Branded Apparel

November 6, 2002

As of close 11/4/2002:

S&P 500:	**908.35**
10-Year Bond:	**4.045%**
Universe of Coverage:	
JNY	**34.39**
VFC	**37.3**
LIZ	**29.67**
RL	**18.6**
COLM	**40.85**
TOM	**7.27**
ZQK	**24.51**

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Apparel needs to stretch its assets a bit

Photo from JNY website.

Definition of Ratings

<u>Over Weight</u>
Stocks in universe of coverage will exceed expected returns.

<u>Market Weight</u>
Stocks in universe of coverage will match expected returns.

<u>Under Weight</u>
Stocks in universe of coverage will not generate expected returns.

Recommendation ……....**Market Weight**
Timeframe………………..**12 months**

At this time, we feel that the branded apparel sector is fairly valued as a whole. Our recommendation of market weight takes account of upside potential for several players in the industry, although this is tempered by several economically sensitive betas and a flat economy.

On the downside, several stocks in our universe seem to suffer from under-performing assets. Balance sheets bloated by goodwill and intangibles result in poor efficiency for several debt-heavy, acquisitive companies. Whether these companies can produce adequate returns in the future is certainly in question.

In this low-growth sector, we favor the companies that show promise with respect to the efficient use of capital and assets. We disfavor companies that show signs of not being able to cover their respective long-run costs of capital.

Industry Overview

- The branded apparel industry is highly fragmented with low long-term growth prospects.
- Increased customer sensitivity and competition from department store brands have served to decrease margins in the industry as manufacturers are forced to price competitively or risk losing sales.
- Cost cutting measures, such as changing overseas sourcing partners, have been employed by major manufacturers in an attempt to try and improve margins.

Except for the Infants' & Toddlers' segment, apparel sales declined about 6% for all market segments in 2001

2001 U.S. Apparel Sales by Market Segment (billions)

Market Segment	Dollar Volume	Percent Change 00/01	Dollar Share Percent
Total Apparel	$166 b	-5.9%	100%
Men's	$51.0 b	-7.0%	30.7%
Women's	$89.3 b	-6.7%	53.9%
Boys'	$7.3 b	-5.6%	4.4%
Girls'	$7.5 b	-4.1%	4.5%
Infants' & Toddlers'	$10.6 b	5.7%	6.4%

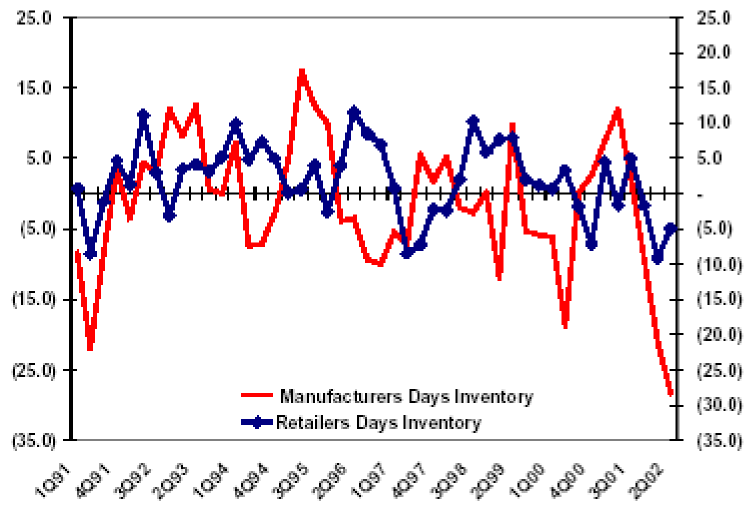
Source: NPDFashionworld℠ consumer data

Biggest decline in history of apparel manufacturers' inventory level poses a mixed impact for future

Over the past year, apparel manufacturers made the biggest YOY adjustment to their inventory level. This has two effects on the industry's future sales performance. On one hand, reduced inventory improves the current cash cycle and gross margins. On the other hand, with the relatively smaller adjustment made in the retailer side,[1] the manufacturers' may not be as quick to catch future sales upside once the economy rebounds.

[1] Morgan Stanley equity research report, September 3, 2002.

Manufacturer's Day's Inventory vs. Retailer's Days Inventory (YoY Change In Days Inventory).



Source: Morgan Stanley Research, Factset, and company documents.

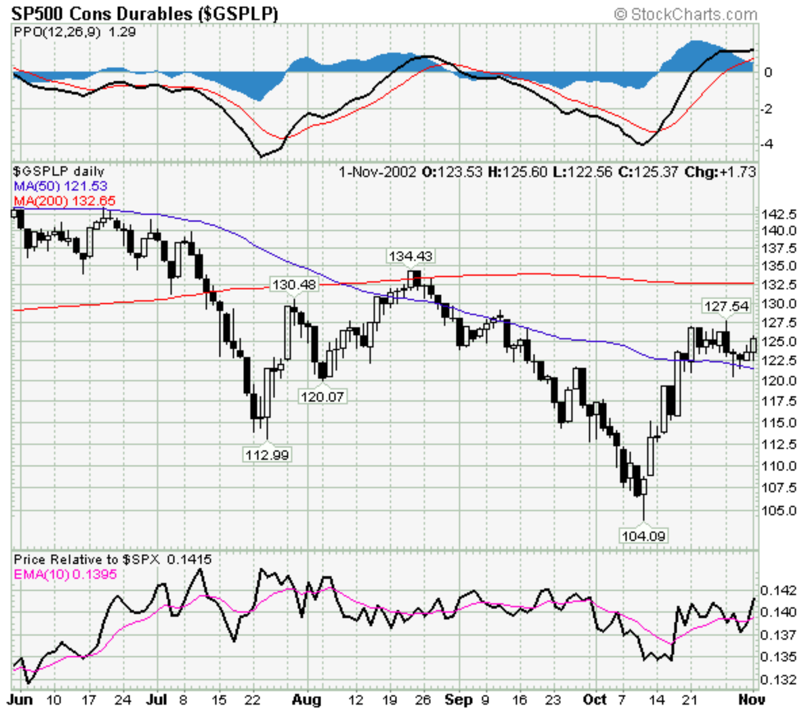
A highly fragmented industry with low long-term growth prospects

Less than 4% average growth per year is expected for the highly fragmented $160 billion apparel industry. Current weak consumer spending poses further challenges to industry growth in the short-term.

S&P 500 Consumer Durable & Apparel Industry Group Index (source: StockCHarts.com)

S&P 500 Consumer Durable & Apparel Industry Group Index reveals a short-term downward but long-term slightly upward trend.

Note: The black bars are the daily index, the blue line is the moving average of 50 days of the index, and the red line is the moving average of 200 days of the index.



Retailers show overall conservative buying

The ability for Branded Apparel manufacturers to diversify their distribution channels is a key factor in handling short-term demand variations brought about by the current[2] conservative buying patterns shown by retailers.

Competition from retailers' own brands has impacted sales.

Competition from retailers' own brands, particularly in department stores, has impacted the sales of branded apparel. Stores are taking advantage of increased price sensitivity of customers who increasingly want more competitively priced products.

Consequently, some manufacturers are considering expanding their product lines to include lower-margin businesses that are priced more competitively but sufficiently differentiated from their current products that there is no adverse effect on their current brand.

Lower-margin businesses result in the reshuffling of overseas sourcing partners

Companies are sometimes forced to find lower-cost sourcing deals to take on the low-margin (low-cost) business. While apparel companies may benefit from renegotiating terms with its existing partners, the failure to either get a better renegotiation term or find alternative appropriate sourcing partners poses a threat to these companies' future earnings performances.

[2] As at 3Q 2002

Revenues

Revenues overall have decreased YOY from 2001 till 2002, a trend that looks likely to continue in the short term[3].

Prices have dropped on average due to the increased price sensitivity of buyers and increased competition for internal brands from department stores.

Cost reduction measures by branded apparel companies to improve profitability have not been able to counter this decline in margins.

Revenue Segments

Branded apparel manufacturers generally recognize revenue from three major business segments, analogous to their main distribution channels. These are:

- Wholesale – Revenues from the design, manufacture and marketing of merchandise to wholesale customers. This accounted for an average of almost 70% of revenues for the top branded apparel manufacturers in 2002Q2. However, this is the least profitable segment, providing only 22% of the total profits.[4]

- Retail – Revenues accruing from the sale of merchandise to the public through specialty retail and outlet stores (usually operated by the manufacturer), and concession stores (where products are sold in third-party owned locations). This represented a total of 23% of sales on average in 2002Q2 for the top manufacturers. Contribution to overall profits by this segment was slightly over 20%.

- Licensing - Major apparel brands license the right to manufacture, market and sell selected products (at wholesale) to third parties. Usually, the licensing agreement provides for the payment to the brand owner of a percentage of the licensee's sales of the licensed products against a guaranteed minimum royalty, which generally increases over the term of the agreement. This accounted for less than 8% of total sales but contributed 56.3% of total profits for major brand manufacturers.

Other sources of revenue include sales generated from mail order catalogues and the internet. However currently, their contributions to total revenues are comparably negligible (less than 1% on average).

Performance Overview

Overall, revenues for the industry declined by 1.1% YOY for the first three quarters of 2002. This drop was mostly due to reduction in volume sales to wholesalers who have increasingly begun to also market their own individual apparel brands.[5]

[3] Within a 12 month time frame
[4] Tommy Hilfiger figures used as being representative of industry
[5] Hoover's Online Industry report – Consumer Products (Non-Durables) – Apparel - Clothing

However, the larger branded apparel manufacturers with diversified product lines and self owned outlets were able to report revenue growth of between 2% and 9%.

Revenue Recognition

Customer orders precede the related shipping periods by several months. Hence, to accurately project demand for different products and adjust manufacturing schedules accordingly, apparel manufacturers discuss retail trends and forecasts for product demand with major customers.

Revenue for wholesale operations is recognized at the point in time when the merchandise is shipped to the wholesaler, from the manufacturer's distribution centers. Wholesale revenue is net of returns, discounts and allowances. Discounts and allowances are recognized when the related revenues are recognized.

Retail revenues are recognized at the time of sale. Retail revenues are net of returns.

Revenue Stability

Revenues (and profitability) in the branded apparel industry are highly volatile. Continuous changes in tastes, demographics and fashions as well as shifts in consumer buying behavior all have an impact on revenues in the industry especially for companies focused on a particular market segment or demographic.

In addition, the growing level of imports over the last few years has impacted revenues of US manufacturing firms, in what was already a mature market.

Revenue Drivers

Major revenue drivers:

- Performance of the US Economy: The health of the US economy determines the spending power of consumers and hence, their willingness and ability to purchase (apparel) goods.
- Changing Demographics: The changing face of the decision maker in US households as well as the buying characteristics of individuals in their prime earning years determines which merchandise and how much of it is purchased. This also plays a role in the overall price sensitivity of consumers and the impact on profitability.
- Corporate Culture - The increasing movement towards casual clothing in the office will continue to have an impact on projected revenues. Casual clothes are less expensive than tailored clothes. Also, the increasing number of women in the workforce has resulted in greater revenues from ladies corporate clothing.

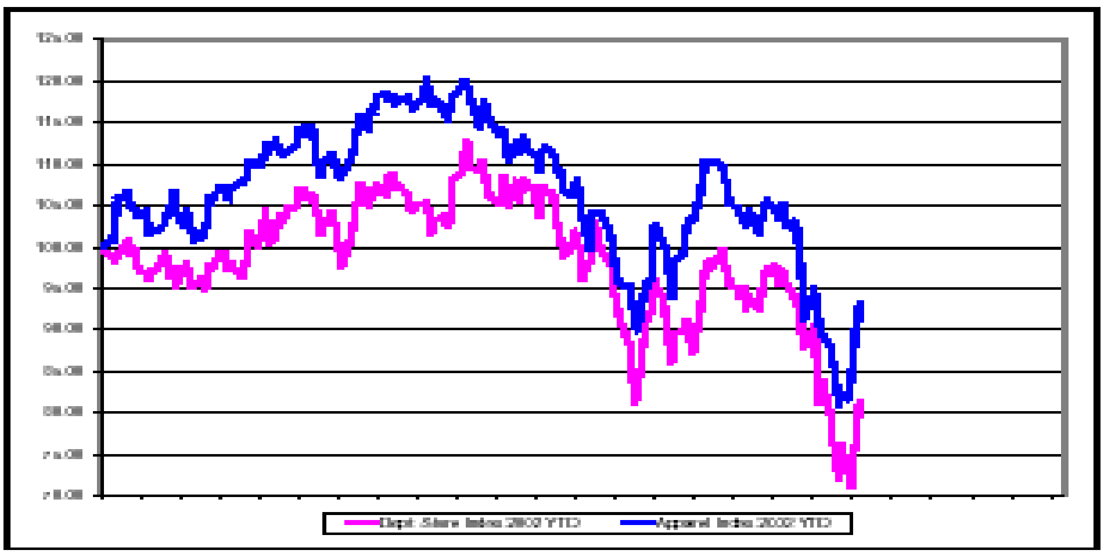
Imports and Exports – The trade off between competition from imported goods (which are comparable in terms of quality and more competitively priced) and the opportunities for market expansion through exporting to other countries is of major concern in determining the revenue performance within this industry.

Future Outlook

Consumer spending on apparel could potentially decrease in 4Q2002 and 2003 in line with the projected slow recovery of the US economy as well as slow recovery from high levels of unemployment. The effect of this is lower average levels of personal income and hence, spending.

Also of note is the hypothesis that sales of branded apparel tracks overall departmental store sales (see chart below – Merrill Lynch Branded Apparel Quarterly Preview Report, 16th October, 2002). Sales for department stores are expected to at best remain flat in the final quarter of 2002 and early into 2003, according to analyst projections.

Performance of Branded Apparel vs. the Department Stores



Note: Our branded apparel index is a market cap weighted index of JNY, LIZ, RL, TOM, NAUT, and VFC. Our dept. store index is a market cap weighted index of FD, MAY, DDS, KSS, JWN and SKS.

Despite cost reduction measures by branded apparel companies to improve profitability, department stores remain a major sales outlet.

However, department stores are in effect also competition for the same consumers (since they also market their own name brands) who, given the tight economic conditions and lower levels of available funds, are more price sensitive. This has resulted in the continued erosion of market share for branded apparel by department store brands.

The rise of mass marketing stores and discount retailers with low overhead costs and low prices has gradually eroded a significant share of the sales of traditional apparel retailers such as department and specialty stores. Consumers have become more cautious in their buying habits as evidenced by the decreasing portion of their disposable income that they spend on apparel.

In addition, consumers are increasingly demanding quality goods at low prices. Retailers have often been forced to sell merchandise permanently at "sale" prices, with promotions occurring throughout the year.

Costs

As costs have already been reduced to an all-time low level, we project no more gains for the industry in the next one-year period. Manufacturing and distribution costs will likely stay stable during our investment horizon.

Additionally, we believe the market has already incorporated all the gains that have been made on the cost front in the past few years. Further, there is no evidence to suggest that there will be any shifts in the cost structure of this industry in the near future that could affect the pricing of the equities in our investment universe.

Manufacturing & Distribution

Manufacturing costs comprise a significant portion of the total cost structure for large branded apparel companies. Once “Made in the U.S.A”, virtually every maker of brand-name apparel has moved production overseas to contain labor costs and evade strict U.S. environmental restrictions. For example, at VF Corporation, the world’s leading jean maker, 80% of the products are made in Latin America and Asia.

According to the U.S. Department of Labor, the number of domestic apparel manufacturing industry employees fell to 633,000 in 2000, down almost 10% from the 1999-level and down 56% from 1970. The Department of Labor projects a loss of 103,000 jobs in the U.S. in this industry between the years 2000 and 2010.[6]

[6] U.S. Department of Labor, http://www.bls.gov/oco/cg/cgs007.htm

Example:
Men's Trousers by Revenue

Leading Exporters to the U.S. Apparel Market-2001

Rank	Country	Percent
1	Mexico	30
2	Dominican Republic	12
3	Hong Kong	7
4	Costa Rica	4
5	China	4
6	Honduras	4
7	Bangladesh	3
8	Guatemala	3
9	Indonesia	3
10	Philippines	3

No shortage of suppliers

Branded apparel companies will typically have hundreds of suppliers in dozens of countries around the world. The largest supplier to a branded apparel company will often comprise only five to ten percent of total supply. The ten largest suppliers at Liz Claiborne, for example, supply a total of 35% of LIZ's products for the year.[7] This enables LIZ and others to retain those suppliers who have superior pricing, quality, and resources, while discontinuing a fair number of under-performers each year. This structure also assures competitive, downward pricing pressure on the suppliers. Long-term contract are not often used in the industry.

Bulk purchasing of inputs

Currently, the branded apparel company will typically purchase the raw material in order to capitalize on economies of large purchases. The trend is a movement away from this, as companies seek to manage the process less. Again, long-term contracts here are unusual and hundreds of suppliers of raw materials will typically supply any one large branded apparel company.

Tariff/Quota reductions

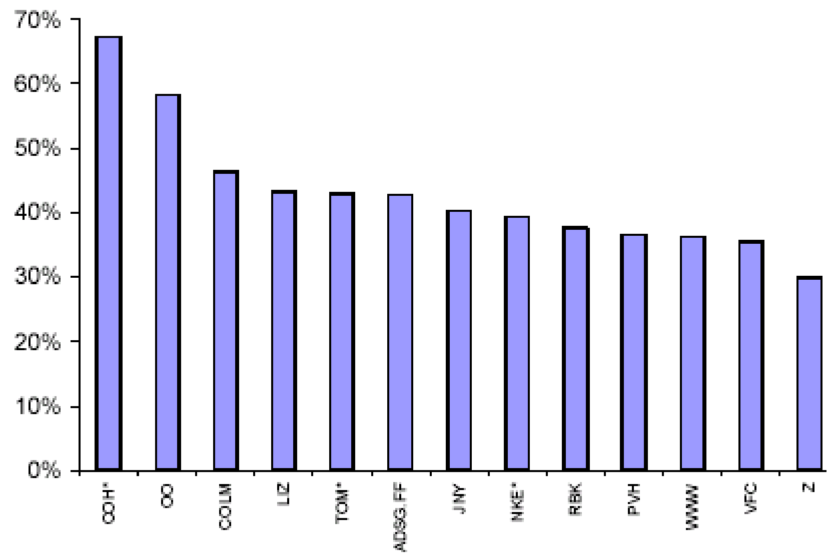
Currently, virtually all merchandise imported into the U.S. is subject to tariffs and quota restrictions, in a move to protect the domestic manufacturing industries. The Uruguay Round, effective since 1995, is designed to gradually phase out textile quotas on World Trade Organization countries over 10 years. In addition to import-to-U.S. restrictions and tariffs, the companies in this industry are also subject to taxes and restrictions for any imports into foreign countries (other than the US).

Distribution is often handled in-house through warehousing facilities within the United States.

[7] Liz Claiborne, 10K, December 29, 2001.

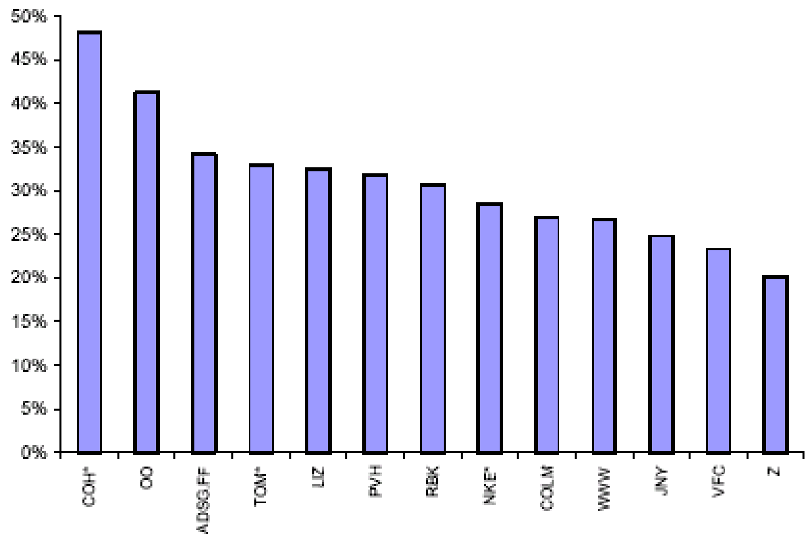
COGS can comprise from 32% to 68% of Sales

2001 COGS of Major Manufacturers



SG&A Margins may account for 52% to 75% of Sales

2001 SG&A Margins



With highly competitive pricing in the marketplace, comes a big reliance on cost containment. Branded apparel companies focus heavily on their operating margins. Small differences here, can lead to selling advantages in the department store.

Inventories

After several years of inventory build-ups, the apparel industry's inventory-to-sales ratio declined in 1996, and it remains close to its lowest levels in almost 20 years. According to the U.S. Department of Commerce, the inventory-to-sales ratio was 1.30 in 2000, below the 1.36 level of 1998. The lower inventory levels could signal the relatively good health of the apparel industry. However, consumers have become more and more value conscious – they want quality merchandise at the lowest possible price. This trend is evident in the successful growth of off-price retail stores; the discount segment led retail channels in revenue growth in 2001, with a gain of 7%, raising its share to over 20% of all apparel dollars.[8]

U.S. Employees

Three unions form the collective bargaining agreements for U.S. Apparel companies: the Union of Needletrades, the Industrial and Textile Employees (UNITE), and the Professional & Technical Workers International Union.

Properties

Distribution and administrative functions are performed in both leased and owned facilities for typical companies in this industry. Space is often leased for retail specialty, outlet, and concession stores.

Legal Proceedings

Various legal actions are pending against some of the companies in this industry. The actions assert suppliers based in other countries engage in unlawful practices related to the recruitment and employment of foreign workers, and the U.S. apparel companies, by virtue of their relationship to these foreign suppliers, have violated various federal and state laws. The outcomes of these suits rarely have material adverse effects on the financial positions of large companies within this industry.

Mixed Results from Internet

In January 2000, apparel was the fourth most popular e-commerce category, but many manufacturers have decided not to sell directly on the internet yet, fearing a backlash from retailers that constitute their primary method of distribution. Another deterrent to the manufacturer is the high cost of establishing and maintaining the web site. While gains in the industry were predicted due to the internet, these gains have been largely unfulfilled as the internet strategies have proven much more costly than expected and the threat of weakening the relationship with retailers.[9]

Financial Analysis

We analyze Branded Apparel using a specific set of financial indicators. We are mainly interested in the efficient use of capital as well as the efficient use of the assets/resources that are acquired with the use of capital.

- A strong pattern is evident with the branded apparel companies. As a company leverages up, ROE declines, such that we don't observe the expected results of the use of debt. ROA also decreases in parallel with higher debt levels, leading us to believe that certain acquisitive, debt-laden

[8] U.S. Department of Commerce, Apparel Industry Statistics
[9] U.S. Department of Commerce, Apparel Industry Statistics

apparel companies are much less efficient with the use of capital/resources than ones that maintain lower debt levels and grow organically.

- The balance sheets of the leveraged companies are typically bloated with goodwill and/or intangibles. This further supports our viewpoint that the acquisitive companies fail to produce a reasonable return on acquired assets.
- See the Company Outlooks section for a discussion of each company's performance along the key indicators.

Key Financial Data

	Market Capital.	*Current P/E*	*ROE*	*ROA*	*Debt / Equity*	*Price / Book*	*Beta*
Consumer Cyclicals	585.7B	19.2	9.2%	5.3%	2.45	2.7	1.05
Apparel/Accessories	37.3B	20.2	17.6%	9.9%	0.37	3.6	1.01
Coverage Universe	**16.4B**	**15.8**	**15.0%**	**8.8%**	**0.39**	**2.3**	**1.22**
Columbia Sportswear	1.52B	15.8	27.4%	19.6%	0.11	4.0	1.75
Liz Claiborne	3.18B	14.8	19.8%	10.6%	0.30	2.7	1.19
Polo Ralph Lauren	1.90B	12.9	15.7%	8.6%	0.35	1.9	0.83
Quiksilver	582M	21.1	12.2%	6.5%	0.46	2.3	1.18
Jones Apparel Group	4.26B	15.0	12.1%	6.5%	0.46	2.0	1.37
VF Corporation	4.13B	23.0	9.2%	4.8%	0.47	2.5	0.70
Tommy Hilfiger	859M	7.3	8.6%	4.8%	0.56	0.8	1.54

Note: Companies in the coverage universe above sorted by debt/equity ratio, from lowest to highest.

Source: Multex Investor, Market Guide

	Op Margin	*Inv Turns*	*Asset Turns*	*% Inst. Owner.*	*2002 Consensus EPS*	*2003 Consensus EPS*	*Consensus EPS Increase 2002-03*
Coverage Universe	**10.8%**	**3.81**	**1.38**	**76%**			
Columbia Sportswear	18.9%	2.86	1.64	52%	2.45	2.73	11%
Polo Ralph Lauren	11.1%	3.06	1.35	38%	1.83	2.08	14%
Jones Apparel Group	10.9%	4.43	1.16	88%	2.74	3.03	11%
Liz Claiborne	9.7%	4.27	1.78	88%	2.19	2.51	15%
Tommy Hilfiger	9.7%	4.42	0.77	82%	1.20	1.23	3%
Quiksilver	8.1%	4.04	1.59	95%	1.47	1.73	18%
VF Corporation	6.8%	3.60	1.34	87%	3.36	3.65	9%

Note: Companies in the coverage universe above sorted by operating margin from highest to lowest.

Source: Multex Investor, Market Guide

Company Outlooks

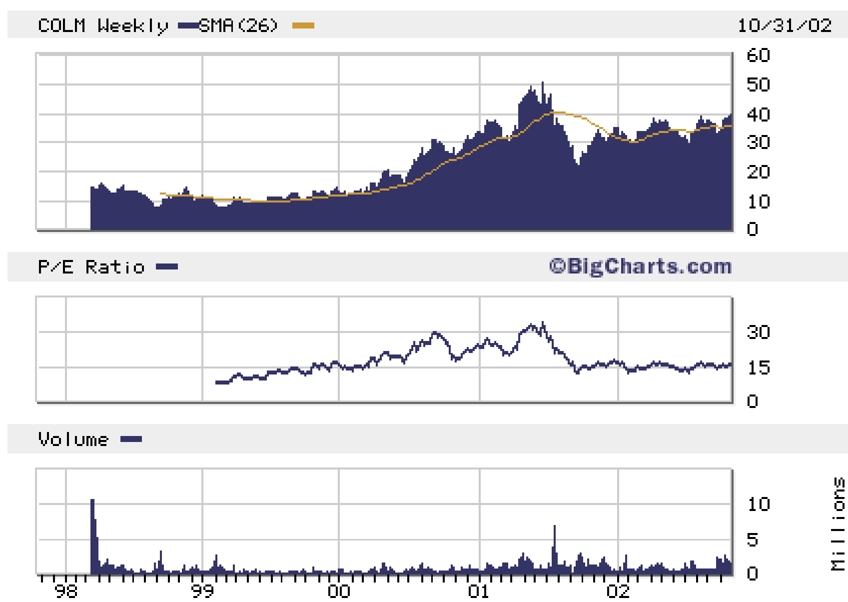
Companies Covered	Outlook	Remarks
Columbia Sportswear	Neutral to Positive	Great indicators but economically sensitive.
Jones Apparel	Neutral	Stalwart with mixed message.
Liz Claiborne	Positive	Exemplary player in sector.
Polo Ralph Lauren	Neutral	Strong brand needs to turn inventories faster.
Quiksilver	Neutral	Looking to turn the corner after investing heavily.
Tommy Hilfiger	Negative	Inflated book doesn't deliver.
VF Corporation	Negative	Simply overpriced.

Columbia Sportswear (COLM)

COLM's P/E and Price to Book ratio are roughly about average for our coverage universe. COLM's high beta (1.75) is evidence of its reliance on high margins. Its high operating margin and low inventory turnover speak of a Company that thrives on high prices instead of volume.

The Company achieves best-in-class ROE and ROA despite its lack of financial leverage. We tend to like COLM's strategic niche and we are curious why the market has applied such a low P/E ratio to a high-quality equity, despite modest consensus EPS estimates for 2003.

Our stance on COLM at initiation of coverage is neutral to positive.

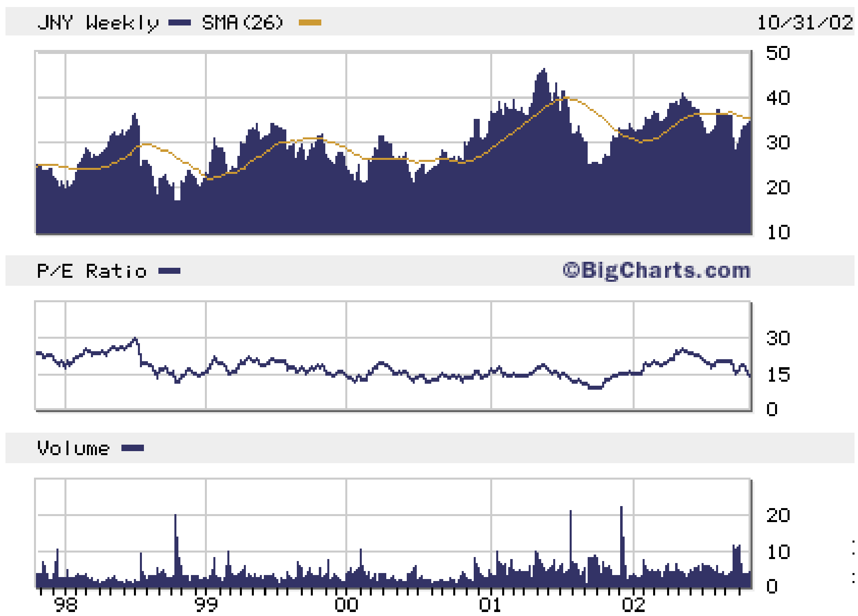


Jones Apparel (JNY)

JNY is at or below average on most indicators, except when we consider its high debt load and beta. JNY makes up for many of its shortcomings with the highest inventory turns in our coverage universe. Even so, we wonder why the market places such a premium on this security, which appears weighed down by its acquired assets.

With the leverage JNY has in place, we would prefer to see a better than average ROE to compensate for the debt load, although consensus EPS estimates for 2003 appear perfectly reasonable. JNY keeps making money, and the equity seems fairly priced for this stalwart.

Our stance on JNY at initiation of coverage is neutral.

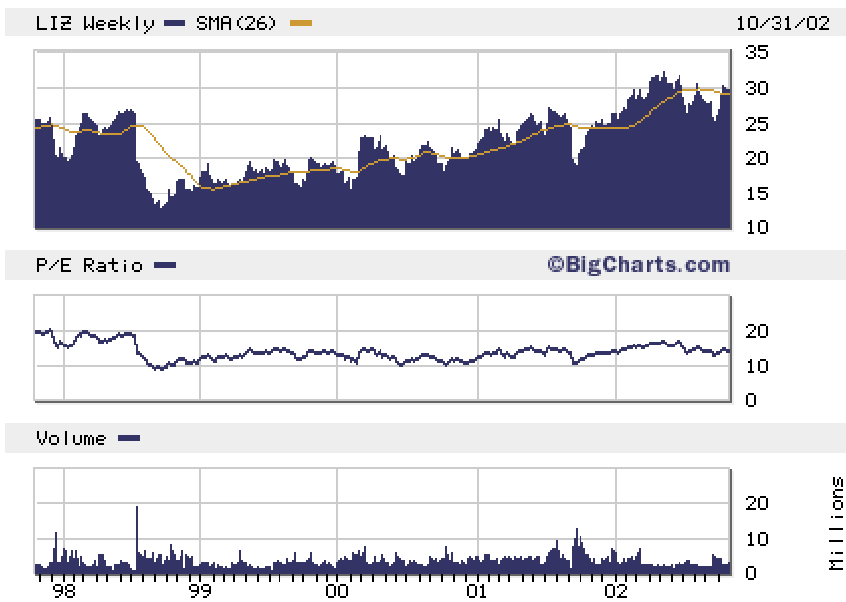


Liz Claiborne (LIZ)

LIZ pretty much hits the averages in our coverage universe, but generates above average ROE with lower than average debt levels. Consensus EPS for 2003 appear strong.

Although we would like to see slightly higher operating margins, LIZ seems to carry its size better than JNY, achieving best-in-class asset turns. The market has currently priced the equity below average with respect to earnings, which doesn't make sense for the company we believe exemplifies the strength of U.S. branded apparel.

Our stance on LIZ at initiation of coverage is positive.

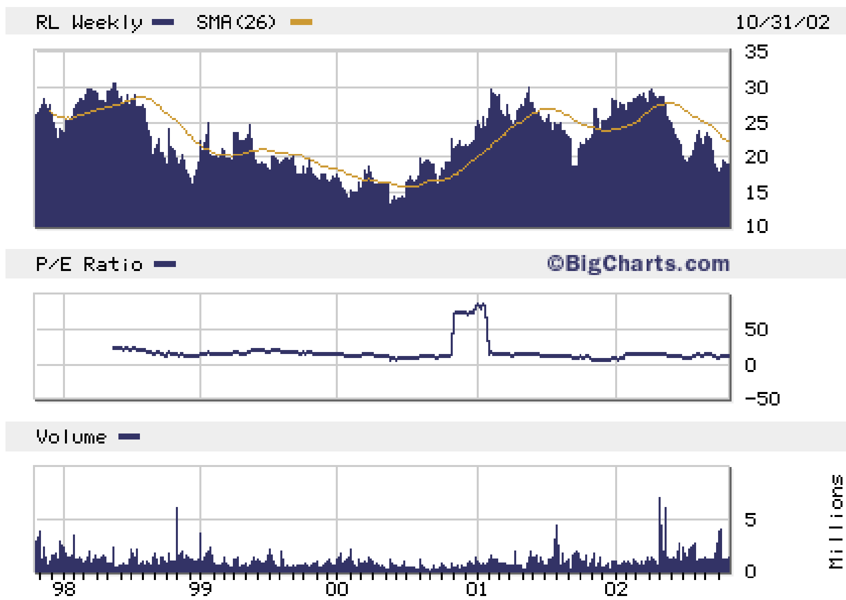


Polo Ralph Lauren (RL)

RL trades at a P/E discount to the rest of our coverage universe. Although the Company generally hits the average indicators for our coverage universe, it falls down with respect to inventory turns (3.06 for RL versus 3.81 for the companies we cover).

RL's lower than average beta (0.83) supports its status as a must-have brand despite the economic environment. Although we would like to see the Company become a bit more efficient, RL's low P/E and solid earnings outlook provide us with the confidence that the equity is at least fairly valued.

Our stance on RL at initiation of coverage is neutral.

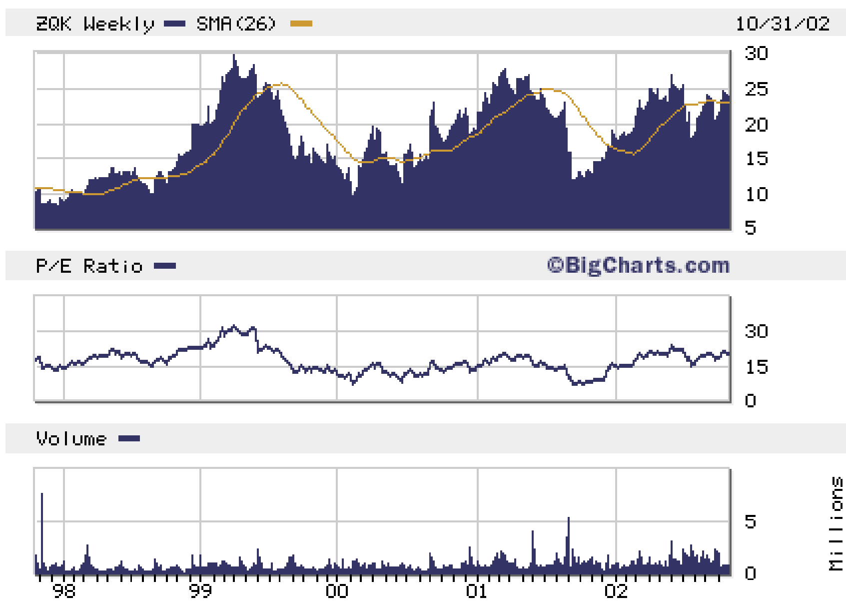


Quiksilver (ZQK)

ZQK's low margins are a cause for concern at a company with so much debt, although the bulk of the debt is short-term. ZQK has been growing capital spending at a better than 35% clip for the past 5 years, so we would expect a rise in its debt levels to cover these expenditures.

With above-average asset turns, ZQK seems to be using its capital effectively, although we'd like to see a little more in the way of operating efficiency. Consensus earnings per share in 2003 look very strong (+18% YOY), but we think the market has probably already caught on to this.

Our stance on ZQK at initiation of coverage is neutral.

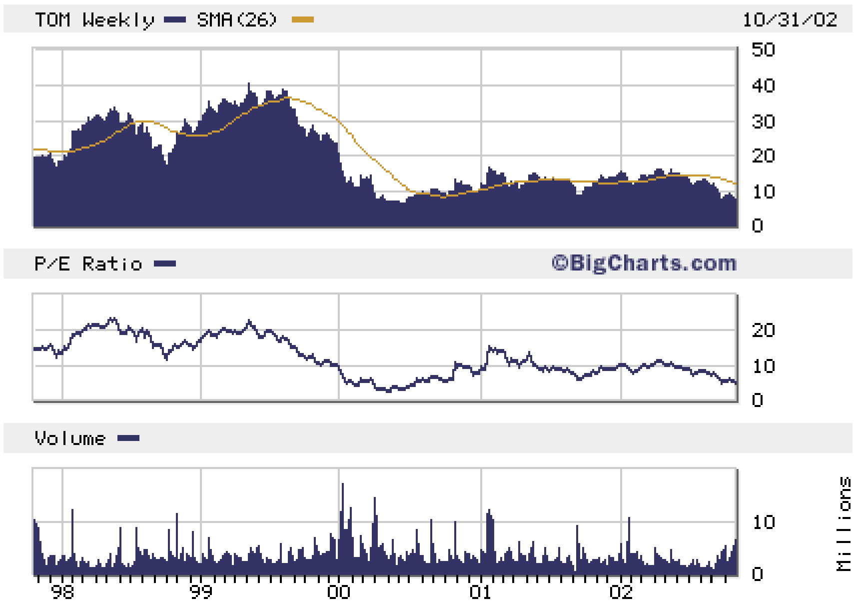


Tommy Hilfiger (TOM)

TOM has the lowest P/E, ROE and ROA and the highest Debt/Equity ratio of the equities in our coverage universe. While it's hard to imagine TOM being battered down any further, its beta of 1.54 and shrinking margins give us cause for hesitation in a faltering economy

Although TOM already trades at less than book value (Price to Book is 0.8), we are not in the "only place to go is up" camp, and expect that TOM will sink further.

Our stance on TOM at initiation of coverage is negative.

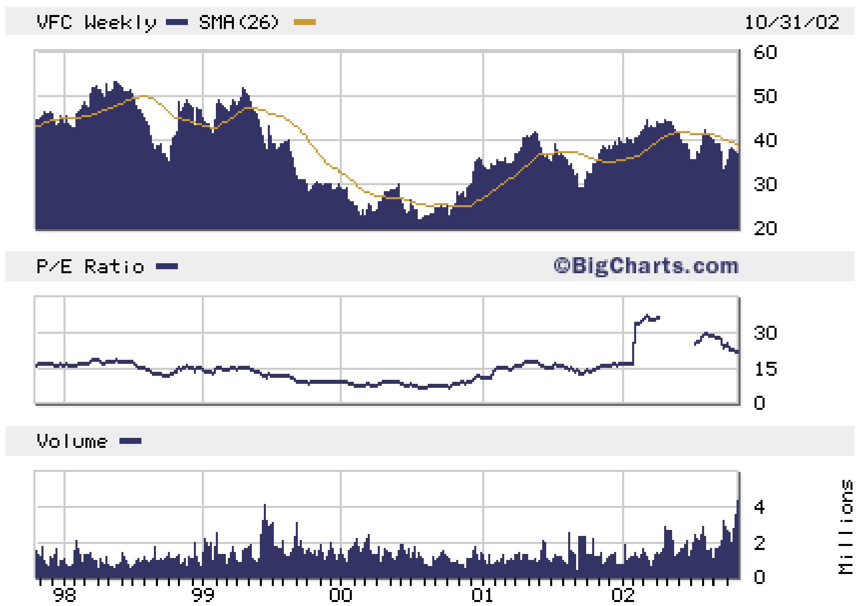


VF Corp. (VFC)

VFC trades at a significant P/E premium to our coverage universe (23.6 versus 16.4), although we are not quite sure why. With below-average operating margins, ROE, ROA and inventory turns, as well as a relatively high debt load, the market seems to be overreaching with this company's prospects.

VFC's size and the diversity of its business portfolio may go some of the way towards supporting the current market price, but we don't see why such a growth premium is merited for a stock with the lowest beta (0.70) in our coverage universe.

Our stance on VFC at initiation of coverage is negative.



Reiteration of Viewpoint: We favor the equities that use capital / assets efficiently.

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