

Urban Outfitters, Inc. – A ‘Deep Dive’ Into the Fashion Shift

SPECIALTY APPAREL

Since September 2010, URBN has been pointing to a ‘fashion shift’ as the primary driver of decelerating comp and margin trends across both the Urban Outfitters (46% of 2010 sales, 176 stores) and Anthropologie (45% of 2010 sales, 153 stores) brands. However, in part owing to competitive reasons, management has not been specific as to the changes it is seeing, which has resulted in investor uncertainty and multiple contraction. As such, we thought it was timely to take a closer look at both the current fashion shift and previous product missteps, in order to better grasp the potential depth and duration of the earnings pressure

While near-term trends remain weak, we continue to see long-term opportunity and maintain our 12-month price target of \$36-\$38.

Based on our channel checks and historical analysis, we believe that trends have remained weak through the balance of 1Q11 and see it as likely that product issues will linger into 2H11. While we view the consensus EPS estimates as optimistic (TAG est. 2011 EPS of \$1.55 vs. cons. \$1.71, and 1Q11 EPS of \$0.24 vs. cons. of \$0.27), we believe much of this downside risk is currently baked into buy-side expectations. Although near-term trends should remain challenging and there is the potential for the stock to trade lower, we continue to see the longer-term risk reward as favorable. With the stock trading at only 15.5x the consensus 2012 EPS estimate of \$2.05 (vs. the historical average of ~19.3x), we are seeing a greater willingness from investors to look past the near-term choppiness and use the current dip as a buying opportunity to own a retailer with significant square footage growth potential. We are maintaining our 12-month price target of \$36-\$38, which assumes the stock trades at 19.5x our 2012 EPS estimate of \$1.88, which is essentially in-line with its 5-year average.

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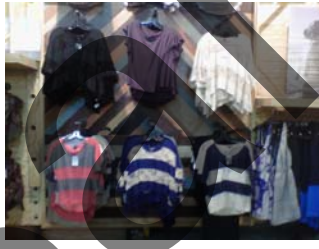
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- > **What exactly is the much-discussed ‘fashion shift?’** We view URBN as currently being ‘stuck in the middle’, having become too mainstream for the true ‘early adopter’ and too edgy for the less-fashion forward consumer. This phenomenon may take some time to correct itself, as it hinges on the more mainstream consumer beginning to embrace the new styles. Although the fashion shift is a near-term drag, we do eventually expect the changing trends to serve as a catalyst, given the consumers’ need to restock her closet with the newer looks. Below are the highlights of the emerging trends we are seeing in Urban Outfitters and Anthropologie stores:
- **Greater diversity in the bottoms category:** While the skinny silhouette remains an important wardrobe staple, the more fashion-forward Urban Outfitters consumer is gravitating towards a greater diversity in bottoms, having grown tired of the ‘skinny jean’ that first made its appearance with the most recent fashion shift roughly five years ago. This includes everything from flare-leg/bell bottom jeans, to harem pants and high-waisted trousers.
 - **Cropped tops and tailored blouses are more easily paired with the new bottoms styles:** Whereas shoppers have grown accustomed to pairing their skinny jeans with wide, billowy tops, both flare-leg and high-waisted bottoms need to be balanced by more tailored tops or shirts that can be easily tucked-in. We are also seeing a growing penetration of cropped tops or shirts with asymmetrical hemlines, which are being paired with high-waisted shorts, skirts, and pants.
 - **Maxi dresses are hitting the floors, but may be harder for some to wear:** After several seasons of the short, body-hugging dresses, we are seeing a growing penetration of floor-length maxi dresses for summer. In addition, long skirts seem to be playing a larger role in the assortment. However, these styles may be less flattering on some body types, and may initially be rejected by less fashion-forward consumers.
 - **The trend towards minimalism does not play into URBN’s core competency:** Over the past few years, the trends have played into URBN’s core competency of embellishment and detailing. However, the current trends speak to minimalism (e.g. modest prints, color blocking and solid colors, simple silhouettes), which may be harder for URBN to interpret.

URBAN OUTFITTERS EMERGING FASHION TRENDS



Bell Bottom Jeans



*Tops With Asymmetrical Hems
and Minimalist Patterns*



Long skirts, maxi dresses and jeans



*Tailored Tops With High-Waisted
Shorts*

Source: TAG Research. Pictures taken from malls in NY/NJ, April 2011.

ANTHROPOLOGIE EMERGING FASHION TRENDS



Bell-bottom jeans and Bolero top



Bohemian Maxi Dresses



Flare-leg jeans, wide belts, layered tops in varied lengths



High-waisted skirt with blouse

Source: TAG Research. Pictures taken from malls in NY/NJ, April 2011.

- > **Our channel checks point to the continuation of a challenging environment in April, particularly at the core Urban Outfitters division.** After reporting in the 10-K that comparable retail segment sales (including Direct) through March 27th were tracking down in the low-single digits, we believe that trends have remained soft in April. Although URBN likely received a modest benefit from the Easter shift, we have continued to see elevated promotional levels, particularly at the core Urban Outfitters division. Whereas the sale section has historically represented only a small portion of the store, we have seen this section grow to 20%-30% of the total floor space in some cases, with discounts averaging 50%-60% off. The section has been dominated by heavy flannel shirts (which we used to see paired with skinny jeans) and oversized sweaters, as well as t-shirts. In addition, given the underperformance of apparel, we have begun to see a larger amount of floor space allocated to the home/accessories/footwear segments, which have been outperforming.

URBAN OUTFITTERS CLEARANCE SECTION



Source: TAG Research. Pictures taken from malls in PA, April 2011.

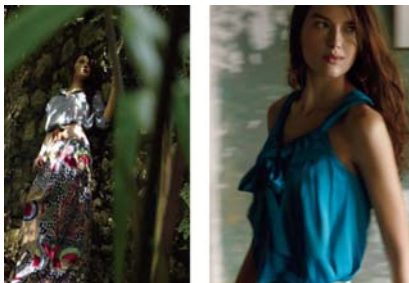
URBAN OUTFITTERS EXPANDED FOOTWEAR AND ACCESSORIES SECTION



Source: TAG Research. Photo above is at King of Prussia Mall, April 2011.

- > **The Direct business is also slowing during 1Q11, partially owing to a poorly resonating Anthropologie catalog.** Throughout the entire fashion shift, the Direct business has remained solid. In 2010, the Direct business generated \$434MM, or 19%, of total company sales. Despite the decelerating trends at retail, Direct sales still rose 29% in 4Q10 vs. a 28% increase in 4Q09. The divergent trends between the retail and Direct channels has been attributed to management's ability to quickly adjust the 'storefront' online to highlight those items which are trending best. However, the lack of commercial print on the March Anthropologie catalog led to a deceleration in Direct sales during 1Q11. While we believe the misstep was corrected with the April 2011 catalog, we expect some resultant 1Q11 margin pressure, given that the Direct business is a higher-margin segment.

ANTHROPOLOGIE MARCH 2011 CATALOG



The March 2011 Anthropologie catalog was artistic and brand-right, but lacked copy, which diminished the commercial impact and led to a slowdown in Direct sales.

Source: Company website.

ANTHROPOLOGIE APRIL 2011 CATALOG



The April 2011 catalog reintroduced copy alongside the photos. The bright, vibrant colors are seasonally appropriate, while the featured looks appear more 'mainstream' than those from March.

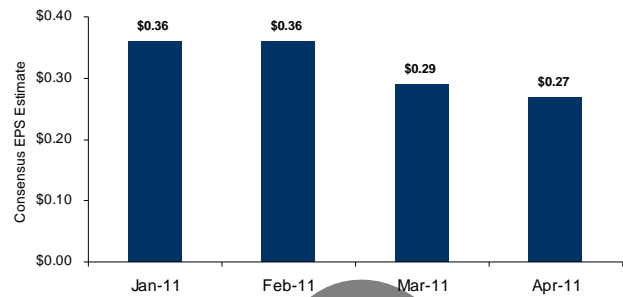
Source: Company website.

- > **Although we have begun to see downward earnings revisions, we believe consensus EPS estimates are too high and will continue to move downward.** Our below-consensus 1Q11 EPS estimate of \$0.24 vs. \$0.31 LY (vs. the consensus of \$0.27) assumes a 1.5% decline in comparable retail segment sales, compared to the consensus estimate of a 1.4% increase. With comparable retail segment sales up ~3% in February, they were likely down in the mid-to-high single digits in March. As such, the consensus estimate of 1.4% implies a substantial pick-up from March to April, which we think is overly optimistic, despite the Easter shift. On the margin side, we estimate that the gross margin will decline 400 bps in 1Q11, compared to the consensus estimate of only 300 bps of pressure. We sense that URBN has been aggressive in discounting to move through underperforming styles, which should lead the gross margin compression to be more severe than the 200 bps in 4Q10. We note that 1Q11 is the most challenging gross margin compare of the year, as it lapses 460 bps of expansion last year and a historical peak 1Q gross margin.

ANNUAL CONSENSUS EPS ESTIMATE



1Q11 CONSENSUS EPS ESTIMATE

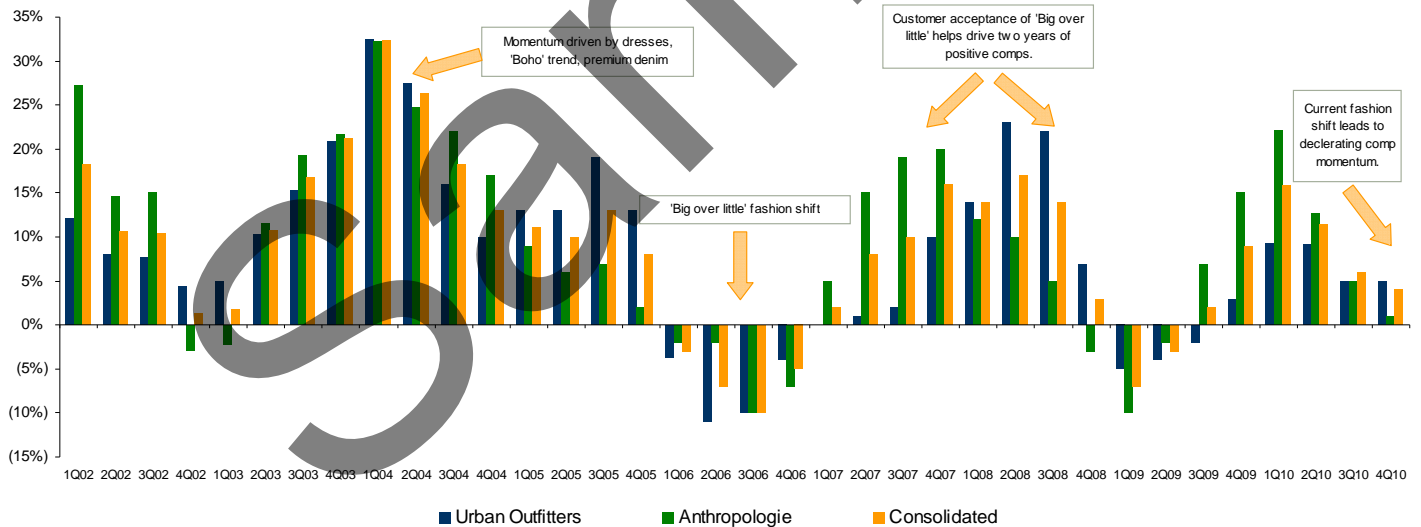


Source: TAG Research, Factset.

Source: TAG Research, Factset.

- > **What will be the depth and the duration of the fashion shift?** Over the course of its history, same-store sales trends at Urban Outfitters and Anthropologie have tended to move in tandem, as a fashion shift affecting one of the brands tends to impact all three. Because Free People (9% of 2010 sales, with 42 stores) has an edgier consumer than the other two brands, its trends have remained robust; the change in fashion trends has served as a catalyst rather than a headwind. However, at Urban Outfitters and Anthropologie, the customer has been slower to accept these changes. The chart below depicts the quarterly same-store sales history for Urban Outfitters and Anthropologie, showing that changing fashion trends tend to serve as a drag on both brands at once, but eventually tends to become a catalyst.

HISTORICAL SAME-STORE SALES TRENDS



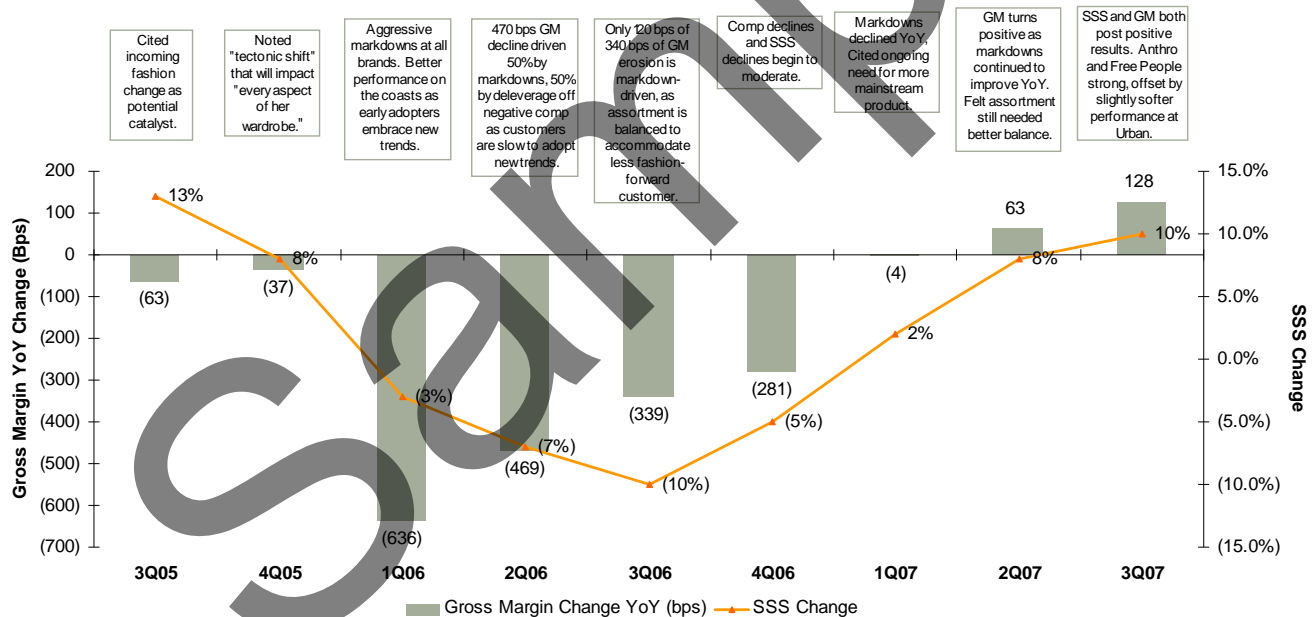
Source: TAG Metrics, TAG Research and company reports. Note: SSS include Direct-to-Consumer sales beginning in 2007.

- > **A look back at the 2005-2007 fashion shift shows that the current deceleration could be more prolonged than expected.** When looking back at the 2005-2007 'fashion shift', we can gain insight into how the current change in consumer preference may mirror the last one. During the previous fashion shift, customers were slow to accept the onset of 'big over little', or the pairing of skinny pants and large tops. The change in trend was first accepted in Europe (where customers tend to be more fashion-forward), followed by the U.S. coastal cities. However, the rest of the country was more hesitant to accept the new trends, and the penetration of new fashion relative to more

mainstream product had to be continually adjusted to accommodate this consumer. While the assortment was constantly tweaked to meet the customers' changing needs, to some extent, URBN was at the mercy of the consumer, who needed to fully embrace the new trends before comps and margins could reaccelerate. As such, in the mean time, the company experienced 7 consecutive quarters of gross margin compression (although 1Q07 was essentially flat, down a slight 4 bps) and 4 consecutive quarters of negative same-store sales.

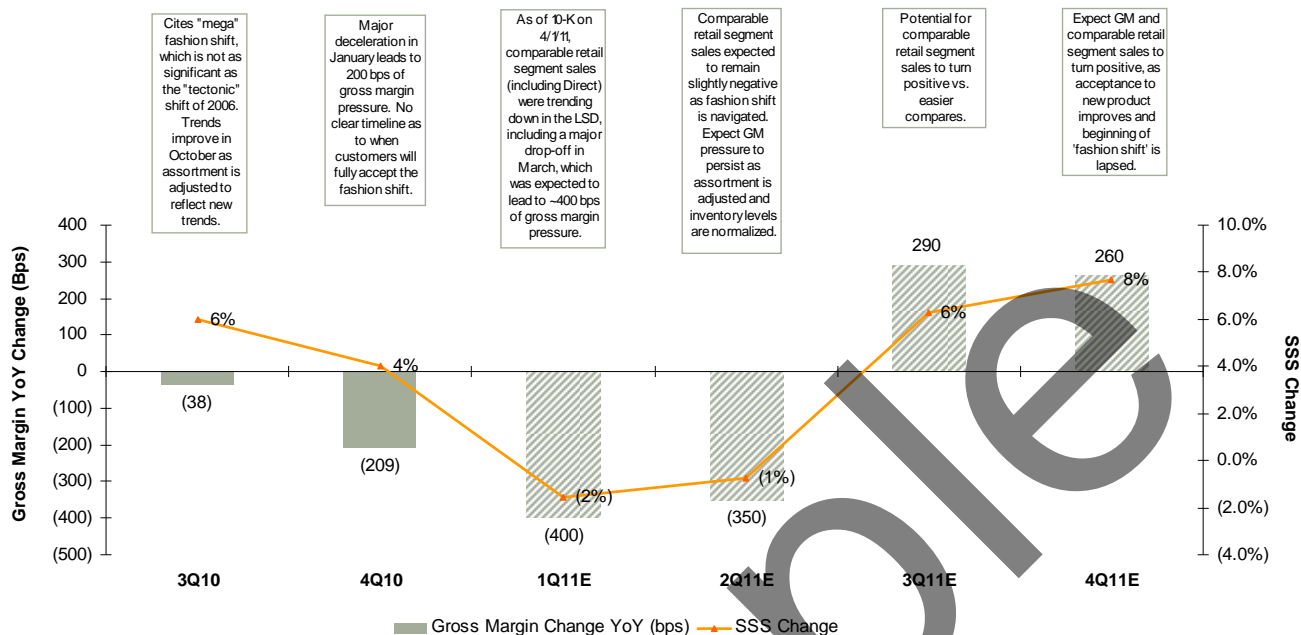
- **The current fashion shift seems to be closely paralleling the last one.** While at first appearing to be a minor product transition, the customer has been slower than originally anticipated to accept the incoming trends, which has led to substantial margin pressure. Although URBN has reduced its lead times (now maintaining 50% open-to-buy, compared to very little open-to-buy five years ago), this can only partially mitigate the impact of the shift, given that it is an issue of the timing of customer acceptance, more so than product. While the previous fashion shift lasted more than two years, we do expect the current transition to be somewhat shorter in duration. However, we do not expect an immediate recovery, and see substantial margin pressure as likely, at least through the first half of 2011 and likely lingering into 2H11. In addition, while cost pressures should be modest for URBN relative to the rest of the specialty retail universe (URBN targeted a flat IMU for 2011), the company had the benefit of a tailwind from lower product costs during the previous fashion shift. This brings an additional element of challenge to the current product transition. We also note that the departure of Urban Outfitters Global Brand President Steven Murray earlier this month leaves the core Urban Outfitters division in a state of flux, which may also delay the timing of a turnaround.

THE 2005-2007 FASHION SHIFT: SALES AND GROSS MARGIN PERFORMANCE



Source: TAG Metrics, TAG Research and company reports. Note: SSS exclude Direct-to-Consumer sales.

THE 2010-2011 FASHION SHIFT: SALES AND GROSS MARGIN PERFORMANCE



Cites "mega" fashion shift, which is not as significant as the "tectonic" shift of 2006. Trends improve in October as assortment is adjusted to reflect new trends.

Major deceleration in January leads to 200 bps of gross margin pressure. No clear timeline as to when customers will fully accept the fashion shift.

As of 10-K on 4/11, comparable retail segment sales (including Direct) were trending down in the LSD, including a major drop-off in March, which was expected to lead to ~400 bps of gross margin pressure.

Comparable retail segment sales expected to remain slightly negative as fashion shift is navigated. Expect GM pressure to persist as assortment is adjusted and inventory levels are normalized.

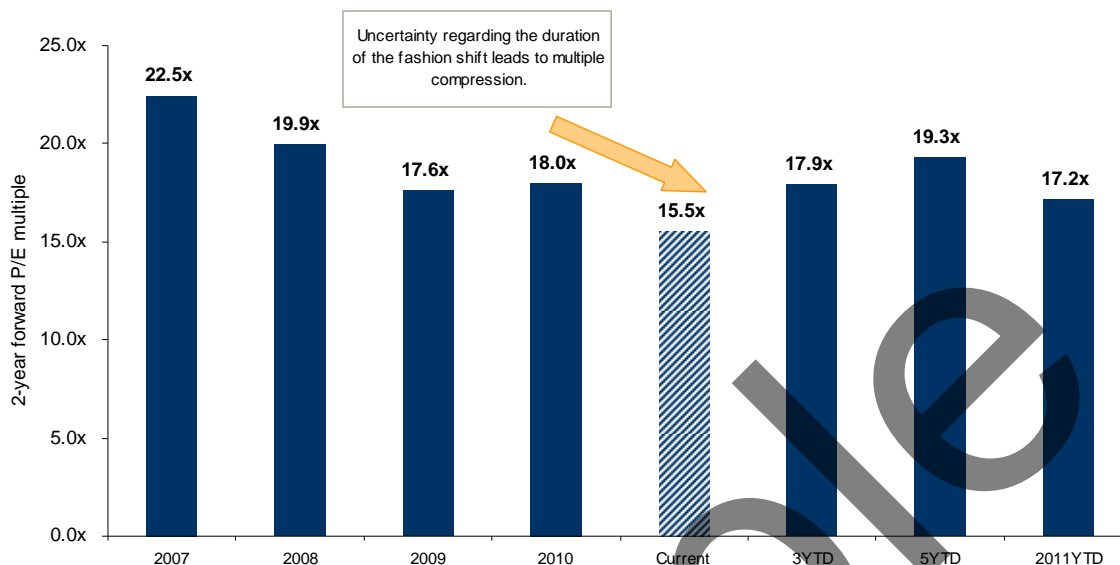
Potential for comparable retail segment sales to turn positive vs. easier compares.

Expect GM and comparable retail segment sales to turn positive, as acceptance to new product improves and beginning of 'fashion shift' is lapsed.

Source: TAG Metrics, TAG Research and company reports. Note: SSS include Direct-to-Consumer sales.

- > **If the fashion shift persists through 2H11, there is potential downside to our EPS estimates.** We currently estimate that the gross margin will show sequential improvement from 2Q11 to 3Q11, with 350 bps and 50 bps of gross margin compression, respectively. However, our estimates do not reflect a 'worse case scenario'. If the current fashion shift were to more closely follow the trajectory of the 2005-2007 fashion shift, we would expect to see several hundred bps of gross margin pressure in 2H11. If we assume a more conservative scenario, by modeling 200 bps and 150 bps of gross margin compression in 3Q11 and 4Q11, respectively, our 2011 EPS estimate would be \$1.45, ~6% below our current 2011 EPS estimate of \$1.55 and 15% below the current consensus of \$1.71.
- > **The recent multiple compression reflects investor uncertainty and the downside risk to consensus EPS estimates.** Below, we see the multiple compression that URBN has experienced due to the uncertainty around the fashion shift. YTD, URBN has traded at 17.2x on a 2-year forward basis, compared to its 2010 average of 18.0x and its recent peak annual average of 22.5x in 2007. Currently, the stock is only trading at 15.5x the consensus 2012 EPS estimate of \$2.05. We believe the recent multiple compression reflects a combination of: 1) the uncertainty around the depth and duration of the sales and margin softness, 2) the buy-side expectation for EPS to fall below the current consensus estimates.

URBAN OUTFITTERS HISTORICAL 2-YEAR FORWARD P/E MULTIPLES



Source: TAG Metrics, TAG Research and company reports. P/E multiples reflect two-year forward consensus estimates.

- > Below we present three potential scenarios, highlighting our view of the potential upside and downside for URBN. Our current 12-month price target of \$36-\$38 implies a 1-year forward P/E multiple of 23.8x, which is nearly in-line with the 5-year average. However, assuming that comparable retail segment sales remain in negative territory and margin pressure persists, we see potential for ~10% downside to our 2011 EPS estimate of \$1.55. By applying an 18.0x P/E multiple to our 2011 EPS estimate, which was the trough during the 2005-2007 fashion shift, we see up to ~20% downside to the current stock price. Conversely, should sales and margin trends recover more quickly than we anticipate, we see \$1.73 in 2011 EPS as achievable, only slightly above the current consensus of \$1.71. We believe the current depressed multiple reflects the expectation for URBN to miss the consensus 2011 EPS estimate. We would expect multiple expansion should URBN hit this number, which would make a return to a \$40+ stock price achievable.

2011E UPSIDE/DOWNSIDE POTENTIAL

Scenario	2011E Comparable Retail Segment Sales Growth	2011E Net Sales	Implied EBIT Margin	2011E EPS	Applied P/E	Price Target	Upside/Downside	Commentary
Aggressive	3.3%	\$2,534	17.8%	\$1.73	25.8x	\$44.63	40.5%	Multiple reflects average high 1-year forward P/E over last 3 years
Base (Current)	1.3%	\$2,488	16.3%	\$1.55	23.8x	\$37.00	16.5%	Our 12-month price target of \$36-\$38 implies a 1-year forward P/E multiple of ~24x, in-line with the 5-year average
Conservative	(0.7%)	\$2,444	14.8%	\$1.39	18.0x	\$25.02	(21.2%)	P/E multiple of 18.0x reflects the trough 1-year forward low multiple in the 2005-2007 fashion shift

Source: TAG Metrics, TAG Research and company reports.

ADDENDUM

Important Disclosures:

Valuation Method for Target Price: Price-to-Earnings, price-to-EBITDA, P/E to growth, price to free cash flow, and discounted cash flow analysis.

Investment Risks: Slower consumer spending, rising interest rates, weaker consumer confidence, rising unemployment, supply chain disruptions, fashion misses, and excessive markdowns.

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Historical Price Targets

To see price charts and TAG's historical price targets please click the following link: <http://www.telseygroup.com/files/historicalprices.pdf>

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Disclosures required by United States laws and regulations

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