

ABERCROMBIE AND FITCH (ANF)

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COMPANY OVERVIEW

Location

New Albany, Ohio

Industry

Retail-Apparel

Price	Siena Target Price	S&P 500	DJIA	S&P Industry
\$23.62	\$26.07	\$842.50	\$8017.59	\$24.76

DESCRIPTION

Abercrombie and Fitch is an apparel retailer specializing in trendy merchandise for young men, women, and children. Operating under the 5 storefronts titled Abercrombie and Fitch, Abercrombie, Hollister, Gilly Hicks, and RUEHL, the company targets consumers ages 10-35.

Company Website

www.Abercrombie.com

MARKET DATA

Market Cap	\$2,090,000,000.00	1 Yr Price App.	3.12%
Price to book	\$1.12	Country	USA/Canada/UK
Beta	1.46	Industry	Apparel Stores
Dividend yield	2.80%	Industry Price	15.33
Shares O/S	87,836,000	Industry Beta	1.15
Current price	\$23.62	Country Risk Premium	8.71%
52 week range	13.66 - 78.35	Risk Free Rate	2.68%

Valuation	Current	2009E
EPS	\$3.05	\$2.13
P/E	13.84	10.10
CFPS	\$5.77	\$4.68
P/CFPS	6.21	6.20

RECCOMENDATION

Buy: outperform the industry; high growth potential

SEGMENTS & CUSTOMERS

Abercrombie and Fitch

ANF's flagship storefront which provides casual and sportswear apparel for young men and women at luxury prices. Abercrombie and Fitch stores flaunt an East Coast image of prosperity and privilege. Merchandise includes; woven, knit, and graphic t-shirts, fleece, jeans, pants, sweaters, outerwear, underwear, accessories, and personal care products. ANF conducts business in 356 Abercrombie and Fitch stores.

Abercrombie

ANF's children's merchandise business split into both male and female merchandise categories. Selling similar products to the flagship storefront, Abercrombie has experienced rapid expansion to 211 stores in January 2009 from its conception of 9 stores in July 1998.

Hollister

ANF's lower priced version of its flagship storefront aimed at the young adult segment (14 to 17 year olds). Split into male and female merchandise segments, Hollister touts west-coast inspiration through its unique retailing concept. Each store is staged accordingly, immersing consumers in the west-coast styling theme. The Hollister brand concept began in July 2000 with a single store. ANF currently operates 516 Hollister stores with an expected expansion of 10 domestic stores in 2009.

RUEHL

ANF's 2004 entry into the post-college casual luxury market aims to attract consumers with deeper pockets and more developed tastes. RUEHL's brand image is inspired by the culture of New York City's Greenwich Village. Aimed at college graduates age 22-35, RUEHL offers "office-appropriate" clothing, accessories, personal care products, and leather outerwear. This exclusive luxury brand is currently available at 29 domestic stores.

Gilly Hicks

ANF's newest retail concept offers bras, underwear, accessories, personal care, sleepwear, and at-home products to female consumers. Morningstar estimates the company to operate an expected 40 Gilly Hicks stores in 2010, a large jump from its birth of 5 stores at the beginning of 2008.

Bargaining Power of Customers

Because of the nature of A&F business model, they cater primarily to teenagers who have discretionary income. Their income tends not to change, even in macroeconomic times such as now. Customers within the apparel industry really have no bargaining power; A&F must price their products strictly on what they believe the consumer will pay for them.

STRATEGY

Founded in 1892, Abercrombie and Fitch has experienced rapid change in recent years under the leadership of CEO Michael Jeffries. Since his rise to power in 1992, the apparel retailer has experienced dramatic growth on the heels of Jeffries' somewhat visionary initiatives. ANF's premium pricing and concept evolution approach aims to appeal to brand-conscious men, women, and children. ANF maintains an exclusive brand image by conducting business in only the most prestigious retail environments domestically and abroad. Avoidance of deep product discounting is a characteristic consistent with ANF's exclusive business model. Operating under a number of physical and web-based storefronts including Abercrombie, Abercrombie and Fitch, Hollister, Gilly Hicks, and RUEHL, ANF has developed a system to capture continual sales dollars in the ever-changing youth fashion industry.

This hierarchy of store concepts and merchandise intends to appeal to consumers as they outgrow opinions of fashion throughout their youth. Each storefront targets a slightly different demographic by providing merchandise tailored to its target customers. This is reflected in the breakdown of each storefront's characteristics above.

SUPPLIERS

Abercrombie & Fitch has approximately 210 suppliers worldwide. ANF does not buy more than 5% of its apparel or personal products from an individual factory with the exception of a single South American vendor. They have vendors in 37 different countries. Since ANF has such a diverse variety of vendors, the bargaining power of their suppliers is limited. This diversification also limits their exposure to political and financial risks that could occur in specific regions of the world.

MARKET SEGMENTATION



LATEST DEVELOPMENTS

In ANF's February 2009 conference call CEO Michael Jeffries outlined the company's plan for the New Year. Cash preservation, international expansion, and a reduced emphasis on domestic expansion were among the most interesting topics. Q4 2009 EPS would have been \$1.10 per share if not for one time charges due to write downs on store-related assets and execution of an element within Jeffries' employment contract. The \$1.10 EPS beats ANF's guidance along with estimates of many analysts. This news led to intraday gains of over 11% on February 3, 2009.

INDUSTRY ANALYSIS

OVERVIEW

The economic recession has had a negative effect on the majority of industries. The apparel retail industry specifically has been hurt by the downturn. The apparel retail industry is dependent on spending, and fares best when the economy is thriving. However, the recession has caused declining consumer spending and therefore has hurt apparel companies. The apparel industry is highly seasonal with a high percentage of income coming from back-to-school shopping and the holiday season. It is also subject to a high level of change due to changing trends and fads. Companies in this industry must be quick to capitalize on these trends or they will lose out to a competitor.

Companies in this industry have several different strategies to survive. Some offer a best quality strategy where the company has high prices, but the brand is known for its high quality and premium name. Others look to be a best value provider where they offer good quality at affordable prices. Some companies have formed a differentiation strategy, where they offer a unique style that other companies don't offer at fair prices. Another successful strategy is to be a low cost provider and simply compete by offering the lowest price in the industry.

CRITICAL ISSUES

GDP

The Bureau of Economic Analysis released fourth quarter GDP for 2008 on March, 26, 2009. Gross Domestic Product decreased at a reported annual rate of 6.3 percent in quarter four. The decrease is due to declining exports and decreased personal consumption expenditures. GDP was at 2.00 percent in 2007 and fell to 1.10 percent in 2008. It is also estimated to be -2.50 percent in 2009 and finally recover in 2010 where it is expected to improve to 1.80 percent (Bloomberg). The Federal Reserve has a more optimistic forecast with GDP at -.9 percent in 2009 and a larger recovery of 2.90 percent in 2010. Both forecasts agree that the economy will suffer in 2009 and this will translate to a difficult year for ANF. Abercrombie will need to be efficient in its operations to keep costs low. It will also need to do what is necessary to find ways to sell its products and turnover inventory despite an environment with decreased spending. In 2010, the company will benefit from the recovery and likely see its sales and profitability increase.

Retail Sales

Retail sales have declined year over year for the months of January and February for 2008 and 2009. The data below was taken from the U.S. Census Bureau:

	Feb-09	Feb-08	Jan-09	Jan-08
Retail & Food Services, Total (millions)	346,810	379,355	347,191	381,421
Percent Change (yoy)	-8.58%		-8.97%	
Retail	308,148	341,729	308,461	343,739
Percent Change (yoy)	-9.83%		-10.26%	
Clothing & Clothing Accessories Stores	18,227	18,804	17,739	18,981
Percent Change (yoy)	-3.07%		-6.54%	

As shown, retail sales in general have fallen from 2008 to 2009. When including food services. Clothing and Clothing Accessories stores sub-industry have fared better than the retail industry in general over the past year. One can infer that this is due to the nature of the consumer targeted by clothing retailers. Many of these stores target customers that are in their teens. These customers are dependent on a guardian who provides most things to them. Therefore, any discretionary income they have is spent on things desirable to teens, clothing being one. The downturn in the economy has likely had less of an effect on teenagers than someone who provides for themselves or a family.

Unemployment

The national unemployment rate is currently around 8.1 percent; however it can vary state to state. The estimate for 2009 is for unemployment to increase to 8.9 percent and continue to increase to 9 percent in 2010 (Bloomberg). As unemployment continues to rise, more and more people will be without a steady source of income. As a result consumer spending will continue to decrease as people only spend on necessities and look for low cost items. This will negatively affect most industries and companies. However, companies that are low cost providers such as Wal-Mart and McDonalds may actually benefit from this trend. Apparel companies will likely be affected as more people cannot afford higher quality clothing and brand names and consumers will look to cheaper sources of clothing. Apparel companies will need to compete by keeping prices as low as possible.

Consumer Confidence

According to a report on Bloomberg, consumer confidence stayed flat in March after declining in February. This decline is based on the data obtained from the confidence index. The confidence index was created by *The Conference Board* is a representative sample of 5,000 households that measures the positive or negative attitude of the surveyors on economic outlook. The decline in consumer confidence is due to

continued increases in the unemployment rate and economic estimates that 2009 will continue to be a difficult year for consumers and businesses. It is likely that confidence will remain low until consumers feel that the economy is about to recover or the government's plan to revive the economy can be successful. Until the confidence is restored, spending will be low and as a result retail sales will not be as strong as they were in the past.

Consumer Spending

The Bureau of Economic Research reported that consumer spending decreased in the fourth quarter by 3.01 percentage points. This is from a decline in demand for goods as services actually increased. Consumer spending accounts for around two-thirds of GDP and is one of the driving forces of the economic downturn. The continued job losses and fears of a long recession have caused consumers to stop their spending and save for emergency and necessities. Since consumer spending drives the economy, it is likely that when consumer spending increases retail sales will follow.

Inflation

Currently inflation is not a factor that the economy is facing. The CPI, which is a measure of the average price paid for a basket of goods and services, is forecasted to be at -.70 percent at the end of 2009 and increase to 1.90 in 2010. This shows that prices are low and that inflation is not currently a problem. However, because the economy is in a recession, the U.S. government and the Federal Reserve have done a number of things to keep the economy stable and attempt to revive it. Through the actions of the government and Fed, more money has been introduced into the economy that has the potential to cause inflation in the future. While these funds now are being used to attempt to keep companies in business and encourage spending, it is likely that a large problem will occur years after the initial recovery. The increase in the money in the economy will cause a decline in purchasing power. While the next few years the economy is not forecasted to see inflation, it will become a factor in the years to come. This will increase the price of goods and this will affect the economy and apparel stores such as Abercrombie & Fitch, which will have to increase prices to maintain margins.

Drivers of Profitability

Within the retail apparel industry, there are many factors that can be attributed to their success. First and foremost, they apparel stores must be sensitive to changing consumer preferences in trends in a well-timed manner. It is absolutely key that their shelves carry the latest products or styles before their competitors can stock their shelves with them. They must be knowledgeable about the target demographic they are catering to and sensitive to the styles they demand. Stores must effectively respond to changing trends and discontinue inventory that is not selling.

Timeliness is a major factor of the apparel industry. They also must receive their products in a timely fashion from their manufacturers. With many apparel stores, including A&F, they have third party manufacturers. The stores must make sure that their manufacturers are complying with time guidelines set forth by the apparel stores to ensure that they are meeting customer demands and not losing market share. If inventory is not received in a well timed manner, consumer confidence in the quality of the products decreases and gives market share to their competitors which would have an undesirable outcome for their profits.

Other major key success factors include the ability for corporations in the apparel industry to negotiate real estate lease. Most stores rent, and they must strive for the cheapest possible monthly rents to enhance financial stability for the firm.

Managing inventory efficiently in relationship with demands for their products is vital. The less excess they hold, the less holding and setup costs they incur. It would also be advantageous to hold less because it would require less credit borrowing. It assists in attaining exceptional operating margins for their store.

Lastly, successful market development of their products during times of expansion is key. This ensures that as the company grows in domestic and international segments, they are creating strong customer loyalty to their stores, which further enhances their brand name and raises the value of their products.

COMPETITORS

Threat of Substitutes

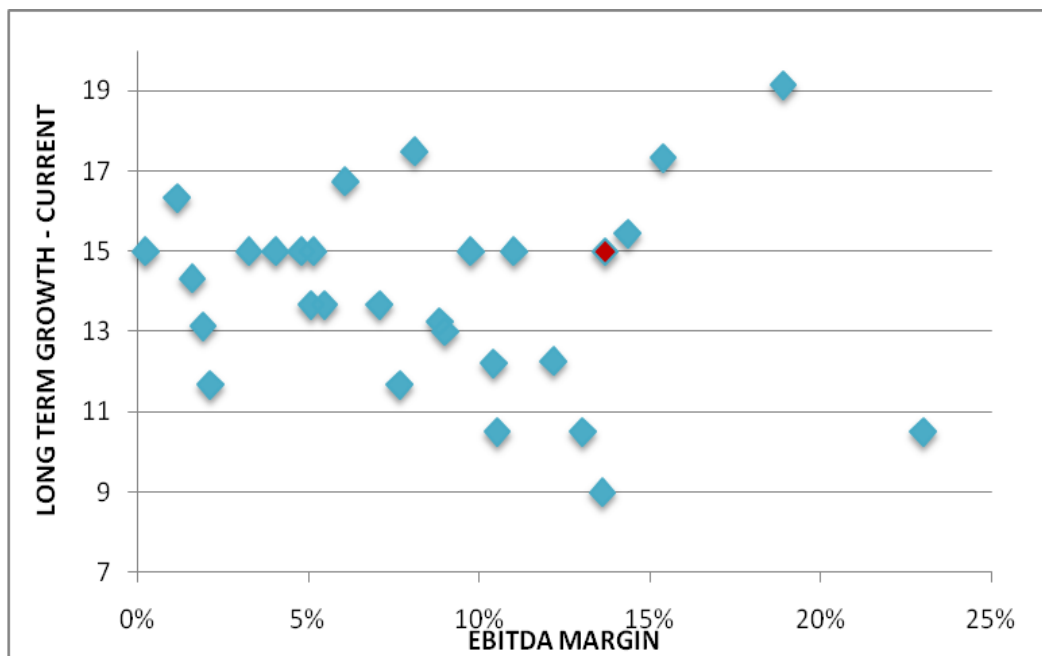
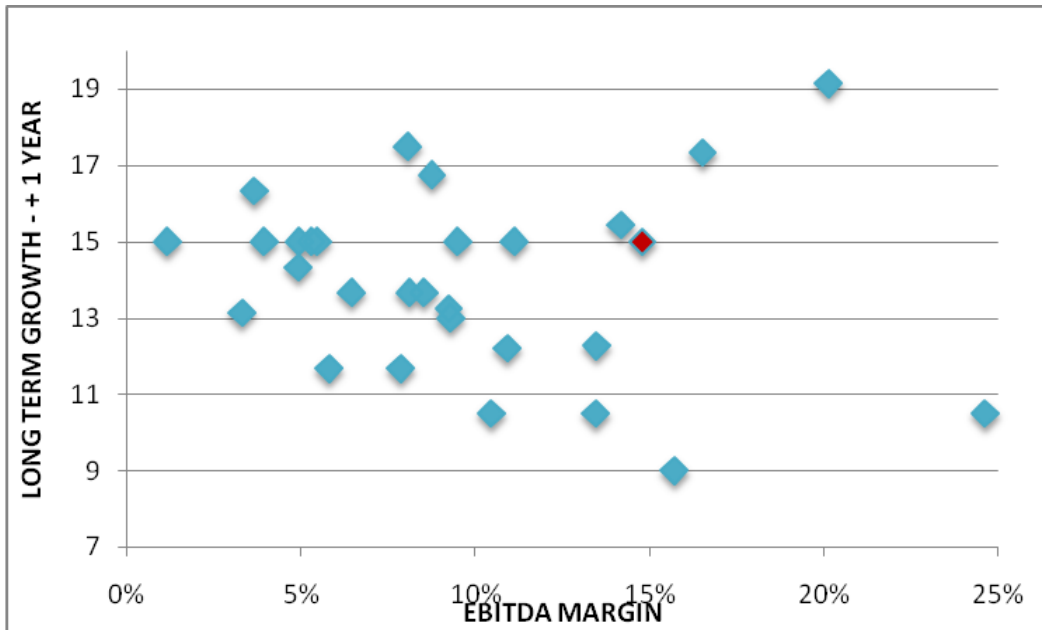
The products that Abercrombie & Fitch carries are very exclusive. The target market that wears their clothing lines take pride in shirts and wear that say "A&F" on it. It is very difficult to have a substitute for clothing, yet ANF must stay on the lookout for the latest fashion trends that aim to take market share away from them. For example, the newest look in ripped jeans or the modern new shirts with funny tag lines on them need to always be on their shelves before their competitors if they want to stay a top destination for high school kids to spend their allowance dollars.

Threat of New Competitors

The threat of entry of new competitors in this market is slim. Because of current macroeconomic conditions, the retail industry as a whole is not seeing new stores emerge. Due to the decrease in consumer spending and frozen credit markets, the apparel industry has not seen an increased entrance of competitors. This works in favor of ANF in which they can manage their pricing wars with competitors that they currently have.

Competitive Rivalry

Abercrombie & Fitch is constantly striving to enhance its image against competitors and steal more market share away. They are under the constant struggle of countering promotional actions of its competitors while not reducing the brand or image of the ANF. ANF understands that they have no guarantee that they will be successful in the future so they strive to continuously aim higher than its competition in pricing, products, and services. They aim their marketing to target demographics so they can compete as effectively as possible. Their main competitors include American Eagle, Aeropostale, and J. Crew.



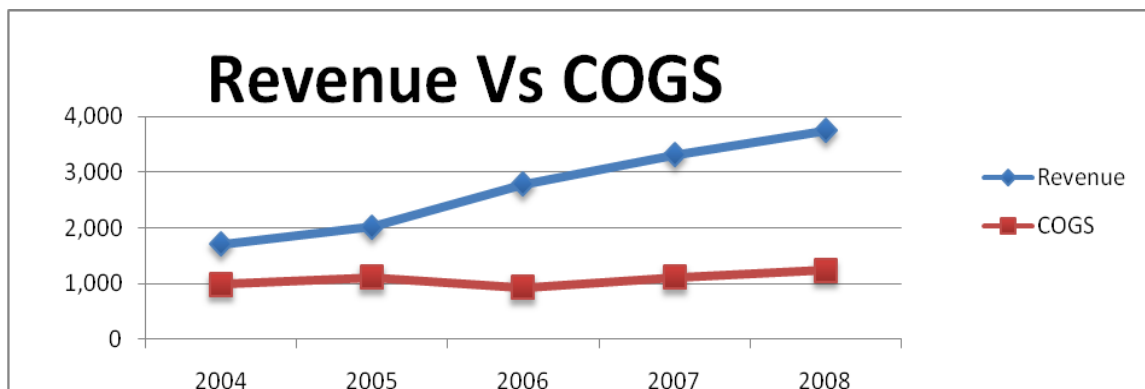
COMPANY ANALYSIS

RISK

In order to assess the company's risk, let us have a look on certain financial statement figures. The table below sums up these figures:

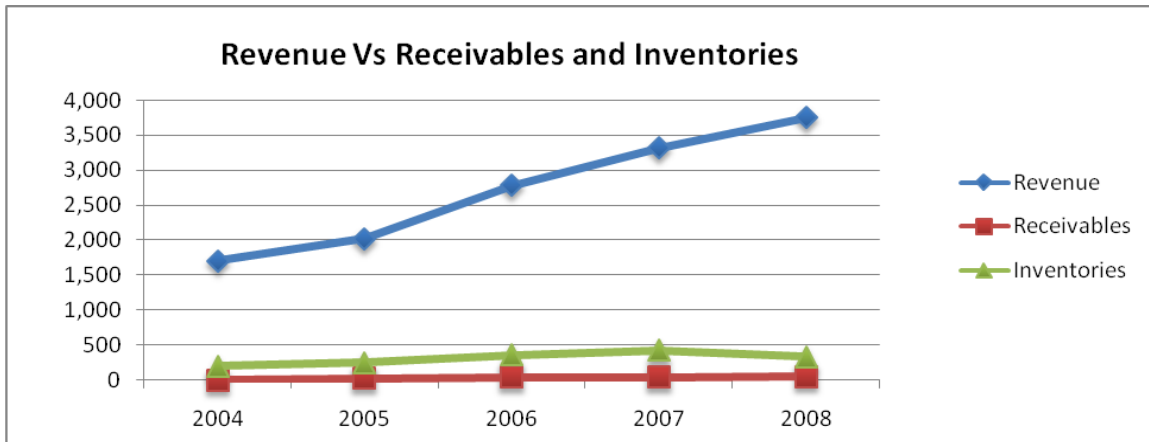
\$Million	2004	2005	2006	2007	2008	CAGR
revenue	1,708	2,021	2,784	3,318	3,750	21.73%
Receivables	7.2	26.1	42	43	54	65.49%
COGS	990	1112	933	1109	1239	5.77%
Inventories	201	248	363	428	333	13.45%
EBITDA	335	353	549	672	759	22.69%
Debt	328	678	795	843	949	30.42%
Debt/EBITDA	0.98	1.92	1.45	1.25	1.25	6.30%

Revenues increased by 21.73% from 2004 to 2008 but COGS increased by 5.77%. The company is thus able to generate more revenues to cover its COGS. The revenue growth has to be higher than the COGS's growth as it would indicate that the company will have trouble funding its COGS. According to the graph below, the company is not facing this risk.



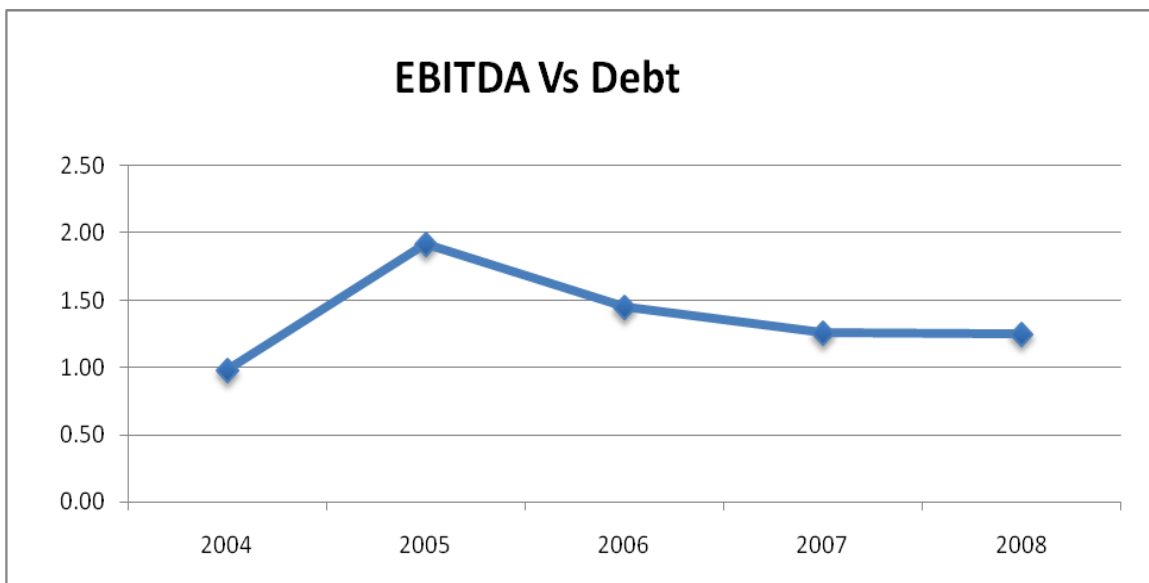
According to the table, receivables are increasing at a much higher rate than the revenues (65.49% compared to 21.73%). This could be harmful for the company if the company has trouble collecting money from its customers. ANF will have to find money to fund its receivables and take this money from its cash flow eventually and if possible. However, the receivables represent on average 1.19% of total revenues. Even if receivables keep increasing, in 2008, it represented only 1.44% of total revenues; this is not a major concern for ANF as it represents only a very small part of revenues. The company has to keep an eye on these receivables and make sure they do not increase to reach revenues.

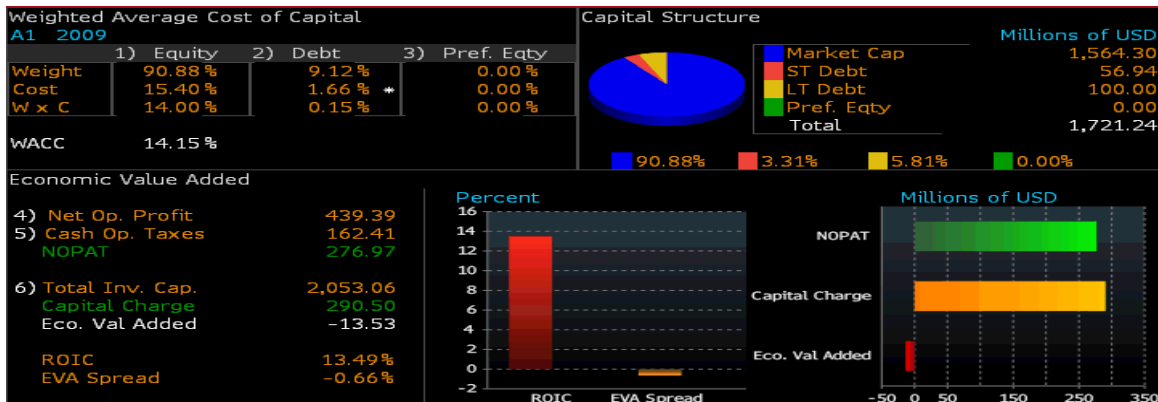
Concerning its inventories, this is the same analysis. It has been increasing by 13.45% compared to a 21.73% increase in revenues. This is a high rate of growth but over the past 4 years inventories represent only 11.77% of total revenues. The Senior Management team has to make sure it does not increase above revenues otherwise ANF will have to fund them. The graph below depicts the comparative increase in revenues, inventories, and receivables over the past 4 years.



The Debt to EBITDA ratio depicts the number of years it will take the company to pay off its debt. The ratio increased by 6.30% over the past 4 years. Indeed, in 2004, it took less than one year to pay off its debt knowing its level of EBITDA but in 2008, it took 1.25 years to pay off its debt knowing its EBITDA level. Debt increased at a higher level (30.42%) as compared to EBITDA (22.69%). Currently, the company has two loans: one of \$250 million which is maturing in December this year, and one of \$450 million maturing in 2013.

This is why the ratio rose to 1.92 in 2005 and later began decreasing after the company did not borrow additional funds. Meanwhile ANF continued to pay interest and revenues were increasing year over year.





The chart above depicts the economic value added (EVA) by the firm. It assesses the financial performance of ANF to calculate its true economic profit. EVA spread is negative (-0.66%) as the economic value added equals \$- 13.53 Million. It means that ANF's earnings are lower than the required minimum rate of return as measured by the WACC (14.15%) by 0.66%. It indicates that ANF is not generating enough cash to satisfy the creditors and shareholders, but also does not generate enough cash to get a surplus, thus the added value. In contrast the return on investment capital (ROIC) is lower than the WACC (13.49%). However, the Altman Z-score is equal to 3.70 meaning that there is no potential risk of bankruptcy for the company. The cash flow from operating activities is growing at a lower rate than the net income, at 15.82% and 25.82% respectively. The company is not able to generate more cash from its operations beyond the scope of their own net income. This could be harmful as the company doesn't have a high level of cash to cover its liabilities. However, in terms of free cash flow, it increased at a higher rate (38.82%). The current free cash flow is \$123.73 million but ANF needs to be able to pay off their \$250 million loan coming to maturity in December.

To sum up, ANF is not facing a high risk of default as its cash flow and net income allows them to cover their liabilities. Moreover, revenues are much higher than ANF's inventories and receivables allowing them to cover their short-term receivables as well as inventories.

VALUATION

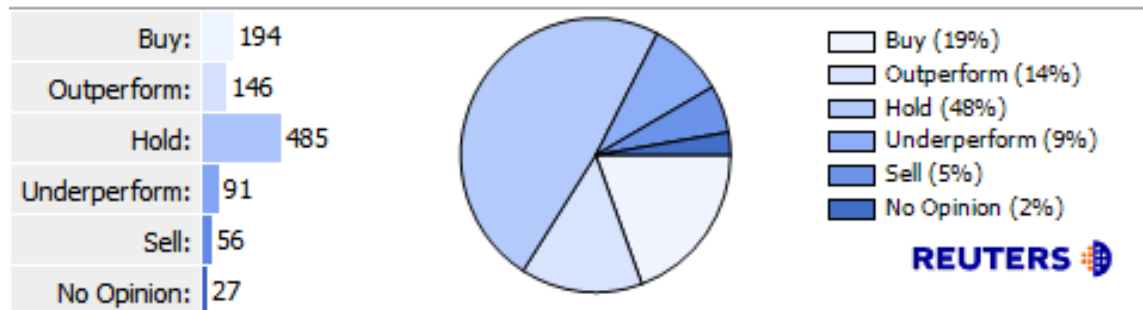
In ANF's February 13, 2009 conference call, CEO Michael Jeffries described Q4 2008 as a "retail nightmare." Citing the competitive promotional environment of apparel retailers and plummeting consumer discretionary spending, Jeffries described goals for 2009 including brand protection and international growth in a disciplined and controlled manner. Jeffries restated confidence in the management's ability to 'control' the business yet CFO Jonathan Ramsden described ANF's ability to provide estimated EPS guidance as "an exercise in false precision." This, according to Ramsden, is a result of largely unpredictable sales trends as a result of macroeconomic conditions.

Our calculated target price of \$25.98 a share is somewhat conservative given the almost inevitable recovery of the consumer discretionary environment. Meanwhile, ANF must minimize the decline of its profit margins while maintaining the inspirational images of its unique brands. ANF's ability to weather the volatility of its overall operating environment will play a predominant role in determining share valuation upon economic recovery. We feel ANF's business model of utilizing five separate storefronts to customize selling is among the company's strongest features. This model minimizes variations in consumer spending as a result of unavoidable changes in lifestyle brought by age. ANF's ability to capture sales revenues through the opening of new stores has not yet experienced the power of foreign markets to full capacity.

Though ANF trades slightly above our projected target price, this can be attributed to the conservatism of our projection, but we do have a strong feeling that ANF is a long-term bull. The consumer discretionary segment is one that can rebound right alongside the economy, as increased spending will surely increase with consumer confidence. Specialty retailers will benefit the most within the

segment, as brand loyalty becomes a key factor. The following Reuters chart shows analyst expectations for the retail apparel industry, and much of the weight is on the bullish side. Nearly half of the brokers did recommend a hold on the market, and this is an indication why our target price is very similar to ANF's current price.

Broker Recommendations



We do expect ANF to be profitable in upcoming quarters, though EPS is well lower than figures from a year ago. 2010 is not going to be a blockbuster year as the economy still needs to regain momentum, but estimates for 2011 EPS figures look strong for ANF and the apparel retail industry. The following chart shows 3-years of EPS data for ANF.

Reuters Consensus Estimates (Mean)

Recommendation	Target Price	LT Growth Rate			
HOLD(2.96)	USD 23.53	15.00%			
EPS (Pre Except) (USD, Major)					
FY (Jan.)	Q1	Q2	Q3	Q4	FY
2009:	0.69a	0.87a	0.72a	1.10a	3.38a
2010:	0.02e	0.30e	0.42e	1.02e	1.78e
2011:	0.06e	0.23e	0.44e	1.28e	2.12e

As mentioned, some weaker quarters (Q1;2010) will happen due to the nature of the industry and its timing with the movement of the economy, but FY EPS is projected to begin to climb from 2010 into 2011 by nearly 20%. This exceeds the company's long term growth rate of 15% and shows that they are poised to start to regain sales momentum and profitability which has been slashed over the past few quarters. ANF has a strong brand name and recognition, which are key to bringing repeat and new customers into their stores.

SWOT

Strengths

ANF's single greatest strength is its tried and true brand image. Largely a product of CEO Michael Jeffries' visionary approach to brand development, Abercrombie and Fitch now consists of 5 brands. Realizing the rapid development within the youth fashion industry, ANF has devised a comprehensive plan to appeal to consumers of all ages and tastes. ANF's captures revenues from consumers aged 10 to 35 years of age through the utilization of each brands unique storefront imitative. Overall expansion may result in

revenues totaling over \$1 billion considering strong international demand for brands such as Hollister. Domestically, Hollister's strength will likely result in an expanded amount of storefront locations beyond the current number of 516. Other operations, such as ANF's Gilly Hick's brand aims to capture market share currently enjoyed by the likes of Victoria's Secret. Consumers who have outgrown the Abercrombie and Fitch brand may expand their wardrobes via ANF's RUEHL brand established in 2004. The RUEHL brand intends to appeal to post-collegiate consumers age 22-35 with more established merchandise and higher price points.

Weaknesses

The overall nature of ANF's teen fashion business is their most prevalent risk. A large drop in consumer discretionary spending has resulted in a 19% year over year decline in ANF's sales revenues. Combined with higher expenses associated with running its stores, ANF's operating income has dropped from over 27% of sales in Q4 2007 to a modest 12.5% in Q4 2008. This decline is further illustrated by a -64% 1 year return on ANF's publicly traded equity.

Opportunities

Domestic expansion of brands such as Gilly Hicks and Hollister will provide ANF with opportunities to grasp additional market share. By entering into specialty retailing at luxury prices, brands such as Gilly Hick's stand to grasp higher revenue from market share not yet tapped by ANF. As a growth retailer, ANF experiences sales growth as a result of opening new store locations. Strong international demand for many of ANF's brands will provide the company with the opportunity to expand their operations globally. This is consistent with ANF's plans to expand into the markets of Tokyo and Milan throughout 2009.

Threats

With relatively high priced merchandise falling into a "Luxury Casual" category, ANF faces the risk associated with consumer confidence and subsequent discretionary spending. Controversial marketing schemes may prevent certain customers from purchasing ANF's branded merchandise. Ironically, these tactics are relied upon by ANF to maintain brand image. ANF's exclusive brands and customer devotion could be damaged as a result of mistakes made within constant development and growth efforts. Limited discounting tactics could hurt sales revenues in times of decreased consumer spending and result in slower consumer traffic upon retail environment change. Brand loyalty, in this case, could be considered a double edged sword. The same note, domestic growth has been maximized in recent years, forcing prospects beyond ANF's realm of familiarity, in some cases.

RECOMMENDATION

We recommend a buy below \$26.07. Strong growth potential and tested brand image makes this stock a long-term buy. Historically strong returns on invested capital indicate ability to adapt and expand in an inherently volatile luxury-retail environment.

Target prices

Target Prices

Yahoo target price	\$25.56
Reuters target price	\$23.53
Bloomberg target price	\$23.93
Thomson one target price	\$22.50
Siena College CGFS target price	\$26.07
Siena College CGFS target price volatility	3.23
Siena College CGFS 68 percentile target price	\$22.84
Siena College CGFS 95 percentile target price	\$19.61
Siena College CGFS 99 percentile firm target price	\$16.39
Siena College CGFS industry target price	\$12.49

1-year forecasted Returns

1-year forecasted Industry Return	-16.39%
1-year forecasted Industry Return Volatility	33.00%
1-year forecasted Firm Return	13.31%
1-year forecasted Firm Return Volatility	60.18%