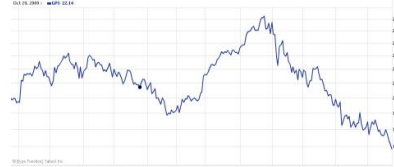


Stock Statistics

Ticker	GPS
Exchange	NYSE
Financial Year End	January
Market Price *	\$16.86
Market Cap (\$ bln) *	10.89B
52-Week Hi / Low	\$16.6 / \$26.3
Average Daily Volume	> 8,000,000

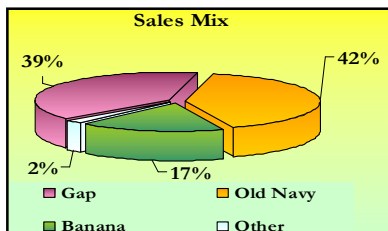
*As of previous day close



Sources: Yahoo finance

Company Description

Established in July, 1969 and based in San Francisco, California, The Gap functions as the largest specialty apparel retailer in the U.S. It offers clothing, accessories and personal care products for men, women, children and babies. It owns five apparel brands ó The Gap, Banana Republic, Old Navy, Piperlime and Athleta. Its core brand, Gap, includes Gap, Gap Kids, Baby Gap, Gap Maternity and Gap Body. Gap offers casual clothing and accessories spanning across all age-groups.



Old Navy provides a wide range of apparel, shoes, and accessories as well as its maternity line, consumables and personal care products. Banana Republic, being the premium brand, offers the same products as Gap at higher price points. Piperlime offers footwear and handbags and Athleta offers sports apparel and footwear for women (only).

The company has e-commerce stores through which it markets its products to its customers in the U.S. It has more than 3,000 corporate-owned stores throughout the U.S., Canada, Western Europe, and Japan as well as 121 franchise stores in the Middle East, Southeast Asia, Eastern Europe, and other parts of the world.

Investment Recommendation -- Buy -- 2011-2012 price target: \$24

GPS ranked # 17 out of 800 names according to our 155-variable computer model in our Russell-1000 report from 08/03/2010. The name passed our subjective and fundamental overlays. We initiated coverage on this name on 08/19 pre-market before GPS reported that day (after-the-close). ANF was raised from Hold to Accumulate on the same day and is also covered in this report.¹ Since 08/19, GPS is - 258 bps versus the S&P, while ANF is + 276 bps. News broke recently that the ANF CEO is selling out his position of > 1,500,000 shares. Jefferies, 65, had already announced that he will be resigning and may be following other executives who are trying to avoid an expected increase in capital gains taxes. **In this report we will focus more on the retail apparel industry and GPS -- less on ANF. Note: there was not a single red mark on the GPS profile.** See page 3. GPS did rank in the bottom 25% on two measures: revenue growth and relative strength -- a contrarian indicator when it gets this low. As do most companies, GPS has its issues/concerns. **That being said -- at 9X estimates for next year, it seems the market has priced these in (and may have over-reacted). Our target is 13.3X \$1.80 in EPS potential looking out two years.**

Investment Summary

- Robust Brand Portfolio Covering Wide Spectrum of Consumers** -- GPS flagship brands include its namesake brand, The Gap, Old Navy and Banana Republic. Between these brands, Gap offers products for all age groups at reasonable price points. This branding strategy earned The Gap a unique positioning and competitive advantage in the 1990s. Despite the gradual dilution of these competitive advantages, GPS still enjoys very strong brand recognition which can be well capitalized in newer markets of Asia and Australia, provided costs and pricing are managed properly in those markets.
- Improved Merchandising** -- GPS improved merchandising is likely to give a boost to the top-line in the near- to medium-term. However, the low entry barrier and competition will most likely erode that edge in the long run.
- Robust Margins; Strong Liquidity** -- The liquidity position of the company is very strong. As of July 31, 2010, cash & cash equivalents including short term investments at GPS amounted to \$1.7 billion. The company can conveniently cover the year-to-date capital expenditures of \$250 mln. On July 31, 2010, GPS was debt-free without any long-term debt obligations, further strengthening the liquidity position of the company. Management has repurchased ~ 38,000,000 shares for ~ \$800 mln during the second quarter of 2010, and has further authorized repurchase worth \$750 mln, thus relieving the company of its obligation to return excess cash to the shareholders. The size of these repurchases is quite significant relative to the GPS market capitalization. However, we expect the operational cash-flow to gradually trend down in the near- to medium-term, from \$1.9 billion in FY09 to ~ \$1.6 billion in FY-12. Despite its struggle with managing top-line growth, GPS has managed its margins reasonably well, thanks to its tight expense controls. We expect GPS to maintain its gross margin at the current 40% level in the near- to medium-term. The EBITDA margin however may see a gradual decline from 17.4% in FY09 to ~15% in FY-12.
- Organic Expansion in the U.S. is Difficult** -- Given its already large company-owned and franchise-operated store network in the U.S., the space for organic expansion here is limited. GPS is not a vertically integrated global operation, and unlike Inditex (for example), faces intense price pressures in price sensitive Asian markets. GPS not being vertically integrated also results in it being slow in *time-to-market* causing it to miss fashion trends. This hurts GPS in *fashion-fast* Asian markets.

Peer Benchmarking ó additional comparisons below

Ticker / Mkt Cap	LT debt-to-cap	EPS 3-Yr.	P/S	EV/EBIDTA
GPS / 11.0B	0%	18%	0.76	3.4
TJX / 16.6B	21%	23%	0.78	5.9
JCG / 1.9B	10%	15%	1.26	5.8
AEO / 2.8B	0%	-41%	0.91	5.7

¹ Our recommendations usually go out before the reports do -- it is because these reports take a long time to prepare once the idea is generated -- if we wait until the report is complete before putting out the recommendation, we risk having the share price rise as the report is being prepared -- rendering the report less useful. A second concern is that another research firm will go out with a call on that same name while we are preparing the respective report. The third issue is that oftentimes we have reports backed up in the queue, and weeks may go by between the time an idea is generated and the earliest possible report delivery date.

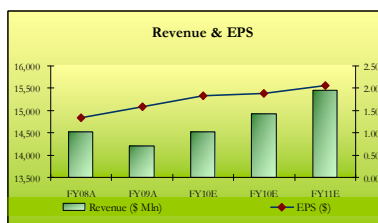
Financial Analysis

Management Guidance – GPS did not provide revenue guidance for 2010. It reiterated its EPS guidance for FY10 and forecasted its earnings per share to be in the range of \$1.77-\$1.82. The company expects Capex at ~ \$575 million for FY10. Additionally, GPS expects its tax rate to be ~ 39% in FY10. It expects to open ~ 65 stores and to close down ~ 110 stores in FY10. GPS continues to expect net square footage to decrease by approximately 3% in FY10.

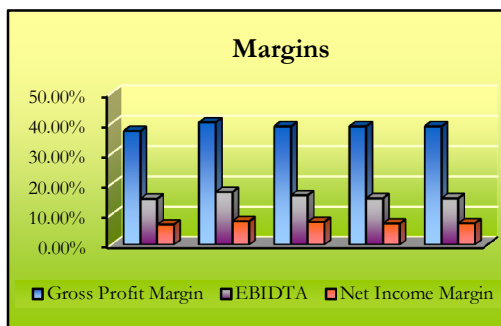
Reuters Consensus Estimates – The mean consensus estimate for revenue is \$14.49 billion and for EPS it is \$1.80 for FY10. For FY11, the revenue estimate is \$14.83 billion and EPS is \$1.89. The shares are now trading at < 9X estimates for 2011.

Note: The estimates in this section will not always match estimates on the right side, as those are from an independent forecasting service.

Revenue -- During 2Q, 2010, revenue was \$3.32 billion compared to \$3.25 billion in 2Q, 2009 representing a 6.5% increase y/y. The company's online sales for 2Q, 2010 increased 15% y/y. FY09 revenue declined by 2% to \$14.2 billion compared to \$14.5 billion in FY08. In 2Q, 2010, revenue from its Gap segment increased 5% to \$1.3 billion. Old Navy segment revenue increased 6% to \$1.4 billion, and Banana Republic segment revenue increased 7% to \$570 mln billion. Other segment revenues increased 29% to \$100 mln. The Old Navy segment is expected to deliver a 4% comparable sales increase in 2010 owing to its product-strength, evolution of the SuperModelquin marketing campaign, and 200 store remodels. Though there was a decline in revenue by 2% y/y in FY09, we expect an increase in revenue going forward owing to the changes made in the marketing and product distribution strategies.



Mixed Margins -- GPS gross margins have increased in recent years from 36.1% in FY07, to 37.5% in FY08 and 40.3% in FY09. The EBITDA margin jumped to 17.4% in FY09, up 500bps versus FY07. The company's net margin was 5.3% in FY07, 6.6% in FY08 and 7.7% in FY09. The gross margin, net margin and EBITDA margin are expected to remain almost flat in short to medium term.



Balance Sheet & Liquidity – Gap has stable balance sheet with a strong cash flow through which it supports its ongoing share repurchase programs. GAP's share repurchase authorization totaled \$7.25 billion since October 2004. It is a debt-free company strengthening the liquidity position of the company.

Share Repurchase Program – In Nov-2009, the Board of Directors authorized \$500 mln for share repurchases, which was fully utilized by Mar-2010. Earlier in Feb-2008, the Board authorized \$1 bln for share repurchases, which was fully utilized by the end of FY09. In Feb-2010, it announced \$1 billion for additional share repurchases. ~ 38 mln shares were repurchased for \$799 mln during 2Q, 2010, and a further \$750 mln share authorization was made. The entire \$750 mln is expected to be spent in FY10.

Dividend – GPS has declared dividends annually since 1987. GPS recently lifted its quarterly dividend from \$0.085 to \$0.10 and its new yield is 2.4% on

Financial Summary

	2009A	2010E	2011E	2012E
Summary Income Statement				
Revenue	14,197	14,519	14,925	15,457
Gross Profit	5,724	5,662	5,821	6,028
EBIDTA	2,470	2,367	2,284	2,365
Interest Expense	6	-	-	-
Pre Tax Income	1,816	1,792	1,714	1,794
Net Income	1,102	1,093	1,046	1,094
EPS	1.58	1.82	1.88	2.06
Summary Balance Sheet				
Cash and Equivalents	2,591	1,680	1,357	1,442
Total Debt	-	-	-	-
Net Debt	(2,591)	(1,680)	(1,357)	(1,442)
Shareholders' Equity	4,891	3,781	3,672	4,022
Total Asset	7,985	7,206	6,946	7,142
Summary Cash Flow				
Cash from Operations	1,928	1,849	1,621	1,663
Capex	334	575	610	640
Capex, Net	333	569	598	627
Free Cash Flow	1,595	1,280	1,023	1,036
Cash Dividend	234	243	240	239
Key Ratios				
Revenue Growth Y/Y	-2.3%	2.3%	2.8%	3.6%
EPS Growth Y/Y	17.2%	15.7%	3.1%	9.8%
Gross Margin	40.3%	39.0%	39.0%	39.0%
EBIDTA Margin	17.4%	16.3%	15.3%	15.3%
<i>\$ million except EPS</i>				

Significant Developments

(08/24/2010) **GPS launches online shopping platform in Canada** - The Company launched an online shopping platform for its three main brands, The Gap, Old Navy and Banana Republic in Canada.

(08/19/2010) **GPS reported second quarter earnings** – GPS reported 2Q, 2010. EPS was \$0.36 up from \$0.33 in the year-ago period. GPS reported net income of \$234 million in 2Q, 2010 compared to \$228 million in 2Q, 2009.

(06/21/2010) **GPS appoints global business leader Katherine Tsang to the Board of Directors** -- GPS announced the appointment of Katherine Tsang to the Board, effective August 16, 2010. The company's board of directors expanded to 11 members with the new appointment. Ms. Tsang is a leading executive at Standard Chartered PLC, an international bank with more than \$430 billion in assets.

(06/03/2010) **Gap & CFDA-Vogue Fashion Fund introduce limited edition collection designed by 2009 CVFF winners in New York City** -- GPS introduced a limited edition collection of designs shaped solely for GPS by last year's CFDA-Vogue Fashion Fund winners 6 Monique Pean, Patrik Ervell and Sophie Theallet.

(04/22/2010) **Gap Inc. announces successful results from recycled denim drive** -- Gap Inc. proclaimed that more than 270,000 pairs of jeans were donated in the company's "Recycle Your Blues" drive last month. The donated denims will be transformed into UltraTouch Natural Cotton.

(03/18/2010) **Gap Inc. declared Amy Curtis-McIntyre as Senior Vice President, Marketing, Old Navy** -- GPS named Amy Curtis-McIntyre as Old Navy's Senior VP of marketing in order to direct its entire marketing and brand management areas. Prior to joining Old Navy, Amy held a similar position at Hyatt Hotels and was a founding executive at JetBlue.

We recently ran 800 names from the Russell-1000 through our 155-variable computer model. Refer to the *Legend* sheet in our Excel reports for the color code and description of all 155 variables used in our model. The 155-variable scoring is summarized in the 32 categories below (from roe through peg). The number in each of the cells, is the rank out of 800 stocks in the recent run. The seven cells to the right of the peg cell are coded and for internal use. For example -- a weak score for return on equity (roe) can be offset by a strong score on price-to-book (pbk). A weak score on technical indicators (especially at the extremes), is looked at positively if it is combined with strong scores on fundamentals and valuation. Below is the color-coded profile generated by the computer for The Gap, Inc. (GPS). **Note: there was not a single red mark on the GPS profile.** GPS did rank in the bottom 25% on two measures of revenue growth and relative strength (a contrarian indicator when it gets this low).

rank	ticker	roe	roa	roc	ebitda	npm	acct	eps m	rev gr	eps gr	beta	debt	stab gr
17 / 800	GPS	180	40	82	496	428	56	153	703	252	334	1	469

div I	pbk	base	rel-ma	inside	safe	pcf I	pcf II	fcf	div II	rel str	pr mo	ps	rel ps	off hi-lo
150	458	1	47	43	37	495	45	496	278	617	362	212	405	74

pred	pertix	perhis	blend	peg	deducts	t val	t fund	t prop	t misc	t tech	total score
567	276	99	106	135	16488	5038	6557	2433	1434	1026	72.15%

Higher Costs estimated -- GPS is expected to incur higher costs in FY10 due to its international expansion. The launch of e-commerce in Canada and Europe is expected to drive the costs higher. FY10 should see a further rise in depreciation as a total of 80 remodels are planned for Old Navy. In addition, marketing costs are also anticipated to rise due to the grand re-openings scheduled for FY10.

Slowdown in sales -- Comparable sales were flat in the month of Jun-10, resulting from - 3% at The Gap, flat at Old Navy and - 6% at Banana Republic. Towards the end of the month of July, comparable sales at Old Navy declined despite its marketing efforts and promotional activities. **This has been a tough industry of late with BWS, ARO, ZUMZ, DBRN, ANN, PSS, BKE, FL, GYMB, DSW and TLB all down 10%-25% month-to-date.** Our August 19 recommendations ANF and GPS have shown relative strength at of 4.6% and of 6.6%.

Higher inventory levels -- Gap Inc's inventory levels rose in Q1, mainly due to the slower demand for fall basics and the Old Navy merchandise. This is expected to pressure profit margins as inventory clearance sales go through.

Cannibalization risk -- GPS does to a certain extent suffer from cannibalization among its own brands - Old Navy and The Gap. Maintaining The Gap's uniqueness becomes an issue as there is little difference between The Gap and Old Navy. Customers are more or less indifferent to these two brands with cheaper one preferred in this environment.

Installation of the Kiva Robot System -- Gap Inc. has set up a new Kiva system that provides flexible storage and accommodates work flow changes at its Columbus, Ohio fulfillment center. The intention behind this move was to shift the processing of all Piperlime brand orders to Kiva, which would enable efficient handling of excess orders. The deployment of this system enabled the operations scale of Piperlime and the efficiency of its employees to improve. Operating margins at GPS increased to 12.0% -- the highest Q2 operating margin in a decade compared to 11.6% in the year-ago period. As operators spent little or no time walking and waiting, their productivity is 2X-4X higher compared to other automated systems.

Expansion of e-commerce reach -- Gap Inc. extended its e-commerce reach significantly year-to-date, thus making merchandise available to clients outside North America for the first time. As a result, online sales of the company for the 2Q, 2010 increased 15% to \$258 million compared to \$224 million in 2Q, 2009. The company also plans to start dedicated e-commerce sites in Canada and the United Kingdom. By the end of 2010, GPS plans to have stores in China, Italy and Australia. This expansion, along with its emergent online and franchise operations, will get GPS access to customers in more than 70 countries.

International expansion plans -- As a part of its international expansion strategy, Gap Inc. signed a franchise agreement with Brand Republic Ltd., a subsidiary of Busby Holdings (Australia), Ltd. in order to bring its Gap brand to Australia. The first Gap store is expected to open in the trendy Chadstone Mall in Melbourne, Australia in the fall of 2010. More than 130 franchise stores are currently operating in 20 countries, spanning Asia, Europe, Latin America and the Middle East. Continuing with its expansion plans, Gap Inc. revealed its intention to explore China, the third largest retail market in the world. The company expects to open Gap stores in Beijing and Shanghai by the end of 2010 while bringing an online shopping experience to all its Chinese customers at the same time.

Competition -- The apparel retail industry is extremely competitive and has reasonably low obstacles to entry, thus, making it difficult for Gap Inc. to prevent its challengers from imitating its merchandise. With over 1000 stores of Gap and Old Navy in North America, very little room is left for the company to expand domestically. Target and Kohl's, the mass merchants have become huge contenders to Old Navy thus taking away a sizable portion of the profitable market from GPS. To add to the distress, the brand identity of The Gap was blemished when it attempted to move away from its signature basics into younger and trendier fashion clothing.

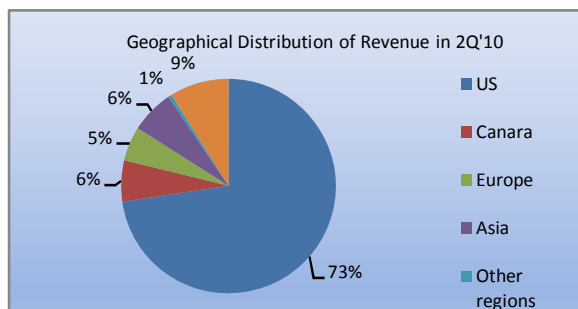
Again, in the absence of any customer switching costs and entry barriers, specialty retailers such as J. Crew and teen retail chains like Abercrombie emerged as new competitors to GPS. They could very easily copy GPS designs and marketing strategies in the absence of any superior technology or structural advantages tied to GPS merchandise. Several fast fashion chains including Inditex's² Zara, H&M, and Forever 21 are becoming popular by offering the latest trends at prices lower than that of Gap and further threatening to steal a portion of its already dwindling markets. Although Gap Inc. has successfully entered into the Asian and European markets, it will face tough competition and must strive hard to retain its identity amid existing casual apparel brands including Giordano and Uniqlo.

At 9X estimates for next year, it seems the market has priced in this issue (and may have over-reacted).

² **Inditex**, is a large Spanish corporation and one of the world's largest fashion groups. It is made up of almost a hundred companies dealing with activities related to textile design, production and distribution. Amancio Ortega Gaona, Spain's richest man, is the founder and current chairman of Inditex. Inditex runs over 4,350 stores worldwide and owns brands like Zara, Massimo Dutti, Bershka, Oysho, Stradivarius, Zara Home, and Uterqüe.

Currency and Political Risks -- With approximately 80% of merchandise sourced from overseas, the company is exposed to social, political and economic risks in all the countries from which it sources its products. Import restrictions, including the alterations in tariffs and quotas could influence the importation of apparel and add to its cost or diminish supplies. Merchandise flow could be unfavorably impacted by political instability and by limitations in the transfer of funds.

Business Segments of Gap Inc -- GPS has two reportable segments, Stores and Direct, each of them selling an assortment of similar products -- clothing, accessories and personal care products. The Stores segment comprises the results of retail stores of each of its brands ó The Gap, Old Navy, Banana Republic, Piperlime and Athleta. The Direct operating segment includes the results of the online business for each of its web-based brands: gap.com, oldnavy.com, bananarepublic.com, piperlime.com, and athleta.com.om September 2008.



Geographical Distribution of Revenue -- There are six geographical segments of GPS. They are the U.S., Canada, Europe, Asia, Other Regions and Others. The "Others" segment includes the wholesale business, franchise business, Piperlime and Athleta. In 2Q, 2010 the company derived approximately 73% and 7% of its revenues from the U.S. and Asia, respectively compared to 75% and 6% in the year-ago period. Though a marginal shift in the geographical revenues was visible, the U.S. remains its primary focus. Hence, turmoil in the United States would have an adverse impact on the company's revenues. In the Asian market, the primary focus of GPS is China, as it is the third largest retail market globally.

Low Entry Barrier; Difficult Competitive Scenario -- GAP's trendsetting foray into establishing trendy but reasonably priced essential clothing brands once gave the company a competitive edge. However, low entry barriers and competitive pressures resulted in GPS declining revenues in five consecutive years from 2005-2009. Faster time to market of vertically integrated competitors on one hand, and price pressures from mass store chains including Target and Kohl's on the other, created a difficult competitive landscape for GPS. Unfortunately, customer loyalty is weak in this industry. GPS strategy can be imitated, and it was. GPS lost market share to other fashion brands including Abercrombie and Fitch and J. Crew. In 2003, GPS's former CEO, Mickey Drexler actually joined J. Crew as its Chairman and CEO, and that was a turning point. Mr. Drexler could successfully imitate and innovate at J. Crew at the chagrin of GPS. Despite early success in an intensely fashion competitive Asia, we believe GPS will face roadblocks, particularly, in the form of price pressure from vertically integrated global retailers.

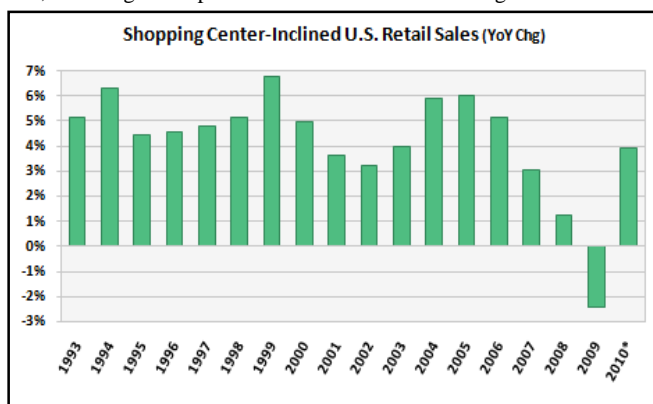
Store openings and closings -- Gap, Inc. had a number of store openings and closings during 2Q, 2010. In total, seven Gap stores and three Old Navy stores were opened; the closed store count was sixteen and three, respectively. At the end of 2Q, 2010, the number of store locations stood at 3,076 spreading across an area of 38.5 million square feet -- leaving the average square feet per store at 12,520.

Industry Outlook

The U.S. is the unquestionable leader of the retail industry in terms of revenues. According to a report published by Deloitte in 2009, nine of the top 20, and nineteen out of the top 50 retail companies in the world were based in the U.S. According to Fortune Magazine's "Global 2006" list published in 2009, 54 of the largest companies across the world that were exclusively in retail or with significant retail operations were U.S.-based companies. Moreover, it is estimated that two-thirds of the U.S. GDP comes from retail consumption.

The U.S retail industry has been through challenging times during the past two years due to the financial crisis. As per the U.S. Census Bureau annual report, the total amount of sales for the U.S. retail industry was \$14.3 trillion in 2009. It was the second consecutive (annual) dip in retail sales, which are both the cause and effect of the U.S. economic recession. U.S. retailers (and other industries) have stayed afloat for the time being via cost-cutting measures and layoffs. Thus, when demand improved marginally, profits rebounded. In 2009, holiday-season sales rose by 1.1% beating the forecasted -1.0% by the National Retail Federation, compared to a dismal 2008 when sales declined by 3.4%. Major multi-store organizations witnessed a decrease in their sales in the first half of 2009, but marginal improvements were observed during the latter half of the year, which extended into early 2010. However, consumers are expected to spend frugally, with the focus on value (for the money).

In early 2010, the NRF forecasted U.S. retail sales to rise 2.5% in 2010 based on the fact that the recovering housing industry and reviving job market would bolster consumer confidence. This appears to be an optimistic forecast in our opinion. The forecast looked reasonable early on as U.S. consumer confidence ticked up in Q4 and Q1, rising to its highest level since September, 2008. Even if the 2.5% figure is reached, it would (excluding 2008-2009) be the lowest since 1995. As many economists and analysts have stated in recent months, the return to pre-recession levels will be slow. The International Council of Shopping Centers (ICSC) expects a gain in shopping-center-related sales of 1.2% in 2010 following a decline of 2.4% in 2009.



In 2009, specialty apparel companies recorded higher operating margins thanks to streamlining of costs, cheaper product sourcing and lower transportation expenses. Since, retailers focus has shifted to revenue growth and market share gains from cost-cutting and inventory management, these costs are expected to rise and will probably bring down margins in Q2 and Q3, 2010 which have probably already been factored in to the valuation of these companies, if the double-digit percentage losses in many of these names can serve as a guide/indication.



According to Thomson-Reuters, retail mergers and acquisitions totaled \$10.7 billion in Q1, 2010. It was a 146% increase over the year-ago period. Analysts, across the board, are expecting the trend to continue in the latter half of the year, as cash-rich retail companies seek inorganic growth with the aid of credit markets that may free up.

There was in Q2, 2010 a \$3 billion deal between PVH and Tommy Hilfiger, and more deals are expected to follow. Apparel retailers including Ann Taylor, Talbots and Charming Shoppes are a few names mentioned in the current speculation. Multi-billion dollar deals are unlikely. If we do see any announcements on this front, they will most likely be in the range of

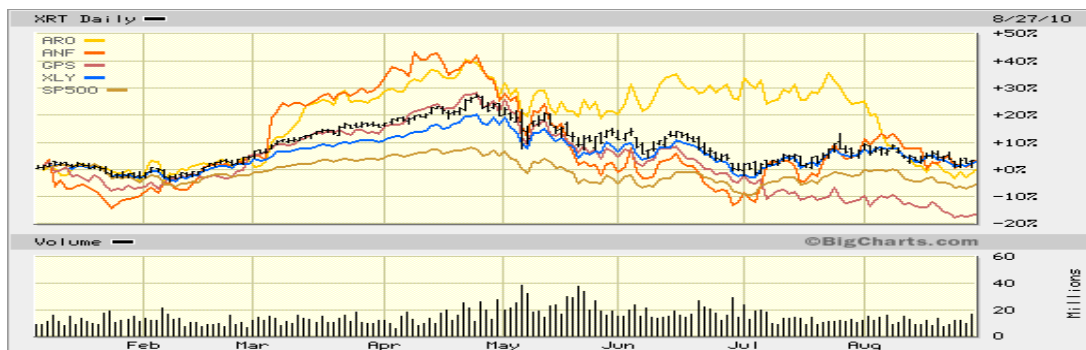
\$500 mln -- \$2 bln are more likely to materialize as companies are still risk-averse and prudent in spending their cash.

We recently put out a report on 300 names from the consumer discretionary sector, running those names through our 155-variable computer model. A glance at that list of names shows only 11 names in retail, footwear, apparel and accessories with market cap > \$7.0 bln RL, VFC, LUX, COH, KSS, M, SHLD, NKE, LTD, GPS and TJX. None of these names have market cap greater than \$17 bln, so that is another reason we will not see any big deals in this space (although a smaller name could be taken out at a significant premium). We will be running these 300 names through our model again first week in September.

The U.S economy is expected to grow at a rate of < 3% in 2010 and the recovery's weakness is evident in the job market. According to the U.S. Bureau of Labor Statistics, the unemployment rate remained unchanged at 9.5% at the end of July, 2010. Goldman Sachs forecasts an unemployment rate peak by mid-2011 and a drop back to 10.5% by the end of the same year. Thus, the U.S. is expected to witness two more years of significantly high unemployment. The persistent impact from financial crisis will mean less investment, less hiring and in-turn less consumption. Thus, it will pull down sales in the retail industry.

There are valid reasons to be apprehensive about the economy's near-term scenario. The combined psyche is so unraveled that if anything else goes wrong, the economy will slip into depression. This is not something expected, but the probability that it might is as high as it has ever been since the Great Depression ended. We are at an inflection point, and it is not clear which way we will break from here. The Dow Jones spiked 164 points and closed at 10,150 on Friday, August 27. This was probably a dead-cat bounce off a short-term oversold condition driven by short-covering. For whoever is holding on to a high-beta portfolio, selling a bit of high-beta at the close may not have been a bad idea as we will probably break 10,000 again on the downside before all is said and done.

The retail apparel industry has taken a hit amid market uncertainty over the past few months. The SPDR Retail ETF XRT, has underperformed the market by ~ 4% since late May. See table above. The largest weighting in the fund, the retail apparel segment, represents ~ 33% of its holdings. Many stocks within this segment have recently fallen toward lows for the year, driven downward by weak earnings, mixed economic data, and a sluggish growth forecast in the near-term. Investors and retailers alike are concerned about consumer spending in the second half of the year, historically the most profitable time for apparel stores which tend to see an increase in sales during the "back-to-school" and holiday seasons. These companies usually have the power to raise prices in order to capitalize on this increase in demand, and regularly put such a strategy into practice during the second half to benefit from greater margins. Executives are cautious moving forward with more aggressive pricing strategies -- doubtful that consumers in this environment will tolerate greater price tags. We advise caution for those who want to add to their investments in this industry, especially those who are already over-weight. If you are under-weight, we would recommend a dollar-cost averaging in strategy. The share prices of these names will rise before fundamentals in the industry do. So, you must invest before seeing light at the end of the tunnel (as difficult as that may be).



Weakness in Economic Figures

Consumer spending in June was unchanged after a marginal rise in May, suggesting that the economy will continue grinding forward at a slower pace in the months ahead. Spending Pulse, a unit of Master Card Worldwide, tracks retail and service sales through Master Card data and estimates of cash and checks, determined that retail sales in July dropped by 0.9% from June (seasonally adjusted), but grew 1.4% from a year earlier. Year-over-year growth appears satisfactory, but is substantially below comparable growth rates in spending from earlier months. Sales growth was seen in major appliances which increased by 1.8% from July of last year.

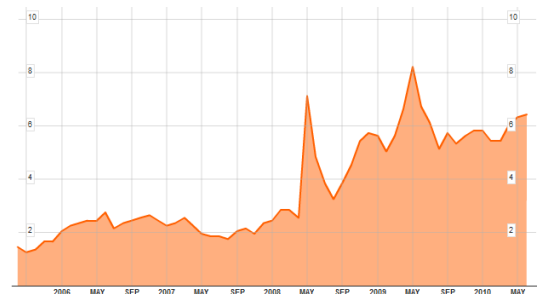
Electronics experienced 0.8% growth in sales which Vice President of Research and Analysis Michael McNamara says was attributable to sales of newer products including the Apple iPad. This was partially offset by heavy discounting on televisions in order to clear room for new models. Apparel sales fell by 1.1% in July from a year earlier ó also the result of heavy discounting. July tends to be the least significant month for apparel retailers, as they regularly use this time to rid stores of old inventory. Spending at apparel stores had risen by 3.3% in June, followed by decreases in both April and May. **Side Note regarding electronics:** We initiated coverage on BBY with a Buy recommendation on August 24, 2010 and will have a long report on BBY for you in September.

The recent dimming outlook for spending and the economy as a whole has left executives at many retailers unsettled. The implications of stagnant ó and particularly deteriorating ó consumer spending are far reaching as the measure accounts for > 65% of total economic activity in the U.S. Executives that were once more optimistic with regard to short-term sales growth have modified projections, with revisions appearing hand-in-hand with the latest economic data releases. Home Depot and Kohl's have reduced sales estimates for the year. Wal-Mart has seen five consecutive quarters of same-store sales declines and is expecting this trend to continue. Abercrombie & Fitch, expecting capital expenditures for 2010 to be between \$205-\$225 mln at the end of 2009, has now cut this figure to \$200 mln as it has decided to close 60 stores this year alone and plans on opening a smaller number of stores than anticipated. Actions like these are not without merit. Not only has spending been depressed, but the personal savings rate in the U.S. has been rising. The figure grew to 6.4% in June, the highest rate in a year and > 3X the average rate of 2.1% that was seen in 2007.

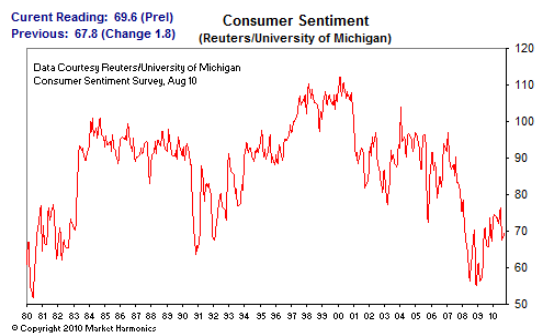
Industry Statistics	
Market Capitalization:	76B
Price / Earnings:	14.8
Price / Book:	3.3
Net Profit Margin (mrq):	5.5%
Price To Free Cash Flow (mrq):	N/A
Return on Equity:	17.6%
Total Debt / Equity:	N/A
Dividend Yield:	2.2%

One study has advised that this number will remain > 6% in 2H10 and fall to < 5.5% by the end of 2011. **Despite a projected savings rate much higher than that seen during the market peak in 2007, this study asserted that stronger growth in consumer spending is closer than many economic indicators seem to suggest. The report claims that the average American has deleveraged at a much faster pace than had been anticipated.** Debt-to-income ratios were estimated at 110.7% at the end of 2Q, closer to levels seen in 2004 and down from 123.6% in 3Q, 2007. Furthermore, the debt-service ratio (the payment of interest and principal on debt with respect to disposable income) has approached what analysts think is a sustainable level (12%) as a result of refinancing and a slight resurgence in income. The ratio is expected to continue falling with mortgage rates near historical lows as refinancing carries on into the next couple of quarters. While a higher personal savings rate would normally signal lower growth in consumer spending, this study contends that the combination of a rise in this rate, a drop in the debt-service rate, and significant cuts in spending over recent quarters has contributed to mounting discretionary income, thus leading to a future rise in consumer spending.

U.S. Personal Savings Rate (Bloomberg)

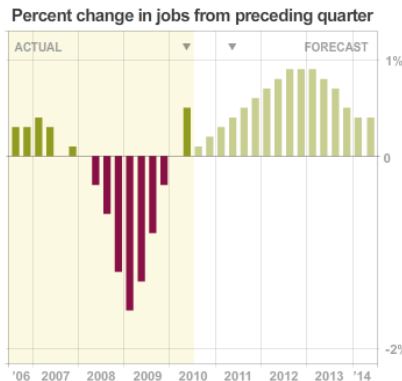


The Thomson Reuters/University of Michigan Survey of Consumers demonstrated that consumer sentiment was inching upward, with its preliminary August reading reaching 69.6 from 67.8 in July ó topping economist estimates of 69.3. **In a study performed by Sydney Ludvigson, Assistant Professor of Economics at New York University, the measure of the University of Michigan Consumer Sentiment Survey explains ~19% of the variation in the next quarter's expenditures on goods (excluding motor vehicles), a statistically and economically significant predictor of growth in consumption.** Job growth, however, has been regarded as the vital factor in propelling this economic recovery forward, and with an unemployment rate at 9.5% this month and jobless claims at a 9-month high, it becomes increasingly difficult to promote higher consumer sentiment. Unfortunately, despite somewhat improved consumer confidence, retail apparel companies will likely see additional strain on profit margins in 2H10 and the beginning of 2011.



Retailers now face the likelihood of a further decrease in profit margins ó this time less a derivative of enticing frugal consumers and more due to an upsurge in costs. They are worried that they will have to absorb increasing supply-chain costs like freight, cotton, and rising wages given already tight consumer spending. Freight costs rose to a two-month high on August 23, driven upward by Russia's ban on wheat exports. This action forced wheat importers in the Middle East and North Africa to obtain the commodity from other countries located at greater distances than Russia, boosting freight demand. According to Peter Norfolk, Research Director at Freight Investor Services, there could be another hike in demand later in the year if U.S. ports attempt to ship bumper crops of corn, soybeans, and wheat at the same time. Analysts forecast that these costs are not sustainable because while demand may be picking up, supply is expected to rise over the short-term.

Experts estimate that cotton prices may rise to 95 cents per pound ◊ a **15-year high** ◊ before new supplies are harvested in October. Despite slowing consumption in the U.S., apparel demand in China has grown 24% and other emerging market countries are following suit as recovery in these nations outpaces that of developed nations. To add to this fear of limited supply is news of floods in Pakistan, the world's fourth-largest cotton producer, having destroyed 30% of the country's crop. World demand for cotton is set to outpace supply for the fifth year in a row, further reducing stockpiles that were already at their lowest levels with regard to demand since 1994 (38%). As a result, prices for cotton-based products are estimated to increase by ~5% starting next year and end up +10% by the end of 2011 according to the American Apparel and Footwear Association and George Feldenkreis, the CEO of Perry Ellis Int'l **PERY**.



Minimum wage increases in China have added to growing costs for apparel retailers, where many maintain production facilities. Wages have increased by 5% - 15% since the beginning of the year as workers have brought up labor disputes and the government has put forth measures to grow manufacturing in the more complex electronics industry and reduce it in low-technology industries such as textiles. Li & Fung Ltd. is a Hong-Kong based liaison between retailers and their many suppliers. Rick Darling, CEO of the company, estimates these wage increases coupled with rising freight costs and cotton prices will force costs for companies with suppliers in China up by 2%-5% per year going forward. Accordingly, apparel

retailers are seeking to relocate manufacturing facilities to countries with low labor costs.

Coach **COH**, for example, has been eyeing India and Vietnam, and Guess Inc. **GES** is considering Cambodia, Indonesia, and Vietnam. This solution is not as simple as it sounds -- the underlying costs associated with any move of manufacturing to another country could erode any savings achieved by doing so. The skill of China's labor force is unparalleled by that of any other Asian nation. In addition, China produces textiles and has major shipping ports, both characteristics lacking in other countries.

The Pricing Problem

Rising costs and a thrifter consumer together form a solid foundation for difficult times in the retail apparel industry. Management teams at these companies are pressing into the holiday season with caution in pricing, all too aware of the delicate balance they must keep between maintaining profit growth and attracting and retaining customers. To maintain profit growth, companies are becoming more creative in passing along costs to customers. The CEO of Children's Place Retail Stores, Jane Elfers, says the company will increase prices only on higher-ticket items. The Buckle Inc.'s strategy lies in raising prices in certain categories ◊ adding embellishments to rationalize these increases. Abercrombie & Fitch claims to have price and cost advantages in place for the second half of the year and plans on moving forward with an aggressive pricing strategy to attract customers. CEO Mike Jeffries, in the company's conference call for 2Q, said that average cost per unit is likely to be slightly lower than last year even with rising labor costs, but that the company will have fewer cost advantages than in the spring season. ANF also has asserted that it has the inventory to support an aggressive promotional environment, putting it at a significant advantage to competitors in the months ahead. The Gap, Inc. has also upheld that it has not been experiencing any cost pressures. As a whole, the company plans to continue promotional activity it has put in place over the past few quarters with more aggressive pricing coming during regular sales seasons or alongside steep competitor price cuts.

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The Bullish Case for Apparel Retailers

Consumer spending, especially on discretionary items, could very well remain depressed over the next few quarters wearing down both top and bottom lines. This bearish outlook is one maintained by most economists who uphold that a battered housing market, tight credit, high unemployment, and many other weak economic data points could not possibly engender anything more than tempered growth. **While growth is expected by most economists to be slight throughout the short-term, a study released by the Milken Institute provides a more optimistic – and even sound – argument.**

The study estimates that the private sector will have added 1.5 mln jobs in 2010, 3.1 mln in 2011, and 2.6 mln in 2012 leading to growth of 3.3%, 3.7%, and 3.8% respectively. The reasons for this optimism emerge from economic data reports that have been overlooked or undervalued in the midst of more downbeat data releases. One point discussed was the resurgence of business spending on information technology and software. This figure jumped by 21.7% in 2Q compared with an increase of 20.4% in 1Q. According to the Commerce Department, this was the highest increase since 1997. Figures on equipment and software spending for July were weaker than in previous months prompting another wave of concern over the future of the economy. While many interpret this as a sign of weaker spending in 2H10, it is unlikely consumption in this segment will fall much further. The fourth quarter tends to be the most profitable quarter for information technology and software firms as businesses seek to spend the remainder of their budgets for the year. Stronger exports to developing countries provided added reinforcement for this contrarian viewpoint. Solid growth in developing countries is expected to contribute to a rise in goods and services shipped out of the United States. U.S. exports to China, the third-largest market for U.S. products as of June, rose 39% between January and May alone. During 1H, 2010, exports to Canada and Mexico (the # 1 and # 2 export markets) were up from 2009 by 26.8% and 31.8% respectively. Real exports of goods and services rose by 10.3% in 2Q compared to an increase of 11.4% in 1Q.

Cotton Spot Price (5 months)



Additionally, according to Federal Reserve Chairman Ben Bernanke, rising demand from households and businesses should help sustain growth. In particular, in the household sector, growth in real consumer spending seems likely to pick up in coming quarters from its recent modest pace, supported by gains in income and improving credit conditions. This growth will be largely contingent on this projected increase in income, and, by extension, an underlying increase in employment. Should consumer spending grow in the quarters ahead as anticipated, certain retailers are likely to benefit more than others.

The Economy and Retailers

There are several metrics that are used to compare the performance of retailers, but the most important of these is sales per square foot with real estate expenses having become a growing fraction of net sales over time. While consumption as a whole suffers during recessions, lower-priced brands tend to outperform higher-priced brands with regard to this metric. This relationship also holds well with the converse economic scenario and higher-priced brands.

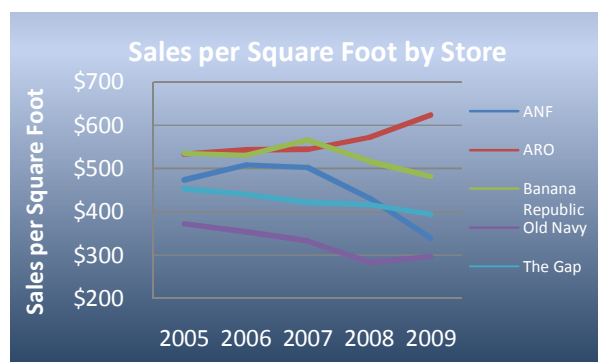
From the end of 2007 through 2009, low-priced apparel stores outperformed higher-priced stores. Aeropostale and The Gap Inc. Old Navy saw greater growth in net sales per square foot than stores like Abercrombie & Fitch and Banana Republic which experienced severe declines. Over the first half of this year, higher-priced brands have begun to grow more quickly in terms of this figure than lower-priced competitors. ANF saw sales per square foot of \$78 in 2Q10 compared to \$70 in 2Q09, an increase of 11%, while ARO grew its sales per square foot by only 6%, from \$118 in 2Q09 to \$125 in 2Q10.

Going forward as the economy grows, however slowly, we expect higher-priced retailers to experience greater growth in sales per square foot than their value-brand counterparts. Year-to-date, Abercrombie & Fitch has grown overall at a much faster pace than direct competitor Aeropostale across other figures as well, including growth in the number of transactions and the average number of units per transaction. This is likely attributable to the ongoing aggressive pricing strategy that ANF has employed this year in order to remain competitive. Because the company plans on continuing deep discounting into 2H10, we expect this outperformance to continue. When the economy recovers, this growth will likely sustain itself, allowing ANF to benefit from increasing profit margins and, moreover, increasing returns to shareholders.

A significant contribution to a rise in sales per square foot will be the cut in square footage that the store is set to implement. The company just reported that it would close 60 underperforming stores this year and up to 50 more next year. The Gap expects to close 110 stores in 2010 alone, opening another 65 in total ó 15 and 10 of those stores being Old Navy and Gap stores respectively and 35 of those stores opening internationally. An approach like this would suggest a more pessimistic economic outlook in the years ahead, and perhaps even a message about the American consumer and his/her spending habits. Banana Republic brought in more revenue per square foot than either Old Navy or Gap (stores), nonetheless, GPS plans to close ten of these stores and open only five more this year.

This action implies anticipation of further erosion of revenue per square foot for the higher-priced stores in the next couple of years. The same can be said for ANF with its similar plan to trim down the number of its pricey apparel stores. Abercrombie & Fitch and The Gap are planning to increase square footage internationally, especially in China and India, which falls in line with expectations that emerging markets will experience recovery at a faster pace than in developed nations such as the U.S.

Both companies have managed to outperform peers so far over the past year. ANF has (even) marginally outperformed the S&P-500 over the past three months while the retail sector as a whole has underperformed by ~4%. Disappointing returns for most peers have given way to takeover speculation in recent weeks.



	ARO		ANF		GPS	
	May 1, 2010	May 2, 2009	May 1, 2010	May 2, 2009	May 1, 2010	May 2, 2009
Increase in Net Sales	14%	21%	14%	(24)%	4%	(8)%
Increase in Comparable Store Sales	8%	11%	1%	(29)%	4%	(8)%
Change in Transactions per store	6%	1%	16%	(27)%	N/A	N/A
Change in average units per transaction	3%	3%	7%	(4)%	N/A	N/A
Change in average units sold	(2)%	6%	(10)%	0%	N/A	N/A
Net Sales per Square Foot	\$125	\$118	\$78	\$70	\$77	\$72

Private-Equity Muses over Retail

Last week there were rumors of private-equity interest in American Eagle which has seen one of the worst returns compared to its peers over the past year. The company has slipped-up in decisions made recently, overstocking on inventory in anticipation of a busy back-to-school season, and offering an unpopular product line this spring. As of August 20, the company was trading at a 26% discount to peers. [AEO is an open recommendation of ours.](#)

Retail has become sought after by private-equity firms because companies in this sector generate cash quickly, and cash can therefore be made use of at a much faster rate than in other industries. Additionally, many of these firms have extended credit terms allowing them to employ the cash that they receive up front (from transactions) towards initiatives that can generate returns. The only problem with a deal in the retail sector ó especially in the case of retail apparel ó is the timing. Recently, consumer spending has been sluggish, unemployment has remained virtually stagnant, and costs for apparel retailers (i.e. cotton, freight, and wages) have been rising. While some companies are trading very close to their respective book values, there is no telling when these companies will begin to see improving results and a more encouraging outlook.

Apparel Stores in 2H10

During the most recent trading week, the retail apparel industry has continued under-performing the S&P-500 as companies in this industry continue to release news and earnings that are less than satisfactory. News of reduced capital expenditures for the year from ANF sent shares downward even after brighter results in 2Q were presented. Apparel company rue21 dropped 11% to a 52-week low on Thursday when revealing that although income increased by 20% in 2Q, same store revenue had dropped by 1.6%. There were other losers as well. *See page 3 in red font.*

Aggressive discounting in this industry as a strategy to combat a cautious consumer will likely continue to keep the retail industry as a whole from outperforming the S&P-500 in the near-term. With this pricing strategy in place at stores such as Abercrombie & Fitch, retailers that were counting on increasing prices to maintain profit margins will perform poorly, unable to generate sales with such tight consumer spending. Faced with rising costs of freight as the result of increased shipping demand, rising costs of cotton alongside increased demand for the commodity and a forecasted lack of supply, and rising wages in China, companies are feeling pressure to raise prices and can see no other option for sustaining margins. Our most recent recommendations, GPS and ANF both attest that their average costs per unit will remain low through the end of 2010 and perhaps throughout 2011, allowing them to discount as needed. Additionally, ANF will have sufficient inventory to be able to continue to provide substantial price cuts to attract customers. In either the bearish or bullish economic case, these two companies are set to outperform peers throughout the remainder of the year ó upholding margins in a time of increasing costs and attracting customers despite lethargic apparel sales. ANF has under-performed the S&P-500 by 1500 bps since we downgraded from Buy to Hold on March 5, 2010. We felt this was the right time to upgrade the name (August 19) following an over-reaction to bad news earlier this month. That being said, the upgrade was to ðAccumulateð because of remaining concerns. The market is on shaky ground at this time and our bias is towards the lower-beta names. ANF beta is quite high at > 1.5X, while GPS will more or less track the market with its beta of 1.0X. If the market comes down further and ANF hit October 2008 levels \$28-\$32, we would upgrade the name and get more aggressive. News broke recently that the ANF CEO is selling out his position of > 1,500,000 shares. Jefferies, 65, had already announced that he will be resigning and may be following other executives who are trying to avoid an expected increase in capital gains taxes.

End of Report

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