sales. When we compare this share to retailers with well-developed online channels such as Fossil, which achieves 50% of its sales via the online channel, we can see significant room within the industry to develop this channel in the near future.

Figure 7: E-commerce as % of total sales (Estimation 2011)



Source: Company reports; William Blair & Company Research; PEC Research

Figure 8: Example of e-commerce evolution as % of sales – GAP



Source: Company reports; Credit Suisse; PEC Research

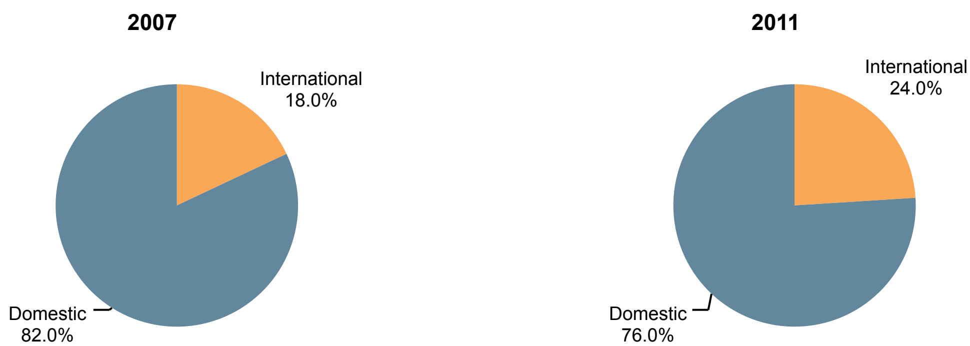
As the Coverage Universe increases online revenue mix, the companies should see an increase in overall margin (operating margin on online sales might be twice as high as the margin for traditional retail sales[11]). However, one should also consider the possibility that increased online sales may cannibalize store sales, necessitating further store closings and potentially adding to the decline in store sales.

International expansion

*Significant **opportunity** to **increase penetration abroad***

Over the past decade, the branded apparel industry has rapidly increased its revenue mix from international sales. Assuming penetration in foreign markets could reach current North American market shares, branded apparel companies could see overall revenues grow in excess of 30% - 50%.[12]

Figure 9: Evolution of sales split (domestic and international) as percentage of total sales



Source: Company Data; PEC Research

We can think about

Industry Investment Negatives

The Branded Apparel Industry faces some challenges and uncertainties that might undermine the outlook of the Coverage Universe.

- **Inability to capitalize on new fashion trends or forecast future trends**. The industry is highly reliant on the firms' ability to forecast and capitalize on new trends. Forecasting future trends can be difficult. The firms attempt to mitigate some of this risk through their market research, but there can be no assurance that the merchandise will consistently resonate with customers.
- **Expansion into new markets with new and growing concepts**. In order to grow, the industry should expand into new (underpenetrated) markets for which it may not have the necessary regional expertise in target demographics.
- **Consumer spending may decline**. Consumer spending habits, including spending on fashionable apparel and related accessories, are affected by economic conditions, levels of employment, salary and wage rates, consumer confidence, and consumer perception of economic conditions. A general slowdown in the economy could result in lower spending and could negatively affect the company's business.

[11] Credit Suisse Research – The GAP, December 2010
[12] Morgan Stanley Research – Branded Apparel & Footwear, May 2012

- **Competition is fierce, with little brand loyalty, low barriers to entry and foreign firm successfully penetrating in USA**. Competition in the retailing sector is fierce, with constant pricing pressure from competitors and a critical need to be fashion-right. Having strong brand equity enables a retailer to price merchandise higher than commoditized retailers who compete solely on price. The coverage universe does not offer the lowest price points, but it attempts to "value price" its goods, offering solid-quality, trend-right merchandise with a desirable brand name.

Moving forward, one may also **think of a couple of more unlikely events that might seriously damage the traditional/mature coverage universe**:

- The **current industry model (retail stores supported by online channel) gets replaced by "online-only" retailers**. In addition to this shock to the industry, it is not the "traditional" firms which we include in our coverage universe that survive this shock. The changed industry is dominated by start-ups who are better positioned for the new industry structure. We believe that this scenario is very unrealistic, given the strong online presence of the firms in our coverage universe. Moreover, the stores fulfil an important marketing function, which will make it hard to run an apparel brand of the scale of the brands in the coverage universe without any/ with hardly any brick and mortar stores
- The **expansion into the US by international retailers**, such as Zara, H&M and Uniqlo, **will take significant market share away from the companies in our coverage universe. This will lead to a significant decline in sales that cannot be compensated by international expansion of our industry**. We believe that this scenario is also quite unrealistic, as the expansion of foreign retailers into the US is not a new trend. The US has been the largest consumer market for over 50 years now and international companies have tried to take advantage of this for a very long time[13]. However, because the US market is so large, US retailers have been slower to look abroad. Therefore, we believe that the opportunity for the companies in the coverage universe to expand their international sales is a lot bigger than the threat to disproportionally lose market share and sales at home.

[13] United Nations Statistics Division – National Accounts Main Aggregates Database

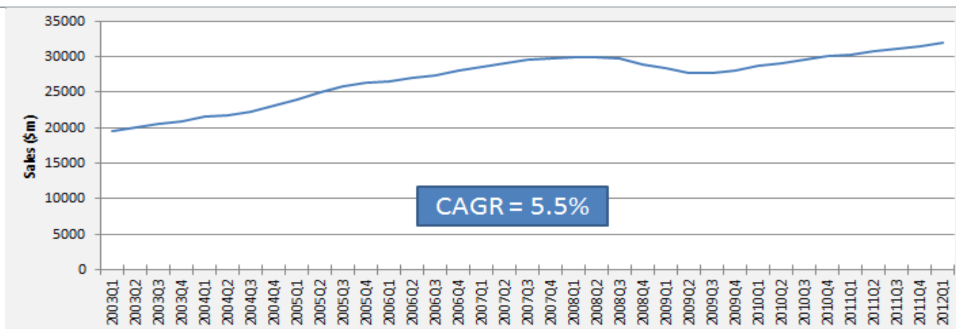
Valuation

We believe that the equity of the Branded Retail Apparel Industry is currently fairly valued. In order to arrive at this conclusion, we used a two pronged approach based on **1) DCF forecast** and **2) multiples analysis**

DCF Valuation

- **Sales forecast** – When forecasting sales growth for the Branded Retail Apparel Industry, one has to differentiate between **domestic sales** and **international sales**. In the US, Branded Retail Apparel should be considered a mature industry, the main driver being GDP growth. While the growth opportunities domestically are limited for US based Branded Retail Apparel, there exists considerable growth potential in the international markets. One only has to look into recent industry trends to see this trend. While **domestic sales** for US based Branded Retail Apparel have actually **declined by a CAGR of -0.6%** (US GDP growth for same period was 2.1%[14]) from 2006 through 2011, **international sales have grown by a CAGR of 11.3%** over the same time frame (Figure 11). The CAGR for total sales (combining international and domestic sales) over this period was about 1.6%.

Figure 10: Total Industry Sales (Rolling 12 months)

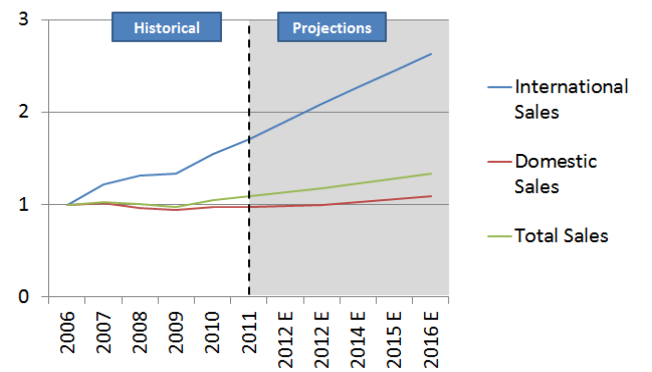


Source: Company Data; PEC Research

Going forward, we believe that the **Industry will continue to achieve significant growth abroad** and as the share of international sales continues to become a larger share of total sales (Figure 12), international growth will have a larger impact on total sales growth. On the flipside, we understand that the international growth rate will eventually taper off over time as the international sales become a larger part of overall sales and as the international markets become more saturated. When this happens, the Industry might continue to grow international sales in terms of absolute added sales for many years going forward but by definition, this will result in a decreasing growth rate.

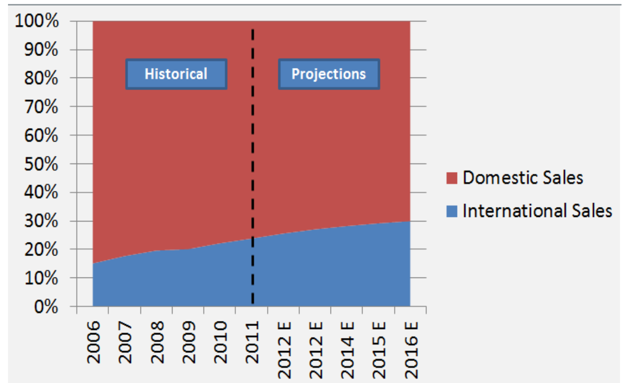
[14] US Bureau of Economic Analysis

Figure 11: Domestic vs. International Sales growth



Source: Company Data; PEC Research

Figure 12: Domestic vs. International Share of Sales



Source: Company Data; PEC Research

With respect to **domestic sales**, we assume that the industry **will grow in line with GDP** estimates. Individual firms might very well be able to achieve growth rates for certain periods of time that are well above GDP growth, but this will not be possible for the industry as a whole, given the maturity of branded apparel sales in the US.

For our forecast, we predict that international sales will grow at 11% during 2012, following the trend we observed during the first few months of 2012 (12.4% in 2011) and taper off to a terminal growth rate of 3% by the end of 2020. At the same time, we are forecasting domestic sales to grow in line with GDP predictions and also assume a terminal growth rate of 3% by the end of 2020 (Figure 13).

Figure 13: Sales forecast

	Historical		Projection									
(in $ m)	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Internationals Sales	6,699.61	7,530.82	8,359.21	9,195.13	10,022.69	10,824.50	11,582.22	12,277.15	13,013.78	13,664.47	14,211.05	14,637.38
% growth (y-o-y)		12%	11%	10%	9%	8%	7%	6%	6%	5%	4%	3%
Domestic Sales	23,542.75	24,052.66	24,293.19	24,779.05	25,522.42	26,288.10	27,076.74	27,889.04	28,725.71	29,587.48	30,475.11	31,389.36
% growth (y-o-y)		2%	1%	2%	3%	3%	3%	3%	3%	3%	3%	3%
Total Sales	30,242.36	31,583.48	32,652.39	33,974.18	35,545.11	37,112.60	38,658.96	40,166.19	41,739.49	43,251.95	44,686.16	46,026.74
% growth (y-o-y)		4%	3%	4%	5%	4%	4%	4%	4%	4%	3%	3%
Share of International Sales	22%	24%	26%	27%	28%	29%	30%	31%	31%	32%	32%	32%
Share of Domestic Sales	78%	76%	74%	73%	72%	71%	70%	69%	69%	68%	68%	68%

Source: Company Data; PEC Research

- **WACC vs. APV** – We decided to use the WACC approach instead of the APV approach for our valuation, as the aggregate Debt level for the industry changed from $615m in 2008 to $1.9bn in 2012. During the same time, total EV of the industry has risen from $31.67bn to $37.21bn. Clearly, the value of the debt outstanding has not remained constant over the past 5 years. Therefore, we feel comfortable with the assumption that the companies in this industry are targeting a certain Debt to Total Value ratio, which lead us to choosing WACC over APV.
- **Estimating beta** – Our approach to estimating the equity beta was to regress the monthly excess returns of each of the companies in our industry over a 60 months period (Data from CRSP) on the excess returns of the market for the same period (Data from Fama French). We then weighted the betas of the individual companies based on their equity market value to derive **an industry beta of 1.22** (Figure 14).

- **Calculating the WACC -** Using our levered equity beta of 1.22, we calculated the required equity return for our industry using the Capital Asset Pricing Model: RE=RF+βE(Rm-Rf). This resulted in a **cost of equity of 9.0%** for the industry. We used the 10-year treasury yield of 1.59%, as our risk free rate. While we are aware that in "normal times" this rate might be overstated, as it includes an implicit risk premium over buying one year bonds over a period of 10 years, we believe that we do not need to make an adjustment given the current interest rate environment. An historic market risk premium of 6.1% was used (Figure 15).

  Using the required return of equity of 9.0%, we used the average tax rate and debt level of the industry to calculate the **weighted average cost of capital of 8.7%**. As the debt levels in the industry are very moderate, we divided the industry's interest payment in 2011 on its outstanding debt to arrive at a **cost of debt of 5.0%**.

Figure 14: Beta Calculation

Company	Levered beta	Market Value of Debt	Market Value of Equity	EV	Debt/ Equity	Marginal Tax Rate	Unlevered beta	weight
GPS	1.184	1,614.0	17,220.0	18,834.0	9.4%	35%	1.08	49%
URBN	0.969	0.0	5,520.0	5,520.0	0.0%	35%	0.97	16%
AEO	0.963	0.0	4,430.0	4,430.0	0.0%	35%	0.96	13%
GES	1.656	10.4	2,280.0	2,290.4	0.5%	35%	1.65	6%
ANF	1.602	290.3	2,890.0	3,180.3	10.0%	35%	1.46	8%
ANN	1.784	0.0	1,819.6	1,819.6	0.0%	35%	1.78	5%
ARO	1.176	0.0	1,140.0	1,140.0	0.0%	35%	1.18	3%

beta (mkt cap weighted)	1.22
unlevered beta (equal weighted)	1.30
beta (equal weighted)	1.34

Source: Company Data; CRSP, PEC Research

Figure 15: WACC Calculation

Target Capital Structure	
Debt-to-Total-Capitalization(1)	5.1%
Equity-to-Total-Capitalization(2)	94.9%

Cost of Debt		***Cost of Equity***	
Cost of debt(3)	5.0%	Risk-free Rate(5)	1.59%
Tax rate(4)	35.0%	Market Risk Premium(6)	6.1%
After-tax Cost of Debt	**3.3%**	Levered Beta	1.22
		Cost of Equity	**9.0%**
WACC	**8.7%**		

1) 2011 ratio - annual reports
2) 2011 ratio - annual reports
3) Total Interest Payments in 2011 ($111m) divided by total Debt Outstanding in 2011 ($2.047bn)
4) http://www.taxrates.cc/html/us-tax-rates.html
5) yield on 10 year treasury, Source: US Treasury Departmen5
6) Ashwath Damodaran - http://pages.stern.nyu.edu/~adamodar/

Source: Company Data; CRSP, PEC Research

- **Putting it all together -** We aggregated the balance sheets, income statements and cash flow statements of the 7 companies in our industry to arrive at our industry valuation. Given the maturity of this industry – the vast majority of sales are incurred domestically – it does not come as surprise that most of line items on the balance sheet and income statement have been fairly consistent in relation to sales over the past 5 years. We used these ratios to project out the balance sheet. We also used this approach for most of the line items on the income statement,

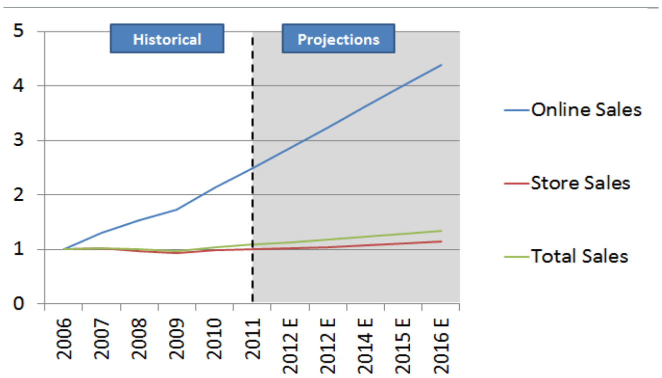
  With respect to the income statement, the industry has experienced an unsual year in 2011 caused by a **spike in cotton prices** (Figure 16). This spike in cotton prices, which was driven by short-term supply shortages and decribed as having elements of panic buying by industry experts, led to an increase in COGS as a percentage of sales in 2011. However, as this is a one time event, we projected COGS to return to their "normal" levels going forward.

Figure 16: Monthly cotton price – US cents per pound

Source: USDA market news

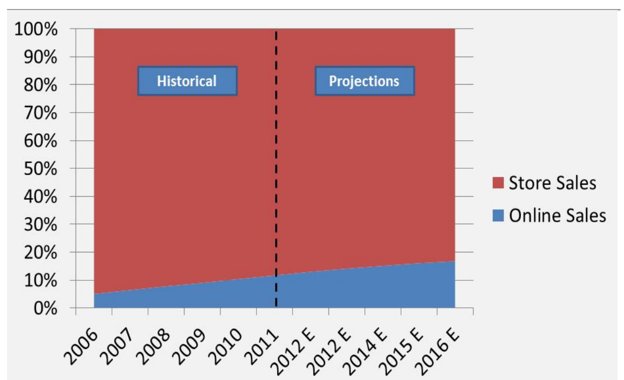
A second item of interest on the income statements is SG&A. Over the past six years, the share of online sales as a percentage of total sales has increased from 5% to 12% (Figure 17). In theory, the online sales should be higher margin sales than the traditional sales, as there are no store operating costs associated with them. Therefore, we expected, to see SG&A as percentage of sales to decrease as a result of the increased online sales. However, we cannot find any evidence of this in the indusry's financials for the past 5 years. SG&A as a percentage of sales was 30.0% in 2007 and remained at 29.9% of sales in 2011. Consequently, while we believe that there should be some potential for margin improvements in the industry going forward due to favorably sales mix shift, we did not include the potential for margin expansion in our base case scenario.

Figure 17: Online vs. Store Sales growth



Source: Company Data; PEC Research

Figure 18: Online vs. Store Share of Sales



Source: Company Data; PEC Research

One has to be aware that while the data has not shown an improvement in SG&A over the previous 5 years, this could also be the result of two offsetting trends. On the one hand, the increased online sales should be margin accretive, as described above. On the other hand, in the short term, the shift to online sales cannibalizes the store sales and absent store closures, the SG&A for store sales as a percentage of total store sales will increase. Therefore, future store network optimization/ closure of unprofitable stores, could lead to the lower SG&A as percentage of total sales, that we expected in the first place. While we did not want to build our base case on this assumption, we have created a **"bull case" scenario** to show the potential magnitude of a an increased EBITDA margin due to a favorable sales mix shift to the online channel (Figure 19). In our bull case, we are assuming that the operting margin on online sales is about twice as high as the margin on traditional sales[15] and that the effect of increased SG&A cost caused by international expansion will significantly decline, leading to an overall increase in EBITDA margins. Please refer to the appendix for a detailed valuation of the "bull case" scenario.

Figure 19: "Bull case" scenario

	Historical					Projection									
(in $ m)	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Total sales	29,813.30	29,007.02	28,190.80	30,242.36	31,583.48	32,652.39	33,974.18	35,545.11	37,112.60	38,658.96	40,166.19	41,739.49	43,251.95	44,686.16	46,026.74
Online share	6.4%	7.8%	9.0%	10.4%	11.7%	0.13	0.14	0.15	0.16	0.17	0.17	0.17	0.18	0.17	0.17
Store share	93.6%	92.2%	91.0%	89.6%	88.3%	0.87	0.86	0.85	0.84	0.83	0.83	0.83	0.82	0.83	0.83
Online sales	1,914.53	2,255.22	2,533.73	3,134.43	3,687.28	4,240.38	4,791.62	5,366.62	5,956.95	6,493.07	6,947.59	7,294.97	7,586.77	7,814.37	8,048.80
Store sales	27,898.76	26,751.80	25,657.08	27,107.93	27,896.20	28,412.02	29,182.55	30,178.49	31,155.65	32,165.89	33,218.61	34,444.53	35,665.19	36,871.79	37,977.94
Online sales growth		17.79%	12.35%	23.71%	17.64%	0.15	0.13	0.12	0.11	0.09	0.07	0.05	0.04	0.03	0.03
Store sales growth		-4.11%	-4.09%	5.65%	2.91%	0.02	0.03	0.03	0.03	0.03	0.03	0.04	0.04	0.03	0.03
Online EBITDA margin	27%	26%	28%	29%	25%	26%	26%	26%	26%	26%	26%	26%	26%	26%	26%
Store EBITDA margin	15%	15%	15%	16%	14%	15%	15%	15%	15%	15%	15%	15%	15%	15%	15%
Online EBITDA	513.42	595.33	700.94	909.38	914.64	1,102.50	1,245.82	1,395.32	1,548.81	1,688.20	1,806.37	1,896.69	1,972.56	2,031.74	2,092.69
Store EBITDA	4,156.48	3,923.30	3,943.27	4,369.28	3,844.27	4,252.25	4,367.57	4,516.62	4,662.87	4,814.06	4,971.62	5,155.09	5,337.78	5,518.37	5,683.92
Total EBITDA	4,669.90	4,518.63	4,644.22	5,278.65	4,758.91	5,354.74	5,613.39	5,911.95	6,211.68	6,502.26	6,777.99	7,051.79	7,310.34	7,550.10	7,776.61
EBITDA margin						16.4%	16.5%	16.6%	16.7%	16.8%	16.9%	16.9%	16.9%	16.9%	16.9%
Base case EBITDA						5,095.58	5,301.85	5,547.00	5,791.62	6,032.93	6,268.14	6,513.67	6,749.69	6,973.51	7,182.71
Base case EBITDA margin						15.6%	15.6%	15.6%	15.6%	15.6%	15.6%	15.6%	15.6%	15.6%	15.6%

Source: Company Data; PEC Research

Below is a summary output of our base case scenario (Figure 22) and two sensitivity tables, that show how the equity value and the "implied" discount of the industry's equity value reacts to different beta and terminal growth rate assumption (Figure 20 and 21). We believe that the **industry equity is worth $37.7bn which is at a 6% discount to the current industry equity valuation of $35.3bn.** However, we do not believe that the 6% is a big enough margin of safety to recommend buying the industry. Hence, **we initiate a HOLD recommendation.**

Figure 20: Equity value sensitivity table (base case)

Equity Value		equity beta				
		1.00	1.10	1.20	1.20	1.40
growth rate	2.00%	43,811.82	39,484.54	35,915.96	35,915.96	30,377.17
	2.25%	45,204.12	40,567.06	36,774.19	36,774.19	30,942.05
	2.50%	46,736.46	41,747.09	37,702.42	37,702.42	31,545.67
	2.75%	48,431.08	43,038.42	38,709.58	38,709.58	32,192.16
	3.00%	50,315.21	44,457.60	39,806.18	39,806.18	32,886.27

Source: PEC Research

Figure 21: Implied discount to current market value of equity (base case)

Discount		equity beta				
		1.00	1.10	1.20	1.20	1.40
growth rate	2.00%	19%	11%	2%	2%	-16%
	2.25%	22%	13%	4%	4%	-14%
	2.50%	24%	15%	6%	6%	-12%
	2.75%	27%	18%	9%	9%	-10%
	3.00%	30%	21%	11%	11%	-7%

Source: PEC Research

[15] Company reports

Figure 22: Base case output

	Historical Period							Projection Period									
	2007	2008	2009	2010	2011	LTM	CAGR	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
GPS	15,763.00	14,526.00	14,197.00	14,664.00	14,549.00	14,930.00	-2.0%										
URBN	1,507.72	1,834.62	1,937.82	2,274.10	2,473.80	2,518.71	13.2%										
AEO	3,055.42	2,988.87	2,940.27	2,967.56	3,159.82	3,333.33	0.8%										
GES	1,749.92	2,093.39	2,128.47	2,487.29	2,688.05	2,633.30	11.3%										
ANF	3,749.85	3,484.06	2,928.63	3,468.78	4,158.06	4,277.25	2.6%										
ANN	2396.51	2194.559	1828.523	1980.195	2212.493	2,285.95	-2.0%										
ARO	1,590.88	1,885.53	2,230.11	2,400.43	2,342.26	2,387.44	10.2%										
Domestic sales	24,534.82	23,315.40	22,515.30	23,542.75	24,052.66	23,754.89	-0.5%	24,293.19	24,779.05	25,522.42	26,288.10	27,076.74	27,889.04	28,725.71	29,587.48	30,475.11	31,389.36
International sales	5,278.48	5,691.63	5,675.50	6,699.61	7,530.82	8,611.08	9.3%	8,359.21	9,195.13	10,022.69	10,824.50	11,582.22	12,277.15	13,013.78	13,664.47	14,211.05	14,637.38
Total Sales	**29,813.30**	**29,007.02**	**28,190.80**	**30,242.36**	**31,583.48**	**32,365.97**	*1.5%*	**32,652.39**	**33,974.18**	**35,545.11**	**37,112.60**	**38,658.96**	**40,166.19**	**41,739.49**	**43,251.95**	**44,686.16**	**46,026.74**
% growth		*-3%*	*-3%*	*7%*	*4%*	*2%*		*3%*	*4%*	*5%*	*4%*	*4%*	*4%*	*4%*	*4%*	*3%*	*3%*
COGS	16,191.63	15,830.69	14,896.55	15,953.10	17,829.40	18,192.97		17,860.86	18,583.88	19,443.18	20,300.59	21,146.45	21,970.91	22,831.50	23,658.82	24,443.33	25,176.63
SG&A	8,935.95	8,657.70	8,650.04	9,010.61	9,449.87	9,977.87		9,795.72	10,192.25	10,663.53	11,133.78	11,597.69	12,049.86	12,521.85	12,975.59	13,405.85	13,808.02
Other Operating Expenses	15.81	-	-	-	3.79	117.11		23.23	24.17	25.29	26.40	27.50	28.57	29.69	30.77	31.79	32.74
EBITDA	**4,669.90**	**4,518.63**	**4,644.22**	**5,278.65**	**4,300.43**	**4,078.03**	*-2.0%*	**4,972.59**	**5,173.88**	**5,413.12**	**5,651.83**	**5,887.32**	**6,116.85**	**6,356.45**	**6,586.78**	**6,805.19**	**7,009.35**
% margin	*15.7%*	*15.6%*	*16.5%*	*17.5%*	*13.6%*	*13%*		*15%*	*15%*	*15%*	*15%*	*15%*	*15%*	*15%*	*15%*	*15%*	*15%*
Depreciation & Amortization	1,114.1	1,235.6	1,338.3	1,344.8	1,311.4	1,167.29		1,357.76	1,412.73	1,478.05	1,543.23	1,607.53	1,670.20	1,735.63	1,798.52	1,858.16	1,913.90
EBIT	**3,555.83**	**3,283.03**	**3,305.91**	**3,933.82**	**2,989.01**	**2,910.74**	*-4.2%*	**3,614.82**	**3,761.15**	**3,935.07**	**4,108.60**	**4,279.79**	**4,446.65**	**4,620.82**	**4,788.26**	**4,947.04**	**5,095.45**
% margin	*12%*	*11%*	*12%*	*13%*	*9%*	*9%*		*11%*	*11%*	*11%*	*11%*	*11%*	*11%*	*11%*	*11%*	*11%*	*11%*
Taxes	1,339.90	1,161.28	1,228.60	1,472.99	1,107.58			1,301.34	1,354.02	1,416.62	1,479.09	1,540.72	1,600.79	1,663.50	1,723.77	1,780.93	1,834.36
EBIAT	**2,215.93**	**2,121.75**	**2,077.31**	**2,460.82**	**1,881.43**		*-4.0%*	**2,313.49**	**2,407.14**	**2,518.44**	**2,629.50**	**2,739.06**	**2,845.86**	**2,957.33**	**3,064.49**	**3,166.10**	**3,261.09**
Plus: Depreciation & Amortization	1,114.08	1,235.59	1,338.31	1,344.84	1,311.42			1,357.76	1,412.73	1,478.05	1,543.23	1,607.53	1,670.20	1,735.63	1,798.52	1,858.16	1,913.90
Less: Capital Expenditures (net)	(1,822.46)	(1,533.50)	(1,081.60)	(1,419.64)	(1,622.69)			(1,654.02)	(1,720.97)	(1,800.55)	(1,879.95)	(1,958.28)	(2,034.63)	(2,114.33)	(2,190.94)	(2,263.59)	(2,331.50)
Less: Increase in Net Working Capital	NA	561.47	(490.35)	505.55	531.28			394.52	90.25	107.27	107.03	105.59	102.92	107.43	103.27	97.93	91.54
Unlevered Free Cash Flow		**2,385.32**	**1,843.67**	**2,891.57**	**2,101.44**	**1,808.99**		**2,411.75**	**2,189.14**	**2,303.21**	**2,399.81**	**2,493.90**	**2,584.34**	**2,686.05**	**2,775.34**	**2,858.60**	**2,935.02**
Discount Period								0.5	1.5	2.5	3.5	4.5	5.5	6.5	7.5	8.5	9.5
Discount Factor								0.96	0.88	0.81	0.75	0.69	0.63	0.58	0.53	0.49	0.45
PV of Cashflow								2,312.86	1,930.73	1,868.15	1,790.15	1,710.89	1,630.52	1,558.55	1,481.00	1,402.89	1,324.69

WACC	**8.73%**
PV of FCF from '13 to '17	**15,685.73**
Terminal Growth	2.5%
PV of Terminal Value	**23,102.91**
Enterprise Value	**38,788.64**
Less: Net Debt	1735.09
Equity Value	**37,053.56**
Current Aggregate Market Cap	**35,299.62**
Current Discount	-5%

Source: Company Data; PEC Research

- **Bull and bear case** – In addition to our base case, we have also created a bull and a bear case. We are most confident in our base case and therefore also base our valuation on this scenario. The motivation behind including a bear and bull case was to give the reader an idea of potential upside and downside scenarios when thinking about investing into the industry.

  Both the bull and the bear case valuation can be found in the appendix. We already discussed the basic assumptions for the bull case – increased EBITDA margins due to a favourable sales mix shift – above. For the bear case, we are basically using two assumptions that differ from the base case; 1) while the spike in cotton prices in 2011 was an outlier, we assume that there will be constant overall rise in cotton prices in the future. This will be driven by an increase demand in the commodity, mainly from India and China. 2) international sales will continue to grow faster than the domestic sales but we assumed a slower growth rate for international sales in the bear case then in the base case.

  Under the bull case scenario, we believe that the fair equity value is about $43.2Bn, implying an 18% upside potential to the current market value of the equity (Figure 23). Under the bear case scenario, we believe that the fair equity value is $32.4Bn, implying that the industry is currently overvalued by about 9% (Figure 24).

Figure 23: Bull case

PV of FCF from '13 to '17	**17,970.85**
Terminal Growth	2.5%
PV of Terminal Value	**26,968.15**
Enterprise Value	**44,939.00**
Less: Net Debt	1735.09
Equity Value	**43,203.91**
Current Aggregate Market Cap	**35,299.62**
Current Discount	-18%

Source: PEC Research

Figure 24: Bear case

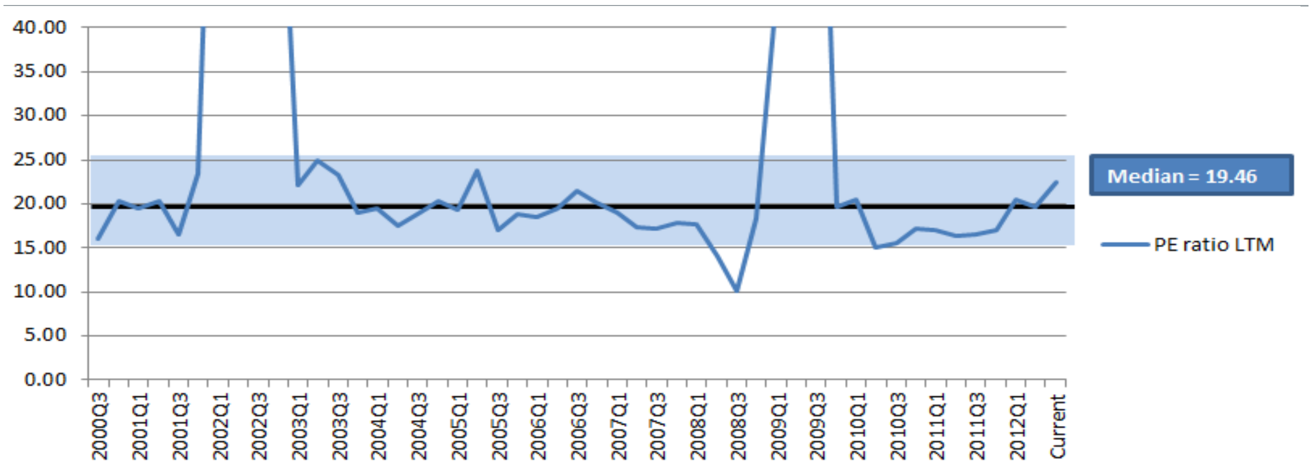
PV of FCF from '13 to '17	**14,478.40**
Terminal Growth	2.5%
PV of Terminal Value	**19,642.64**
Enterprise Value	**34,121.04**
Less: Net Debt	1735.09
Equity Value	**32,385.95**
Current Aggregate Market Cap	**35,299.62**
Current Premium	9%

Source: PEC Research

Multiples Approach

As a sanity check to our DCF valuation, we calculated a quarterly, rolling Price-to-LTM Earnings ratio for the past 12 years. In the PE calculation, we included two companies - Tommy Hilfiger Corp. and J. Crew Group - that fit our industry description but were taken private in 2005 and 2009, respectively. Looking at the chart below, it becomes apparent that over time, this **ratio has fluctuated around a multiple of 20** (median of 19.46). On average, investors were willing to pay 20 times for the industry's past 12 months earnings. The big spikes in 2002 and 2009 were outliers caused by Tommy Hilfiger and Ann Taylor, respectively, reporting negative earnings, as a result of major write-offs. These outliers should be disregarded. Looking at the current industry PE ratio of 22.5, the industry seems fairly valued. This is consistent with our DCF valuation. Similar to our DCF valuation, one could argue that the industry is slightly undervalued as the 2011 Earnings were somewhat depressed due to the price spike in cotton prices. Hence, the current multiple of just above 20 is on slightly depressed earnings, which are the results of a one-time event (price spike for cotton). However, just as in our DCF valuation, we do not believe that the current margin of safety is large enough to initiate our coverage of the industry with a buy recommendation.

Figure 25: Price to LTM Earnings



Source: CRSP, Compustat; PEC Research

Appendix

Base case valuation

	Historical Period					Projection Period									
	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
Sales	29,813.30	29,007.02	28,190.80	30,242.36	31,583.48	32,577.09	33,725.66	35,005.83	36,245.67	37,432.62	38,555.60	39,712.27	40,903.63	42,130.74	43,394.66
Cost of Goods Sold	16,191.63	15,830.69	14,896.55	15,953.10	17,829.40	17,794.69	18,455.81	19,191.36	19,907.33	20,596.68	21,253.13	21,930.44	22,629.26	23,350.26	24,094.17
Current Assets															
Accounts Receivable	887.0	918.2	881.7	1,286.7	1,425.9	1,160.28	1,201.19	1,246.78	1,290.94	1,333.22	1,373.21	1,414.41	1,456.84	1,500.55	1,545.56
Inventories	3,500.8	3,407.6	3,359.4	3,883.7	4,360.5	4,143.97	4,297.93	4,469.22	4,635.95	4,796.49	4,949.36	5,107.09	5,269.83	5,437.73	5,610.97
Prepaid Expenses and Other	1,243.1	1,398.5	1,309.8	1,138.5	1,300.8	1,402.11	1,451.55	1,506.65	1,560.01	1,611.10	1,659.43	1,709.21	1,760.49	1,813.30	1,867.70
Total Current Assets	**5,630.9**	**5,724.3**	**5,551.0**	**6,308.8**	**7,087.2**	**6,706.4**	**6,950.7**	**7,222.7**	**7,486.9**	**7,740.8**	**7,982.0**	**8,230.7**	**8,487.2**	**8,751.6**	**9,024.2**
Current Liabilities															
Accounts Payable	1,987.1	1,827.4	1,926.4	2,085.8	2,160.0	2,204.28	2,286.17	2,377.29	2,465.98	2,551.37	2,632.69	2,716.59	2,803.15	2,892.46	2,984.61
Other Current Liabilities	2,916.7	2,608.4	2,826.4	2,919.3	3,092.1	2,280.40	2,360.80	2,450.41	2,537.20	2,620.28	2,698.89	2,779.86	2,863.25	2,949.15	3,037.63
Total Current Liabilities	**4,903.8**	**4,435.8**	**4,752.8**	**5,005.1**	**5,252.1**	**4,484.7**	**4,647.0**	**4,827.7**	**5,003.2**	**5,171.7**	**5,331.6**	**5,496.4**	**5,666.4**	**5,841.6**	**6,022.2**
Net Working Capital	**727.08**	**1,288.55**	**798.21**	**1,303.75**	**1,835.03**	**2,221.69**	**2,303.70**	**2,394.96**	**2,483.73**	**2,569.15**	**2,650.42**	**2,734.27**	**2,820.75**	**2,909.97**	**3,002.00**
% sales	2.44%	4.44%	2.83%	4.31%	5.81%	6.82%	6.83%	6.84%	6.85%	6.86%	6.87%	6.89%	6.90%	6.91%	6.92%

	Historical Period							Projection Period									
	2007	2008	2009	2010	2011	LTM	CAGR	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
GPS	15,763.00	14,526.00	14,197.00	14,664.00	14,549.00	14,930.00	*-2.0%*										
URBN	1,507.72	1,834.62	1,937.82	2,274.10	2,473.80	2,518.71	*13.2%*										
AEO	3,055.42	2,988.87	2,940.27	2,967.56	3,159.82	3,333.33	*0.8%*										
GES	1,749.92	2,093.39	2,128.47	2,487.29	2,688.05	2,633.30	*11.3%*										
ANF	3,749.85	3,484.06	2,928.63	3,468.78	4,158.06	4,277.25	*2.6%*										
ANN	2396.51	2194.559	1828.523	1980.195	2212.493	2,285.95	*-2.0%*										
ARO	1,590.88	1,885.53	2,230.11	2,400.43	2,342.26	2,387.44	*10.2%*										
Domestic sales	24,534.82	23,315.40	22,515.30	23,542.75	24,052.66	23,754.89	*-0.5%*	24,293.19	24,779.05	25,522.42	26,288.10	27,076.74	27,889.04	28,725.71	29,587.48	30,475.11	31,389.36
International sales	5,278.48	5,691.63	5,675.50	6,699.61	7,530.82	8,611.08	*9.3%*	8,359.21	9,195.13	10,022.69	10,824.50	11,582.22	12,277.15	13,013.78	13,664.47	14,211.05	14,637.38
Total Sales	**29,813.30**	**29,007.02**	**28,190.80**	**30,242.36**	**31,583.48**	**32,365.97**	***1.5%***	**32,652.39**	**33,974.18**	**35,545.11**	**37,112.60**	**38,658.96**	**40,166.19**	**41,739.49**	**43,251.95**	**44,686.16**	**46,026.74**
% growth		*-3%*	*-3%*	*7%*	*4%*	*2%*		*3%*	*4%*	*5%*	*4%*	*4%*	*4%*	*4%*	*4%*	*3%*	*3%*
COGS	16,191.63	15,830.69	14,896.55	15,953.10	17,829.40	18,192.97		17,860.86	18,583.88	19,443.18	20,300.59	21,146.45	21,970.91	22,831.50	23,658.82	24,443.33	25,176.63
SG&A	8,935.95	8,657.70	8,650.04	9,010.61	9,449.87	9,977.87		9,795.72	10,192.25	10,663.53	11,133.78	11,597.69	12,049.86	12,521.85	12,975.59	13,405.85	13,808.02
Other Operating Expenses	15.81	-	-	-	3.79	117.11		23.23	24.17	25.29	26.40	27.50	28.57	29.69	30.77	31.79	32.74
EBITDA	**4,669.90**	**4,518.63**	**4,644.22**	**5,278.65**	**4,300.43**	**4,078.03**	*-2.0%*	**4,972.59**	**5,173.88**	**5,413.12**	**5,651.83**	**5,887.32**	**6,116.85**	**6,356.45**	**6,586.78**	**6,805.19**	**7,009.35**
% margin	*15.7%*	*15.6%*	*16.5%*	*17.5%*	*13.6%*	*13%*		*15%*	*15%*	*15%*	*15%*	*15%*	*15%*	*15%*	*15%*	*15%*	*15%*
Depreciation & Amortization	1,114.1	1,235.6	1,338.3	1,344.8	1,311.4	1,167.29		1,357.76	1,412.73	1,478.05	1,543.23	1,607.53	1,670.20	1,735.63	1,798.52	1,858.16	1,913.90
EBIT	**3,555.83**	**3,283.03**	**3,305.91**	**3,933.82**	**2,989.01**	**2,910.74**	*-4.2%*	**3,614.82**	**3,761.15**	**3,935.07**	**4,108.60**	**4,279.79**	**4,446.65**	**4,620.82**	**4,788.26**	**4,947.04**	**5,095.45**
% margin	*12%*	*11%*	*12%*	*13%*	*9%*	*9%*		*11%*	*11%*	*11%*	*11%*	*11%*	*11%*	*11%*	*11%*	*11%*	*11%*
Taxes	1,339.90	1,161.28	1,228.60	1,472.99	1,107.58			1,301.34	1,354.02	1,416.62	1,479.09	1,540.72	1,600.79	1,663.50	1,723.77	1,780.93	1,834.36
EBIAT	**2,215.93**	**2,121.75**	**2,077.31**	**2,460.82**	**1,881.43**		*-4.0%*	**2,313.49**	**2,407.14**	**2,518.44**	**2,629.50**	**2,739.06**	**2,845.86**	**2,957.33**	**3,064.49**	**3,166.10**	**3,261.09**
Plus: Depreciation & Amortization	1,114.08	1,235.59	1,338.31	1,344.84	1,311.42			1,357.76	1,412.73	1,478.05	1,543.23	1,607.53	1,670.20	1,735.63	1,798.52	1,858.16	1,913.90
Less: Capital Expenditures (net)	(1,822.46)	(1,533.50)	(1,081.60)	(1,419.64)	(1,622.69)			(1,654.02)	(1,720.97)	(1,800.55)	(1,879.95)	(1,958.28)	(2,034.63)	(2,114.33)	(2,190.94)	(2,263.59)	(2,331.50)
Less: Increase in Net Working Capital	NA	561.47	(490.35)	505.55	531.28			394.52	90.25	107.27	107.03	105.59	102.92	107.43	103.27	97.93	91.54
Unlevered Free Cash Flow		**2,385.32**	**1,843.67**	**2,891.57**	**2,101.44**	**1,808.99**		**2,411.75**	**2,189.14**	**2,303.21**	**2,399.81**	**2,493.90**	**2,584.34**	**2,686.05**	**2,775.34**	**2,858.60**	**2,935.02**
Discount Period								0.5	1.5	2.5	3.5	4.5	5.5	6.5	7.5	8.5	9.5
Discount Factor								0.96	0.88	0.81	0.75	0.69	0.63	0.58	0.53	0.49	0.45
PV of Cashflow								2,312.86	1,930.73	1,868.15	1,790.15	1,710.89	1,630.52	1,558.55	1,481.00	1,402.89	1,324.69

Debt-to-Total Capitalization	5%
Equity-to-Total Capitalization	95%
Cost of Debt	
Cost of Debt	5.0%
Tax Rate	35%
After-tax Cost of Debt	**3.3%**
Cost of Equity	
Risk-free Rate[(1)]	1.6%
Market Risk Premium[(2)]	6.1%
Levered Beta	1.22
Cost of Equity	**9.0%**
WACC	**8.73%**
PV of FCF from '13 to '17	**15,685.73**
Terminal Growth	2.5%
PV of Terminal Value	**23,102.91**
Enterprise Value	**38,788.64**
Less: Net Debt	1735.09
Equity Value	**37,053.56**
Current Aggregate Market Cap	**35,299.62**
Current Discount	-5%

Bull case valuation

	Historical Period							Projection Period									
	2007	**2008**	**2009**	**2010**	**2011**	**LTM**	**CAGR**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**
GPS	15,763.00	14,526.00	14,197.00	14,664.00	14,549.00	14,930.00	*-2.0%*										
URBN	1,507.72	1,834.62	1,937.82	2,274.10	2,473.80	2,518.71	*13.2%*										
AEO	3,055.42	2,988.87	2,940.27	2,967.56	3,159.82	3,333.33	*0.8%*										
GES	1,749.92	2,093.39	2,128.47	2,487.29	2,688.05	2,633.30	*11.3%*										
ANF	3,749.85	3,484.06	2,928.63	3,468.78	4,158.06	4,277.25	*2.6%*										
ANN	2396.51	2194.559	1828.523	1980.195	2212.493	2,285.95	*-2.0%*										
ARO	1,590.88	1,885.53	2,230.11	2,400.43	2,342.26	2,387.44	*10.2%*										
Domestic sales	24,534.82	23,315.40	22,515.30	23,542.75	24,052.66	23,754.89	*-0.5%*	24,293.19	24,779.05	25,522.42	26,288.10	27,076.74	27,889.04	28,725.71	29,587.48	30,475.11	31,389.36
International sales	5,278.48	5,691.63	5,675.50	6,699.61	7,530.82	8,611.08	*9.3%*	8,359.21	9,195.13	10,022.69	10,824.50	11,582.22	12,277.15	13,013.78	13,664.47	14,211.05	14,637.38
Total Sales	**29,813.30**	**29,007.02**	**28,190.80**	**30,242.36**	**31,583.48**	**32,365.97**	***1.5%***	**32,652.39**	**33,974.18**	**35,545.11**	**37,112.60**	**38,658.96**	**40,166.19**	**41,739.49**	**43,251.95**	**44,686.16**	**46,026.74**
% growth		*-3%*	*-3%*	*7%*	*4%*	*2%*		*3%*	*4%*	*5%*	*4%*	*4%*	*4%*	*4%*	*4%*	*3%*	*3%*
Direct sales	1,914.53	2,255.22	2,533.73	3,134.43	3,687.28			4,240.38	4,791.62	5,366.62	5,956.95	6,493.07	6,947.59	7,294.97	7,586.77	7,814.37	8,048.80
Store sales	27,898.76	26,751.80	25,657.08	27,107.93	27,896.20			28,412.02	29,182.55	30,178.49	31,155.65	32,165.89	33,218.61	34,444.53	35,665.19	36,871.79	37,977.94
Direct Sales growth	*0%*	*18%*	*12%*	*24%*	*18%*			*15%*	*13%*	*12%*	*11%*	*9%*	*7%*	*5%*	*4%*	*3%*	*3%*
Store sales growth	*0%*	*-4%*	*-4%*	*6%*	*3%*			*2%*	*3%*	*3%*	*3%*	*3%*	*3%*	*4%*	*4%*	*3%*	*3%*
Direct EBITDA	*513.42*	*595.33*	*700.94*	*909.38*	*914.64*			1,102.50	1,245.82	1,395.32	1,548.81	1,688.20	1,806.37	1,896.69	1,972.56	2,031.74	2,092.69
Store EBITDA	*4,156.48*	*3,923.30*	*3,943.27*	*4,369.28*	*3,844.27*			4,252.25	4,367.57	4,516.62	4,662.87	4,814.06	4,971.62	5,155.09	5,337.78	5,518.37	5,683.92
Normalized EBITDA	**4,669.90**	**4,518.63**	**4,644.22**	**5,278.65**	**4,758.91**			**5,354.74**	**5,613.39**	**5,911.95**	**6,211.68**	**6,502.26**	**6,777.99**	**7,051.79**	**7,310.34**	**7,550.10**	**7,776.61**
% margin	*15.7%*	*15.6%*	*16.5%*	*17.5%*	*15.1%*			*16.4%*	*16.5%*	*16.6%*	*16.7%*	*16.8%*	*16.9%*	*16.9%*	*16.9%*	*16.9%*	*16.9%*
Depreciation & Amortization	1,114.1	1,235.6	1,338.3	1,344.8	1,311.4	1,167.29		1,357.76	1,412.73	1,478.05	1,543.23	1,607.53	1,670.20	1,735.63	1,798.52	1,858.16	1,913.90
EBIT	**3,555.83**	**3,283.03**	**3,305.91**	**3,933.82**	**2,989.01**	**2,910.74**	*-4.2%*	**3,996.98**	**4,200.66**	**4,433.90**	**4,668.45**	**4,894.73**	**5,107.79**	**5,316.16**	**5,511.82**	**5,691.95**	**5,862.71**
% margin	*12%*	*11%*	*12%*	*13%*	*9%*	*9%*		*12%*	*12%*	*12%*	*13%*	*13%*	*13%*	*13%*	*13%*	*13%*	*13%*
Taxes	1,339.90	1,161.28	1,228.60	1,472.99	1,107.58			1,438.91	1,512.24	1,596.20	1,680.64	1,762.10	1,838.80	1,913.82	1,984.26	2,049.10	2,110.57
EBIAT	**2,215.93**	**2,121.75**	**2,077.31**	**2,460.82**	**1,881.43**		*-4.0%*	**2,558.07**	**2,688.43**	**2,837.69**	**2,987.81**	**3,132.63**	**3,268.98**	**3,402.34**	**3,527.57**	**3,642.85**	**3,752.13**
Plus: Depreciation & Amortization	1,114.08	1,235.59	1,338.31	1,344.84	1,311.42			1,357.76	1,412.73	1,478.05	1,543.23	1,607.53	1,670.20	1,735.63	1,798.52	1,858.16	1,913.90
Less: Capital Expenditures (net)	(1,822.46)	(1,533.50)	(1,081.60)	(1,419.64)	(1,622.69)			(1,654.02)	(1,720.97)	(1,800.55)	(1,879.95)	(1,958.28)	(2,034.63)	(2,114.33)	(2,190.94)	(2,263.59)	(2,331.50)
Less: Increase in Net Working Capital	NA	561.47	(490.35)	505.55	531.28			394.52	90.25	107.27	107.03	105.59	102.92	107.43	103.27	97.93	91.54
Unlevered Free Cash Flow		**2,385.32**	**1,843.67**	**2,891.57**	**2,101.44**	**1,808.99**		**2,656.33**	**2,470.43**	**2,622.46**	**2,758.11**	**2,887.46**	**3,007.47**	**3,131.07**	**3,238.42**	**3,335.34**	**3,426.07**

Debt-to-Total Capitalization	5%
Equity-to-Total Capitalization	95%
Cost of Debt	
Cost of Debt	5.0%
Tax Rate	35%
After-tax Cost of Debt	**3.3%**
Cost of Equity	
Risk-free Rate[1]	1.6%
Market Risk Premium[2]	6.1%
Levered Beta	1.22
Cost of Equity	**9.0%**
WACC	**8.73%**

Discount Period	0.5	1.5	2.5	3.5	4.5	5.5	6.5	7.5	8.5	9.5
Discount Factor	0.96	0.88	0.81	0.75	0.69	0.63	0.58	0.53	0.49	0.45
PV of Cashflow	2,547.41	2,178.82	2,127.10	2,057.42	1,980.89	1,897.48	1,816.77	1,728.11	1,636.86	1,546.32

PV of FCF from '13 to '17	**17,970.85**
Terminal Growth	2.5%
PV of Terminal Value	**26,968.15**
Enterprise Value	**44,939.00**
Less: Net Debt	1735.09
Equity Value	**43,203.91**
Current Aggregate Market Cap	**35,299.62**
Current Discount	-18%

Bear case valuation

	Historical Period							Projection Period									
	2007	**2008**	**2009**	**2010**	**2011**	**LTM**	**CAGR**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**	**2021**
Domestic sales	24,534.82	23,315.40	22,515.30	23,542.75	24,052.66	23,754.89	*-0.5%*	24,293.19	24,779.05	25,522.42	26,288.10	27,076.74	27,889.04	28,725.71	29,587.48	30,475.11	31,389.36
International sales	5,278.48	5,691.63	5,675.50	6,699.61	7,530.82	8,611.08	*9.3%*	8,283.90	8,946.61	9,483.41	9,957.58	10,355.88	10,666.56	10,986.55	11,316.15	11,655.63	12,005.30
Total Sales	**29,813.30**	**29,007.02**	**28,190.80**	**30,242.36**	**31,583.48**	**32,365.97**	***1.5%***	**32,577.09**	**33,725.66**	**35,005.83**	**36,245.67**	**37,432.62**	**38,555.60**	**39,712.27**	**40,903.63**	**42,130.74**	**43,394.66**
% growth		*-3%*	*-3%*	*7%*	*4%*	*2%*		*3%*	*4%*	*4%*	*4%*	*3%*	*3%*	*3%*	*3%*	*3%*	*3%*
COGS	16,191.63	15,830.69	14,896.55	15,953.10	17,829.40	18,192.97		17,852.24	18,515.39	19,253.21	19,971.37	20,662.81	21,321.25	22,000.60	22,701.52	23,424.69	24,170.83
SG&A	8,935.95	8,657.70	8,650.04	9,010.61	9,449.87	9,977.87		9,773.13	10,117.70	10,501.75	10,873.70	11,229.79	11,566.68	11,913.68	12,271.09	12,639.22	13,018.40
Other Operating Expenses	15.81	-	-	-	3.79	117.11		23.18	23.99	24.90	25.78	26.63	27.43	28.25	29.10	29.97	30.87
EBITDA	**4,669.90**	**4,518.63**	**4,644.22**	**5,278.65**	**4,300.43**	**4,078.03**	*-2.0%*	**4,928.54**	**5,068.58**	**5,225.97**	**5,374.82**	**5,513.40**	**5,640.24**	**5,769.74**	**5,901.93**	**6,036.86**	**6,174.57**
% margin	*15.7%*	*15.6%*	*16.5%*	*17.5%*	*13.6%*	*13%*		*15%*	*15%*	*15%*	*15%*	*15%*	*15%*	*15%*	*14%*	*14%*	*14%*
Depreciation & Amortization	1,114.1	1,235.6	1,338.3	1,344.8	1,311.4	1,167.29		1,354.63	1,402.39	1,455.62	1,507.18	1,556.54	1,603.23	1,651.33	1,700.87	1,751.90	1,804.45
EBIT	**3,555.83**	**3,283.03**	**3,305.91**	**3,933.82**	**2,989.01**	**2,910.74**	*-4.2%*	**3,573.91**	**3,666.19**	**3,770.35**	**3,867.64**	**3,956.86**	**4,037.01**	**4,118.41**	**4,201.06**	**4,284.96**	**4,370.11**
% margin	*12%*	*11%*	*12%*	*13%*	*9%*	*9%*		*11%*	*11%*	*11%*	*11%*	*11%*	*10%*	*10%*	*10%*	*10%*	*10%*
Taxes	1,339.90	1,161.28	1,228.60	1,472.99	1,107.58			1,286.61	1,319.83	1,357.32	1,392.35	1,424.47	1,453.32	1,482.63	1,512.38	1,542.59	1,573.24
EBIAT	**2,215.93**	**2,121.75**	**2,077.31**	**2,460.82**	**1,881.43**		*-4.0%*	**2,287.30**	**2,346.36**	**2,413.02**	**2,475.29**	**2,532.39**	**2,583.69**	**2,635.78**	**2,688.68**	**2,742.37**	**2,796.87**
Plus: Depreciation & Amortization	1,114.08	1,235.59	1,338.31	1,344.84	1,311.42			1,354.63	1,402.39	1,455.62	1,507.18	1,556.54	1,603.23	1,651.33	1,700.87	1,751.90	1,804.45
Less: Capital Expenditures (net)	(1,822.46)	(1,533.50)	(1,081.60)	(1,419.64)	(1,622.69)			(1,650.20)	(1,708.39)	(1,773.23)	(1,836.04)	(1,896.16)	(1,953.05)	(2,011.64)	(2,071.99)	(2,134.15)	(2,198.17)
Less: Increase in Net Working Capital	NA	561.47	(490.35)	505.55	531.28			392.93	82.23	91.51	89.01	85.64	81.49	84.06	86.72	89.45	92.27
Unlevered Free Cash Flow		**2,385.32**	**1,843.67**	**2,891.57**	**2,101.44**	**1,808.99**		**2,384.66**	**2,122.60**	**2,186.92**	**2,235.45**	**2,278.41**	**2,315.37**	**2,359.54**	**2,404.27**	**2,449.57**	**2,495.43**

WACC	**8.73%**

Discount Period	0.5	1.5	2.5	3.5	4.5	5.5	6.5	7.5	8.5	9.5
Discount Factor	0.96	0.88	0.81	0.75	0.69	0.63	0.58	0.53	0.49	0.45
PV of Cashflow	2,286.87	1,872.04	1,773.83	1,667.54	1,563.06	1,460.81	1,369.10	1,282.99	1,202.16	1,126.28

PV of FCF from '13 to '17	**14,478.40**
Terminal Growth	2.5%
PV of Terminal Value	**19,642.64**
Enterprise Value	**34,121.04**
Less: Net Debt	1735.09
Equity Value	**32,385.95**
Current Aggregate Market Cap	**35,299.62**
Current Premium	9%

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