

Analysis of Abercrombie & Fitch

Report by 3one2.com Analysts: Daisy Suryo, Gregory Nathan, Pei-Chun Shang and Jennifer Gold

Investment Recommendation: MARKET PERFORMER

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ANF- NYSE (3/20/01)	\$33.50	EPS Forecast: ANF				
52 Week High	\$33.50	FYE 1/31	2001A	2002E	2003E	2004E
52 Week Low	\$8.00	EPS	1.56	1.80	2.15	2.59
Beta	1.23	Ratios		Firm	Average of Competitors	
Revenue (FY 2001)	\$1,237.60Mil	Forward P/E	18.61	18.01		
Market Capitalization	\$3.28Bil	Forward PEG	0.94	1.06 (median)		
Share Outstanding	98.80Mil	Forward P/B	5.55	4.68		
Dividend Yield	0	P/S	2.67	1.32		
Institutional Holdings	80% (95% of float)	Valuation Predictions: ANF				
Avg. Daily Trading Volume	1.60Mil	Actual Price	\$33.50			
Book Value per Share	\$4.24	P/E Valuation	\$32.41			
Return on Equity	49.33%	PEG Valuation	\$38.01			
Est. 5 Yrs EPS Growth Rate	20.00%	P/S Valuation	\$16.54			
Industry	Specialty Retail	P/B Valuation	\$28.29			
		EBO (Abnormal Earnings) Valuation	\$15.98			
		DCF Valuation	\$31.20			
		Performance: ANF				
		Trailing	13wk	26wk	52wk	
		Actual	92.8%	29.5%	107.1%	
		Relative to S&P500	120.9%	64.5%	177.6%	
		Relative to Competitors	95.0%	70.0%	91.0%	

- Recommend a Market Performer rating on Abercrombie & Fitch's stock based on valuation analyses
- Strong brand equity allows new stores to generate sales quicker than most of its competitors
- Domestic and potential International expansion will be the driving force in its growth
- Significant growth potential via new stores under its abercrombie kids and Hollister Co. names
- Increasing productivity by opening smaller stores to increase sales per avg. gross square feet
- Difficult to grow revenues through increase in margins due to them being relatively high (23.23% compared to its competitors avg. of 11.9%)
- Same store sales has decreased significantly in the past two years (negative growth in FY2001) along with a decrease in sales per average store in FY2001

Rating System:

BUY: A strong purchase recommendation with above average long-term growth potential.

MARKET OUTPERFORM: A purchase recommendation that is expected to marginally outperform the return of the market.

MARKET PERFORMER: A recommendation to maintain current positions with returns to match that of the market.

SELL: A recommendation to sell the security (or short the security) as it is expected to decrease in price in the medium term.

Business Analysis

<u>Core Business Description</u>	<u>Competitors</u>
<p>Established in 1892, Abercrombie & Fitch (ANF) was well known as a supplier of rugged, high quality outdoor gear. One hundred years later, ANF was repositioned as a more fashion-oriented apparel store, targeting ages 18 through 22. In 1988 The Limited acquired ANF. The company went public in October of 1996 followed by a spin-off from The Limited in May of 1998. ANF introduced abercrombie kids in 1997 to target children ages 7-14. Finally, starting in July 2000 ANF opened five Hollister Co. stores, targeting 14-18 year olds. Currently ANF is in the business of purchasing, distributing, and selling men's, women's and kids' quality, casual and classic American sportswear apparel. The merchandise is sold in one of 350 ANF owned and operated retail stores throughout 37 States as well as through catalogs. ANF also runs an e-commerce website at www.abercrombie.com as well as a kids website at www.abercrombiekids.com. ANF has a policy of maintaining sufficient quantities of inventory so that it can offer its customers a full selection of current merchandise. It also concentrates on accomplishing a rapid turnover. ANF faces a very seasonal sales pattern, resulting in increased inventory during back-to-school and Christmas holiday selling times.</p>	<p>Gap A global clothing retailer that runs over 3,650 stores, mostly in the U.S., but also in Canada, France, Germany, Japan, and the UK. Its flagship Gap stores offer a wide variety of men's and women's casual clothing. The company's other chains include Banana Republic, GapKids, babyGap, and its fastest growing, Old Navy. Each chain also has an online incarnation. The Gap is adding GapBody intimate apparel stores and restaurants in flagship Old Navy stores.</p> <p>American Eagle Once a purveyor of outdoor sports apparel and equipment, American Eagle Outfitters (AE) has grown immensely in the past few years. The retailer now sells collegiate-style casual apparel and accessories (shirts, pants, shorts, sweaters, skirts, footwear, belts, and bags) aimed at men and women ages 16-34. Virtually all the company's wares bear its private-label brand names: American Eagle Outfitters and AE. AE operates over 550 mall-based stores in 47 states (primarily east of the Rockies) and Washington, DC, and is expanding.</p> <p>The Limited The Limited is as much of a shopping-mall mainstay as food courts and teenagers. The retailer operates about 5,000 stores in the U.S., focusing mostly on clothing for women. Its women's apparel stores include The Limited, Express, Lerner New York, Lane Bryant (which it is selling), and Henri Bendel. Its Structure stores (to be renamed Express Men's) offer men's clothing. The Limited also owns 84% of Intimate Brands, which operates Victoria's Secret, Bath & Body Works (personal care product stores), and White Barn Candle Co. (candles and fragrances). In addition, it has a 40% stake in Galyan's Trading Co. (sporting goods).</p> <p>Gadzooks Gadzooks is a mall-based, specialty retailer of casual apparel and related accessories for young men and women, principally between the ages of 14 and 18. Gadzooks experienced 20% of sales growth for the FYE 2/3/01. This results from the opening of new stores, the introduction of the private label merchandise, and operational improvements in existing stores. In the year 2001 alone, Gadzooks launched Decibel, the company's newest private label for young men, Candie's Junior Swimwear, and Candie's Time Junior Watches. The company operates 377 stores.</p> <p>Pacific Sunwear Chain of retail stores that is primarily mall-based, specializing in retailing everyday casual apparel, accessories and footwear designed to meet the needs of active teens and young adults. The company also provides sales through online service. In addition, Gadzooks provides trade promotion through trip packages. The company operates 471 retail stores, 52 outlet stores and 82 demo stores for a total of 605 stores in 48 states and Puerto Rico.</p>
<p style="text-align: center;"><u>Risks</u></p> <ul style="list-style-type: none"> • Competitive pressures in the retail apparel industry/market saturation • ANF in mature stage of growth • Less consumer spending in apparel due to slowing of economy • Change in consumer preferences • Missing the next trend • Political/financial instability in countries where goods are manufactured • Challenge of international expansion • Risk of rising interest rates • Trade Restrictions 	<p>* Information taken from finance.yahoo.com</p>

Financial Health and Performance

Revenue, net income and cash flow growth: ANF's past 5-year revenue growth is 269.02% while net income grew an astounding 540.89% and as a result ANF outperformed its competitors. Although these numbers are very impressive, one must recognize that ANF was a much smaller company five years ago and was able to grow revenues and net income on top of a small base. Now that ANF is a much larger company with a market capitalization of over \$3 billion, it is unlikely that it will be able to sustain this kind of accelerated growth in the future. In the same period, cash flows from operations grew 228.40%, which in absolute terms is impressive, but relative to its growth in net income is a cause for some concern. From FY1999 to FY2000, operating cash flow decreased 12.53% while net income increased 46.48%. This was mainly a result of a 70% increase in inventory coupled by a 200% increase in accounts receivable. The biggest cause for concern is its ballooning inventory. ANF is in the clothing business that caters to people mainly between the ages of 18 and 22 whose tastes are very fickle. As a result, trends change quite rapidly and if it is holding over \$75 million in inventory it might have to write some of it down in the future if it is unable to sell it in the near term. However, at the same time it is expected that inventory will increase as it opens more stores.

Store Dynamics: While total sales increased 53.0% and 56.9% in FY1998 and FY1999 respectively, same store sales increased 21.0% and 35.0%, suggesting that much of its growth was due to new store openings, which increased 23% and 26% respectively. However, while total revenues increased 20.1% in FY2001, comparable store sales decreased 7.0%. This is a cause for concern because at some point ANF will have fulfilled its expansion plans and must rely on same store sales growth to grow its earnings. This deceleration in revenue and comp store sales may be a warning sign that ANF's growth is not far from maturity.

Gross and Operating Margins: ANF has been able to consistently increase its gross and operating margins over the past five years. Gross margins increased 10.82% from 33.86% in FY1996 to 44.68% in FY2000. At the same time operating margins increased 13.13% from 10.10% in FY 1996 to 23.23% in FY2000. While ANF has been able to substantially increase its margins, gross margins decreased 2.5% while operating margins decreased 3.0% in FY2001. This may be a result of a slowing economy and consumers' current unwillingness to pay as high a premium for Abercrombie & Fitch clothing they have in the past. This may be a sign that its brand equity cannot command a higher premium for its clothing.

Management Effectiveness: In the past five years, ANF's ROE is 125.28% compared to the industry's average of 33.79%. A better measure is its ROE (TTM) of 49.33% versus the industry's 35.78%. At the same time its ROA in the last five years is 31.54%, almost twice as high as the industry average of 16.95%. ROE was higher than ROA in the same period, indicating that ANF effectively leveraged to boost profitability.

Efficiency: ANF's receivable turnover (TTM) is 87.62 compared to the industry average of 59.22. Its inventory turnover is 5.87 versus the industry's 4.62 while its asset turnover is 2.60 compared to the industry's 2.52. In addition, it has been able to delay payment on its accounts payable. These numbers suggest that ANF is fairly efficient in managing its assets and as a result it is able to finance its own operations with little current debt and no long-term debt.

Financial Strength Cash and cash equivalents decreased 9.57% to \$148 million in FY2000 and at the same time inventories grew 71.08% to a current \$75 million, while accounts receivable grew 200% to \$11.5 million. While ANF's current ratio is 1.41, its quick ratio is 0.62 (versus the industry average of 0.38), which suggests that it may not be able to easily pay off all of its liabilities if they came due immediately. ANF has no long-term debt and as a result has a much lower long-term debt/equity ratio than the industry and sector averages of 0.23 and 0.75 respectively. This could mean that the company may not be as financially constrained by interest payments as its competitors. Its ratio of zero reduces the risk of investing in ANF, possibly making it a more attractive retail investment relative to its competitors.

Growth Prospects

The company plans on opening 49 Abercrombie and Fitch stores, 49 abercrombie kids stores, and 20 more Hollister stores in 2001. Hollister represents a very strong growth opportunity for the company, but would most likely incur a loss in the next year due to the more extensive investments the company will need to make to support the new business. However, the overall concept is very strong and is likely to reach the same number of current Abercrombie & Fitch locations in the future.

Same-store sales growth in 2000 for the most part has been negative. This was partly the result of Abercrombie & Fitch's failure to meet a critical fashion shift to a more feminine style in women's clothes. However, since then the company has focused intensively on the women's line, boosting February 2001 same-store sales growth to 6%, while the industry in the same time period averaged -2.95%.

Despite the success of the women's line, the men's clothes hasn't been able to keep up with the success it had last year with its pants and short offerings. The kids line has also suffered negative same-stores sales growth. The company currently is doing the same thing with the kids division as it had with the Abercrombie & Fitch stores, focusing on the girl's clothing line to improve and better match current fashion trends.

We believe the company is able to strengthen the men's and kid's sales in the future by accurately forecasting fashion trends, and mimic the recent success it had with the women's line. In addition, we anticipate the company to fully exploit the potential Hollister Co. has by rapidly and aggressively expanding the number of locations and the geographic area it covers. Due to the combination of Abercrombie & Fitch's strong brand name, wide clothing and accessories lines, possession of both online and offline channels, and the expandability of its operations, there is still much room for growth in this century-old firm.

Summary of Company Valuation

$$\begin{aligned} \text{CAPM} &= R_f + (R_m - R_f) * b \\ &= 4.88\% + (14\% - 4.88\%) * 1.23 \\ &= 16.10\% \end{aligned}$$

Assumption: Since Abercrombie & Fitch is in the apparel business where competition is very high and has mid-risk b , a R_m of 14% (mid-risk) was used – refer to sensitivity analysis

Methods of Valuation & Analysis	Assumptions	Value	Decision
Forward P/E Analysis	<ul style="list-style-type: none"> Predicted growth for EPS is 20% Price now/ 2002E EPS 	18.61	Fairly valued
Forward PEG Analysis	<ul style="list-style-type: none"> Average growth rate is 19.87% Forward PE/ avg. LT growth rate 	0.94	Slightly undervalued
P/B Analysis	<ul style="list-style-type: none"> $BV_1 = BV_0 + EPS_1 - Div_1$ Dividend growth from analysts' consensus 	5.55	Overvalued
P/S Valuation	<ul style="list-style-type: none"> P/S avg. competitors * ANF Sales/Share 2001A 	\$16.54	Overvalued
Forward P/E Valuation	<ul style="list-style-type: none"> Average of analysts' consensus of competitors' forward EPS P/E avg. competitors * Forward EPS ANF 	\$32.41	Fairly valued
Forward PEG Valuation	<ul style="list-style-type: none"> Average competitors' LT growth rate from analysts' consensus 	\$38.01	Slightly undervalued
Forward P/B Valuation	<ul style="list-style-type: none"> P/B avg. competitors * Forward BV/ share ANF 	\$28.29	Slightly overvalued
EBO Valuation	<ul style="list-style-type: none"> Discount rate using CAPM model Dividend projections from analysts' consensus Perpetuity growth rate of 5% after 2008 due to fewer new store openings 	\$15.98	Overvalued
DCF Valuation	<ul style="list-style-type: none"> Discount rate using CAPM model 5% perpetuity growth rate after 2008 	\$31.20	Fairly valued

- The qualitative analysis shows that Abercrombie & Fitch has an estimated high growth rate in future sales due to the rapid increase in the number of stores.
- The overvaluation in EBO analysis might have been influenced by the current heavy investment in new stores, which cuts into the annual net income, hence understating the potential future abnormal earnings.

Sensitivity Analysis

There are various ways to calculate the discount rate used in the DCF and EBO valuations. Our analysis uses the CAPM formula to calculate this rate. In our CAPM calculation we assumed the market rate of return was 14% due to the mid-risk Beta of 1.23. However, this assumption may not be accurate because of the variability in the risks of its competitors. Nevertheless, the 16.10% discount rate we used based on the CAPM calculation seems appropriate for this company.

Furthermore, our calculations are based on a 5% perpetuity growth rate after the year 2008. We believe this rate is appropriate for ANF because although it is currently expanding and is achieving high growth rates, it is not reasonable to assume that this rate of growth is sustainable over the long term.

The following charts demonstrate the change in the valuations based on different perpetuity growth and discount rates.

		<u>DCF Robustness Checks</u>				
		Discount Rate				
		10%	14%	16.10%	20%	25%
Perpetuity Growth Rate	3%	\$57.36	\$34.74	\$28.53	\$21.23	\$15.84
	5%	\$73.58	\$39.20	\$31.20	\$22.44	\$16.37
	8%	\$158.73	\$51.48	\$37.69	\$25.01	\$17.39
	10%	N/A	\$69.90	\$45.57	\$27.58	\$18.30
	12%	N/A	\$125.16	\$61.12	\$31.44	\$19.49

		<u>EBO Robustness Checks</u>				
		Discount Rate				
		10%	14%	16.10%	20%	25%
Perpetuity Growth Rate	3%	\$25.41	\$17.29	\$15.04	\$12.36	\$10.35
	5%	\$31.14	\$18.87	\$15.98	\$12.78	\$10.53
	8%	\$61.21	\$23.20	\$18.27	\$13.69	\$10.89
	10%	N/A	\$29.71	\$21.05	\$14.60	\$11.22
	12%	N/A	\$49.23	\$26.55	\$15.96	\$11.64

Recommendation

We propose a market performer recommendation. Although ANF has much growth potential through its three brand name stores, given our valuation and the slowing of the retail segment, we believe ANF's stock is currently fully valued. In addition, for FY2001 ANF reported some disappointing numbers for same store sales, cash flow from operations, gross margins, ending inventory and accounts receivable. However, ANF is poised to continue its growth with one of the strongest brand names in the retail apparel business. Its ability to grow the less established brand names of Abercrombie kids and Hollister Co. could be the determining factor in ANF's long-term growth because ANF can only grow so much in the next decade with its flagship Abercrombie name in the niche market of 18-22 year-olds. If both these stores prove to be as successful as Abercrombie & Fitch, it could mean that the stock is currently undervalued. In addition, ANF's negative FY2001 numbers are not necessarily indicative of its future potential. However, with the stock price currently at around its 52-week high, there may be more downside than upside given the potential risk in the expansion of its two new brand names and the retail industry risk due to the softening of the U.S. economy.

DCF Valuation									
(in \$millions)									
Fiscal Year Ending 1/31	Actual 2001	Assumption	Forecast 2002	Forecast 2003	Forecast 2004	Forecast 2005	Forecast 2006	Forecast 2007	Forecast 2008
Growth Rate	11.43%	Analyst Report	15.40%	19.20%	20.90%	20.90%	20.90%	20.90%	20.90%
CF from Operating Activities	153.80	CF Statement	177.49	211.56	255.78	309.24	373.87	452.01	546.47
Discount Rate	16.10%								
Sensitivity Analysis									
Discount Rate									
PV of CFO	3082.77								
Shares Outstanding	98.80								
Price per share (estimated)	\$31.20	Perpetuity	3%	\$57.36	\$34.74	\$28.53	\$21.23	\$15.84	
		Growth	5%	\$73.58	\$39.20	\$31.20	\$22.44	\$16.37	
		Rate	8%	\$158.73	\$51.48	\$37.69	\$25.01	\$17.39	
			10%	N/A	\$69.90	\$45.57	\$27.58	\$18.30	
			12%	N/A	\$125.16	\$61.12	\$31.44	\$19.49	

EBO Model									
Fiscal Year Ending 1/31	Actual 2001	Assumption	Forecast 2002	Forecast 2003	Forecast 2004	Forecast 2005	Forecast 2006	Forecast 2007	Forecast 2008
EPS Growth	11.43%	Analyst Report	15.40%	19.20%	20.90%	20.90%	20.90%	20.90%	20.90%
EPS	1.56		1.80	2.15	2.59	3.14	3.79	4.58	5.54
Book Value	4.24	B/S	6.04	8.19	10.78	13.92	17.71	22.29	27.84
Abnormal Earnings/year			1.12	1.17	1.28	1.40	1.55	1.73	1.95
Price on 1/31/01	\$ 15.98								
Sensitivity Analysis									
Discount Rate									
*Assume 5% perpetuity after 2008									
		Perpetuity	3%	\$25.41	\$17.29	\$15.04	\$12.36	\$10.35	
		Growth	5%	\$31.14	\$18.87	\$15.98	\$12.78	\$10.53	
		Rate	8%	\$61.21	\$23.20	\$18.27	\$13.69	\$10.89	
			10%	N/A	\$29.71	\$21.05	\$14.60	\$11.22	
			12%	N/A	\$49.23	\$26.55	\$15.96	\$11.64	

Company	Last	EPS	EPS	EPS	Shares	Market	1yr NI	NI	Sales	Sales	EBIT	EBIT	P/E	P/E	B.V.	P/B	PEG Ratio	5 year
Name	Price	2001A	2002E	Growth Rate	Out. (M) 2001A	Value of Equity(\$M)	Growth 2001A	(\$M) 2001A	Growth 2001A	(\$M) 2001A	(\$M) 2001A	Margin 2001A	2001A	2002E	2001A	2002E	2002E	Growth
American Eagle (AEOS)	\$31.50	1.30	1.63	22.80%	69.70	\$2,195.55	67.52%	\$90.66	31.41%	\$832.10	\$149.51	17.97%	24.23	19.33	5.20	6.06	1.06	20.00%
Pacific Sunwear (PSUN)	\$28.56	1.23	1.51	22.50%	32.14	\$917.92	50.19%	\$35.30	36.02%	\$436.81	\$56.50	12.94%	23.22	18.91	6.08	4.70	1.03	25.00%
Gap (GPS)	\$23.06	1.00	1.03	6.90%	850.47	\$19,611.84	36.69%	\$1,127.10	28.50%	\$11,635.40	\$1,784.95	15.34%	23.06	22.39	3.44	6.70	3.34	20.00%
The Limited (LTD)	\$15.65	0.96	1.05	8.20%	439.16	\$6,872.85	-77.49%	\$460.80	4.03%	\$9,723.33	\$920.64	9.47%	16.30	14.90	4.90	3.19	1.99	14.50%
Gadzooks (GADZ)	\$24.64	1.38	1.70	23.50%	8.91	\$219.54	1471.44%	\$6.10	16.05%	\$241.62	\$9.20	3.81%	17.86	14.49	8.91	2.77	0.76	25.00%
Competitors' Mean	\$19.75	1.17	1.38	16.78%	280.08	\$5,963.54	309.67%	\$343.99	23.20%	\$4,573.85	\$584.16	11.90%	20.93	18.01	5.71	4.68	1.64	20.90%
Competitors' Median	\$23.06	1.23	1.51	22.50%	69.70	\$2,195.55	50.19%	\$90.66	28.50%	\$832.10	\$149.51	12.94%	23.06	18.91	5.20	4.70	1.06	20.00%
Abercrombie & Fitch (ANF)	\$33.50	1.56	1.80	19.87%	98.80	\$3,309.80	11.43%	\$158.13	18.76%	\$1237.60	\$242.10	23.23%	21.47	18.61	4.24	5.55	0.94	20.00%

*As of 3/20/01

Price-Sales	
Sales FY2001 (in \$millions)	1237.60
Shares Outstanding (in \$millions)	98.80
Sales/Share	12.53
Price	\$33.50
P/S Ratio	2.67
P/S Price	\$16.54
Company	Current P/S Ratio
American Eagle (AEOS)	2.08
Pacific Sunwear (PSUN)	1.57
Gap (GPS)	1.48
The Limited (LTD)	0.69
Gadzooks (GADZ)	0.79
Competitors Avg. P/S ratio	1.32

Price/Earnings Valuation	
Fiscal Year Ended	2001A
Price (3/20/01)	\$33.50
Competitors' Avg. Forward P/E	18.01
Predicted EPS	1.80
Trailing EPS	1.56
Price per share (Estimated)	\$32.41
ANF Forward P/E	18.61
ANF Trailing P/E	21.47

PEG Valuation	
Fiscal Year Ended	2001A
Price (3/20/01)	\$33.50
Competitors' Median Forward PEG	1.06
Predicted EPS	1.80
Growth	19.87%
Forward P/E	18.61
Trailing P/E	21.47
Price (Estimated)	\$38.01
ANF Forward PEG Ratio	0.94
Trailing PEG Ratio	1.08

Price/Book Valuation	
Fiscal Year Ended	2001A
Price (3/20/01)	\$33.50
Competitors' Avg. Forward P/B	4.68
Forward Book Value	6.04
Trailing Book Value	4.24
Price Per Share (Estimated)	\$28.29
ANF Forward P/B	5.55
ANF Trailing P/B	7.90