Yale SCHOOL of MANAGEMENT
Equity Research

November 26, 2004

Apparel Retail:
The Wet Seal, Inc.
(Nasdaq: WTSLA)

Company Rating
SELL

Target Price
$0.05

As of 11/26/04
S&P 500: 1,182.65
S&P Retail: 461.46
10-Yr Bond: 4.240%
WTSLA: $2.00

Rating Definitions
- Buy: Expected to outperform market by 15% or more
- Hold: Expected to perform within 5% of the market
- Sell: Expected to underperform the market by 15% or more

Research Team
Jennifer Dong
jennifer.dong@yale.edu
Victoria Vierling
victoria.vierling@yale.edu

All Washed Up?:

Initiation of The Wet Seal, Inc. (WTSLA) With Sell Rating

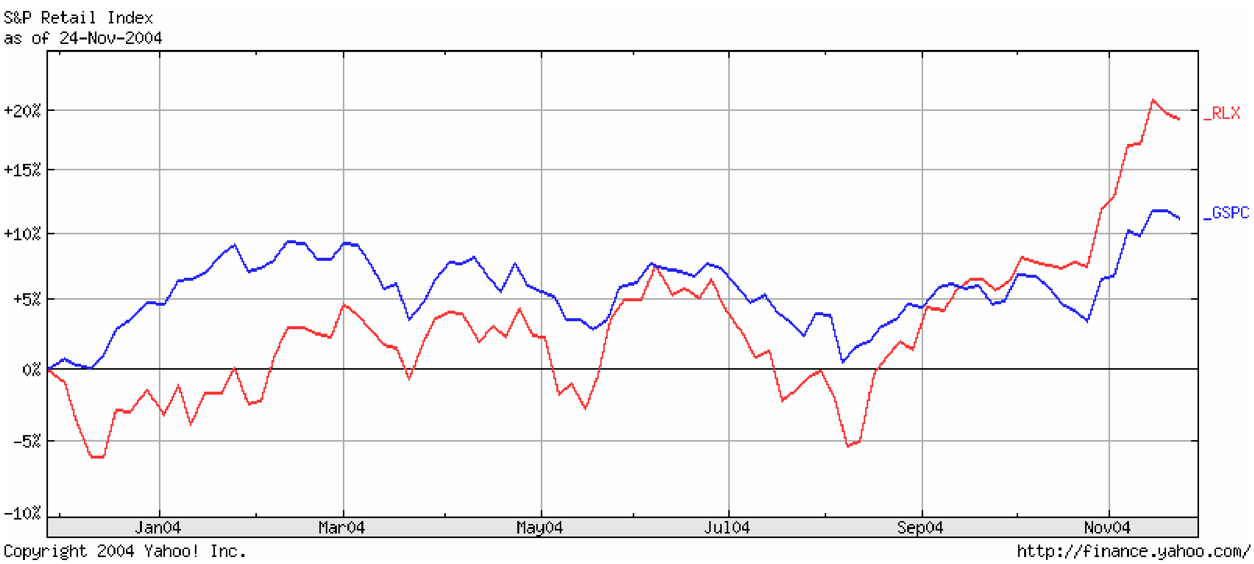
- We are initiating coverage of WTSLA with a SELL rating. The company has made every effort to turn its sales slump around, but we believe that indicators point to impending bankruptcy.
- Based on our valuation of the stock and belief that the company will file for bankruptcy, we cannot recommend WTSLA to any long-term or fundamental investors.
- At its current price of $2, we believe that the market is "irrationally exuberant" about a turnaround potential driven by a recent cash infusion. There is no information available indicating that this investment by SAC Capital Management will translate into any quantifiable sales growth in the future.

Please see the disclaimer at back of this report for important information.

Apparel Retail Industry

As we have previously discussed, the apparel retail industry's financial performance is very sensitive to the condition of the economy and as such, apparel retail stocks tend to closely mirror the overall performance of the market (see industry performance versus S&P 500 performance, below). The Wet Seal posits that its slow sales are due in part to "a more competitive environment for The Wet Seal target customer."[1] Overall, the industry's dependence on the economy means that long-term growth for any retail apparel company is unlikely to exceed the long-term economic growth rate, which we estimate to be 4%.[2]

S&P Retail Index and S&P 500 – 1-Year Return



Source: Yahoo! Finance

[1] Form 10-Q at 17.
[2] Such long-term economic growth figure is used to calculate the company "continuation value" in our DCF spreadsheet.

Competitive Landscape

Other apparel retail companies are in a strong position to move into any market gaps opened by The Wet Seal's current financial issues. For instance, The Wet Seal continues to tout the profitability of its Arden B. division,[3] but that division is currently facing stiff competition from direct competitor bebe (BEBE). bebe has been delivering strong results and is in an excellent position to steal market share from Arden B. In addition, bebe executed a savvy political move by recently hiring one of Wet Seal's top executives as part of bebe's management team.

Another competitor, Forever 21, went "more trendy," while "Wet Seal, with apparel that is more expensive, was improving its quality and brightening its stores."[4] However, "teenagers [do] not want improved quality at a higher price."[5] Further, The Wet Seal's focus away from the back-to-school trends meant that it totally missed the trends for fall. The company admits that this slip-up is a principal reason behind its continued sales decline. We feel that the intense competition in this industry, and the speed with which The Wet Seal's competitors have moved to fill its market niche, are further pieces of evidence supporting the slow ramp-up to growth (e.g. 0% growth in fiscal 2004) which we have built into our discounted cash flow model of the company's turnaround.

[3] Form 10-Q at 17.
[4] Tracie Rozhon, "The Teenage Crush on Wet Seal Is So Over," New York Times 9/3/2004.
[5] *Id.*

Company Overview

The Wet Seal, Inc. is "one of the largest mall-based specialty retailers focusing primarily on young women's apparel and accessories."[6] The company operates Wet Seal, Arden B., and Contempo Casuals stores, and recently closed its Zutopia stores division. The Wet Seal, Inc. began as a "bikini shack" in Newport Beach, California and has expanded (1) by opening new Wet Seal and Arden B. stores and (2) by acquisition, operating Zutopia stores which it purchased from Gymboree and converting Contempo Casuals stores purchased from Neiman Marcus to Wet Seal stores.

Consumer and Product

Wet Seal supplies an ever-changing and variety of clothing choices. Styles range from casual to funky to glamorous and target "fashion-forward teens" primarily between the ages of 17 and 19 years old. The company operates 474 Wet Seal stores (16 of which are Contempo Casuals store concepts) that are approximately 4,000 square feet in size. Arden B. is The Wet Seal, Inc.'s newer store concept. It caters to fashionable, sophisticated, and contemporary women. The 99 Arden B. stores average 3,200 square feet in size.

Revenue

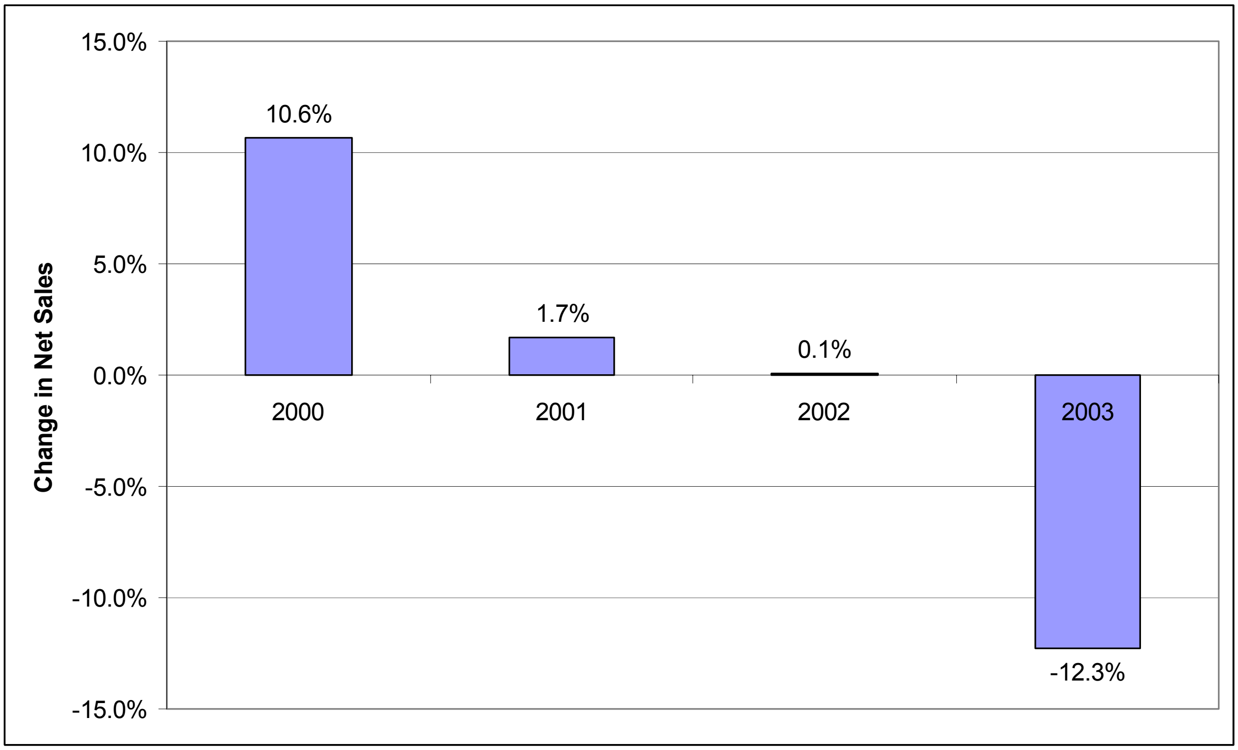
Wet Seal has had disappointing sales revenue. As shown in the graph below, net sales grew 10.6% in 2000, but quickly dropped to 1.7% growth in 2001, 0.1% growth in 2002, and 12.3% decline in 2003. Consecutive negative monthly comparable store sales since July 2002 have contributed to this decline. The company recognizes that missed fashion trends and a misguided attempt to re-establish Wet Seal's position in the teen market have contributed to its comparable store sales results.

Based on the recent departure of The Wet Seal's creative director, Victor Alfaro, we do not believe that the company will have a clear vision for its product as it brings in a new creative team. Management changes, such as the resignation of Chairman and CEO Peter Whitford and President of Wet Seal Stores Division Allan Haims, further strengthen our opinion that The Wet Seal is in the midst of an unsettled transition and therefore not in a position to turn the company's sales growth around in the near term.

We believe that it will be difficult for the company to reverse its declining revenue trend because of the competitiveness of the retail apparel industry and the over-supply of the segments which The Wet Seal targets. As discussed in our industry report, the teenage and young adult women's markets are overcrowded with retail apparel companies. The lack of clear management and leadership will significantly hamper the company's ability to compete and rebound from its current standing.

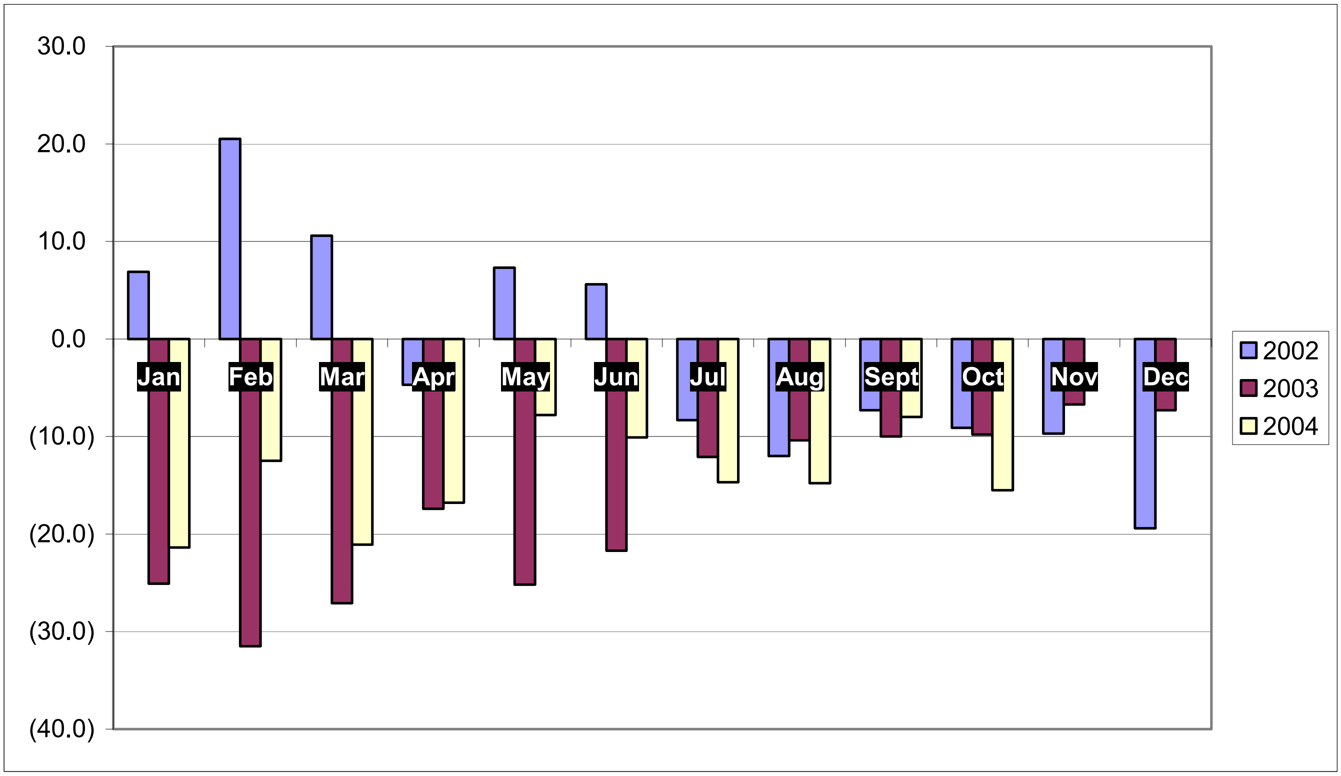
[6] Form 10-Q at 16.

Net Sales History



Source: Company 10-K and 2Q 10-Q filings

Comparable Store Sales History



	2002	2003	2004
Jan	6.9	(25.1)	(21.4)
Feb	20.5	(31.5)	(12.5)
Mar	10.6	(27.1)	(21.1)
Apr	(4.7)	(17.4)	(16.8)
May	7.3	(25.2)	(7.8)
Jun	5.6	(21.7)	(10.1)
Jul	(8.3)	(12.1)	(14.7)
Aug	(12.0)	(10.4)	(14.8)
Sept	(7.3)	(10.0)	(8.0)
Oct	(9.1)	(9.8)	(15.5)
Nov	(9.7)	(6.7)	
Dec	(19.4)	(7.3)	

Source: Company press releases and website

Recent Financing Transactions

- June: $27.2 million ($25.2 million net) for equity securities privately placed (common stock and warrants)
- September: $8 million junior secured term loan (at prime + 7%)
- November: $40 million in convertible 7-year notes at federal rate cash or PIK (conversion price $1.50); two tranches of 4-year warrants (exercise prices of $1.75 and $2.25); two tranches of 5-year warrants (exercise prices of $2.50 and $2.75); two tranches of "additional investment right warrants" to acquire: (a) $9.9 million of 7-year convertible notes (conversion price $1.65) and (b) $5.95 million of 7-year convertible notes (conversion price $1.75)

The last financing transaction, which took place in November, is the "SAC financing" referred to throughout this report. SAC Capital Management, a "highly-regarded hedge fund," has infused the funding—an action which mystifies analysts.[7] Analysts' guesses at SAC's motives for the financing range from the transaction being "an effort by SAC to avoid a big loss on its [June private placement purchase] stake" to the generic "the hedge fund is in a hole [and is] praying for a turnaround."[8]

Arden B. Spin-off/Arden B.-Centered Restructuring

The Wet Seal asserts that its abysmal sales numbers are driven by slow sales at Wet Seal stores, and that the Arden B. stores remain profitable and with solid growth potential.[9] Analyst rumors are that the recent SAC financing relates to either an Arden B. spin-off (and liquidation of Wet Seal stores), or some other restructuring which has at its core Arden B.'s growth, rather than Wet Seal's.[10] The company has a policy of maintaining consolidated sales results for all its divisions,[11] which makes it impossible to predict sales or sales growth possibilities of an Arden B. spin-off. Although Arden B.'s "price tag was estimated as high as $100 million, [which] high valuation signals the promise of some upside surprise at Wet Seal," we agree with the analyst who thinks "it's too early to tell and, at this point, not worth the risk."[12]

We did not factor any particular Arden B. growth strategy or spin-off options into our DCF for the company. Instead, in our turnaround DCF we analyze growth options for the company as a whole. As a side note, we believe a further piece of evidence arguing for our leaving off the possibility of an Arden B. spin-off is the fact that Wet Seal, Inc. owes $8 million in secured bank debt and has about $40 million outstanding in letters of credit issued under a revolving credit facility, which credit facility is senior to the $8 million term loan.[13] This company appears to owe millions of dollars to banks, which makes us doubt its ability to isolate Arden B. from the debts of the consolidated company – such isolation is necessary to make a spin-off attractive.

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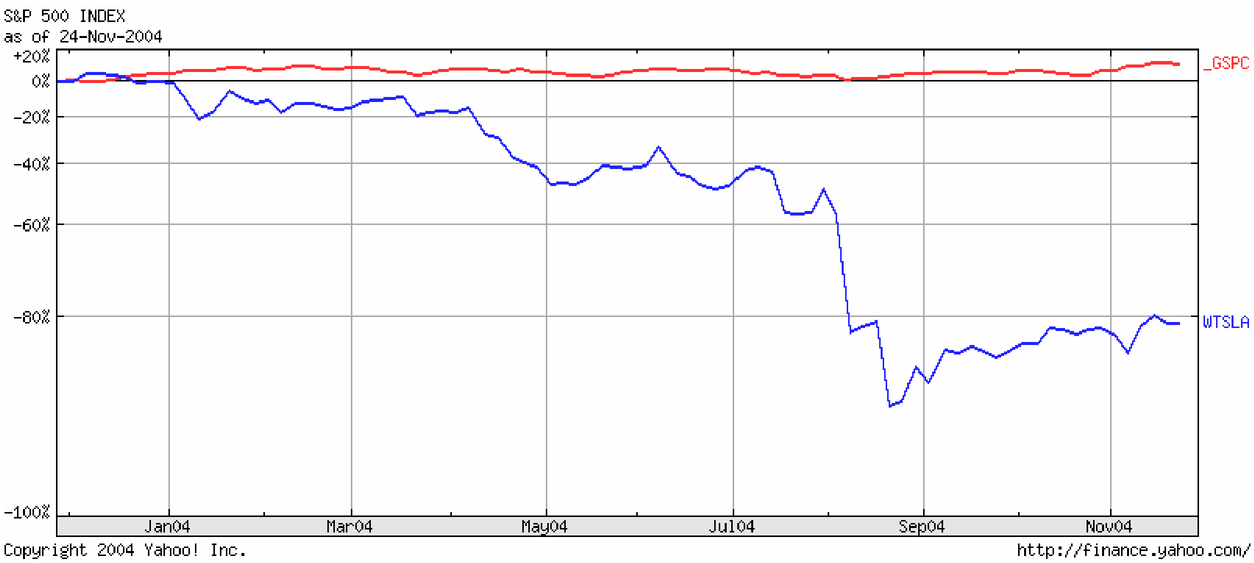
[7] Nat Worden, "No Kmart Coming at Wet Seal," TheStreet.com 11/12/2004.
[8] Ibid.
[9] Form 10-Q at 17.
[10] Worden, supra note 9.
[11] Rozhon, supra note 5.
[12] Worden, supra note 9.
[13] Form 10-Q at 12.

Valuation

Recent Stock Price performance

WTSLA vs. S&P 500



Source: Yahoo! Finance

Discounted Cash Flow Analysis

Our DCF analysis focuses exclusively on the probability that Wet Seal will be able to turn itself around. The company's key problem is the nosedive in sales it has taken in the past eight quarters.[14] Its costs and expenses have remained fairly constant over the past three years, and as a result we used an average of the past three years' percent of revenues in the turnaround scenario. COGS remain at the three-year average of 72.9% of sales which we believe to be reasonable for a seasoned company such as The Wet Seal, Inc. As the company searches for new management and concentrates on increasing its revenue, we believe that it will not see significant improvement in its SG&A costs.

We base our revenues growth on the case of Casual Male, Inc. An investigation of COMPUSTAT listed companies in the last thirty years which have experienced a decline in sales similar to that of Wet Seal and gone on to turn the company around reveals that only Casual Male, Inc. has been able to accomplish the feat. Casual Male, after its sales decline, experienced a ramp-up to an 8% growth figure over four years, and since Wet Seal is following in Casual Male's unique footsteps we use a ramp-up to the same figure in our turnaround model.[15]

The analysis yields a current share price of $1 and a twelve-month target share price of $1 (See appendix.)

[14] Form 10-Q, at 17-18; Rozhon, supra note 5.

[15] Please see Appendix 1. Actually, the figures are 1%, 0%, 104%, 8%, and the high figure in the third year of growth comes from the closing of a licensing deal. We do not expect such a windfall for Wet Seal, so we do not use the 104% figure but instead use a ramp-up to 8%.

Bankruptcy Probability

The likelihood that a company in dire distress, such as The Wet Seal, turns itself around is slim, thus we weight the stock price generated by our turnaround DCF by the probability that the company files for bankruptcy. We use the Altman Z-score to establish the probability of bankruptcy. This score of company financial health has been accurate in predicting 77% of corporate bankruptcies in the last 20 years. We calculated the score using three different methods: (1) the last 10-K method, which uses annual information from the last 10-K (submitted in March); (2) the most recent quarter method, which uses the information provided on the most recent 10-Q (submitted in September); and (3) the extrapolated current twelve months method, which uses information from the last eight months to estimate information for FY2004 (to be submitted in March 2005). Not surprisingly, we attained the highest Z-score using the "last 10-K" method since many of this summer's problems are not reflected in that information. The score was 2.69, which is still terrible – it generally indicates a 90% chance that the company will go bankrupt within two years.[16] The other two methods yielded far lower results, -.1 and .25, respectively, both of which indicate a 95% probability of bankruptcy within one year.[17] We trust these methods more than the first because they better reflect the financial turmoil that FY2005 has wrought on Wet Seal, Inc. Because the Altman Z-score has had consistent accuracy, we use it to weight our turnaround model with a 95% chance that the price per share will be $0 within one year. We consider bankruptcy equivalent to a stock price of zero because of the low ranking of equityholders in the priority hierarchy and the general unlikelihood of equityholders getting anything in a bankruptcy.

Casual Male COMPUSTAT Output

Code #	Code #	Ticker	MM Sales	Company Name	Year
13381	11379	CMRG	40.413	CASUAL MALE RETAIL GRP INC	1987
13381	11379	CMRG	57.659	CASUAL MALE RETAIL GRP INC	1988
13381	11379	CMRG	78.674	CASUAL MALE RETAIL GRP INC	1989
13381	11379	CMRG	120.75	CASUAL MALE RETAIL GRP INC	1990
13381	11379	CMRG	150.82	CASUAL MALE RETAIL GRP INC	1991
13381	11379	CMRG	204.329	CASUAL MALE RETAIL GRP INC	1992
13381	11379	CMRG	240.925	CASUAL MALE RETAIL GRP INC	1993
13381	11379	CMRG	265.91	CASUAL MALE RETAIL GRP INC	1994
13381	11379	CMRG	301.074	CASUAL MALE RETAIL GRP INC	1995
13381	11379	CMRG	289.593	CASUAL MALE RETAIL GRP INC	1996
13381	11379	CMRG	265.726	CASUAL MALE RETAIL GRP INC	1997
13381	11379	CMRG	201.634	CASUAL MALE RETAIL GRP INC	1998
13381	11379	CMRG	192.192	CASUAL MALE RETAIL GRP INC	1999
13381	11379	CMRG	194.53	CASUAL MALE RETAIL GRP INC	2000
13381	11379	CMRG	195.119	CASUAL MALE RETAIL GRP INC	2001
13381	11379	CMRG	398.348	CASUAL MALE RETAIL GRP INC	2002
13381	11379	CMRG	429.524	CASUAL MALE RETAIL GRP INC	2003

Source: Compustat

Recommendation

Based on our discounted cash flow analysis and bankruptcy probability analysis, we do not recommend that investors purchase WTSLA. We believe The Wet Seal has a 95% probability of filing for bankruptcy, thus applied a 0.95 weighting to a $0 stock price. Our DCF valuation of $1 thus receives a weighting of 0.05 yielding a share price of $0.05. We therefore recommend that investors short WTSLA.

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[16] Creditguru.com
[17] Creditguru.com

Exhibit 1: Discounted Cash Flow Analysis

The Wet Seal, Inc.
DCF

Amounts in millions, except per share data

	2003A	2004E	2005E	2006E	2007E	2008E
Revenue	517.6	465.9	465.9	470.5	489.4	528.5
- COGS	420.8	339.5	339.5	342.9	356.7	385.2
-SGA	159.0	130.1	130.1	131.4	136.7	147.6
- Depreciation	25.0	25.1	25.2	25.3	25.3	25.4
= Operating Profit (EBIT)	-87.1	-28.9	-29.0	-29.1	-29.3	-29.6
- Taxes on EBIT	-31.1	-10.5	-10.5	-10.5	-10.6	-10.7
= NOPLAT	-56.0	-18.4	-18.5	-18.5	-18.7	-18.9
+ Depreciation	25.0	25.1	25.2	25.3	25.3	25.4
- Increase in Working Capital Requirements	-9.1	-2.3	0.0	0.9	2.0	3.2
- Capital Expenditures	13.7	0.5	0.5	0.5	0.5	0.5
= Free Cash Flows	-35.6	8.6	6.3	5.3	4.2	2.8
Discounted Free Cash Flows	-35.6	7.7	5.1	3.9	2.8	1.6

PV FCF	-14.6
Continuation Value	40.2
Enterprise Value	25.6
Long Term Debt	0.0
Equity Value	25.6
Shares Outstanding	29.7

Cost of Capital	
R_e	11.17%
R_f	4.24%
R_m - R_f	7.00%
β	0.99

Price per Share	**$**	**1**
12-mo Price per Share	**$**	**1**

Exhibit 2: Consolidated Statements of Income

The Wet Seal, Inc.

Consolidated Statements of Income

Amounts in millions, except per share data

FY end Jan 31 of the following CY	2001A	2002A	2003A	2004E	2005E	2006E	2007E	2008E
Net sales	589.9	590.3	517.6	465.9	465.9	470.5	489.4	528.5
% increase		*0.1%*	*-12.3%*	*-10.0%*	*0.0%*	*1.0%*	*4.0%*	*8.0%*
Cost of sales, including production and occupancy	396.9	413.7	420.8	339.5	339.5	342.9	356.7	385.2
As % of Sales	*67.3%*	*70.1%*	*81.3%*	*72.9%*	*72.9%*	*72.9%*	*72.9%*	*72.9%*
Gross profit	193.0	176.7	96.8	126.3	126.3	127.6	132.7	143.3
Gross Margin	*32.7%*	*29.9%*	*18.7%*	*27.1%*	*27.1%*	*27.1%*	*27.1%*	*27.1%*
Selling, general and administrative expenses	146.4	166.8	159.0	130.1	130.1	131.4	136.7	147.6
As % of Sales / Expense Ratio	*24.8%*	*28.3%*	*30.7%*	*27.9%*	*27.9%*	*27.9%*	*27.9%*	*27.9%*
Income from operations	46.6	9.8	-62.1	-3.8	-3.8	-3.8	-4.0	-4.3
Operating Margin	*7.9%*	*1.7%*	*-12.0%*	*-0.8%*	*-0.8%*	*-0.8%*	*-0.8%*	*-0.8%*
Interest and other income, net	5.1	3.1	1.6	2.6	2.6	2.7	2.8	3.0
As % of Sales	*0.9%*	*0.5%*	*0.3%*	*0.6%*	*0.6%*	*0.6%*	*0.6%*	*0.6%*
Earnings before income taxes	51.8	13.0	-60.6	-1.1	-1.1	-1.1	-1.2	-1.3
% Margin	8.8%	2.2%	-11.7%	-0.2%	-0.2%	-0.2%	-0.2%	-0.2%
Provision (Benefit) for income taxes	19.7	4.5	-21.6	-0.4	-0.4	-0.4	-0.4	-0.5
Effective Tax Rate	*38.0%*	*35.0%*	*35.7%*	*36.2%*	*36.2%*	*36.2%*	*36.2%*	*36.2%*
Net income (loss) from continuing operations	32.1	8.4	-39.0	-0.7	-0.7	-0.7	-0.8	-0.8
Net Margin	*5.4%*	*1.4%*	*-7.5%*	*-0.2%*	*-0.2%*	*-0.2%*	*-0.2%*	*-0.2%*
Loss from discontinued operations, net of income tax	-1.1	-4.2	-8.3	0.0	0.0	0.0	0.0	0.0
Net income (loss)	31.0	4.2	-47.3	-0.7	-0.7	-0.7	-0.8	-0.8
Net Margin	*5.3%*	*0.7%*	*-9.1%*	*-0.2%*	*-0.2%*	*-0.2%*	*-0.2%*	*-0.2%*
Basic earnings per share	1.05	0.14	-1.59	-0.02	-0.02	-0.02	-0.03	-0.03
% Change		*-86.5%*	*-1226.4%*	*-98.5%*	*0.0%*	*1.0%*	*4.0%*	*8.0%*
Diluted earnings per share	1.02	0.14	-1.59	-0.02	-0.02	-0.02	-0.03	-0.03
% Change		*-86.6%*	*-1265.2%*	*-98.5%*	*0.0%*	*1.0%*	*4.0%*	*8.0%*
Basic weighted average shares outstanding	29.6	30.0	29.7	29.7	29.7	29.7	29.7	29.7
Diluted weighted average shares outstanding	30.5	31.1	29.7	29.7	29.7	29.7	29.7	29.7

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