

Internet Retail Industry Update

A Look Ahead

EXECUTIVE SUMMARY

With Internet Retail being one of the fastest growing sectors in the overall retail industry, and with a strong fourth quarter in 2009, we expect retailers will continue to look to online as a next generation vehicle for growth. By contrast, during 2009 the M&A Internet Retail market was dismal. However it is beginning to show signs of recovery and we expect M&A volume to continue to accelerate over the next five years as the industry consolidates around brand name merchants.

MARKET INDICATORS - A LOOK BACK

- Internet Retail sector sales have generated Compound Annual Growth Rate (CAGR) of 18.6%, from \$34.5 billion in 2001 to \$135.0 billion in 2009. As Internet sales grew the growth rate declined steadily until it “fell off the cliff” in 2008.
- As a percent of total retail sales, e-commerce has grown from 1.1% of total retail sales in 2001 to 3.7% of total retail sales in 2009.
- The fourth quarter of 2009 was very strong for online retailers, with total e-commerce sales increasing 14.6% YOY from Q408; and totaling 4.3% of total retail sales in Q409.
- Stock prices for publicly traded online retailers have increased 130% from February 2009. In contrast the S&P 500 Retailing Index is up close to 70% over the same period.

FY End	Retail Sales (\$B)			% Change Year-Over-Year		
	31-Dec	Total	E-commerce	% of Total	Total	E-commerce
2001	\$	3,067,725	\$ 34,451	1.1%		
2002		3,134,322	44,925	1.4	2.2	30.4
2003		3,265,477	56,719	1.7	4.2	26.3
2004		3,474,340	71,087	2.0	6.4	25.3
2005		3,687,364	87,846	2.4	6.1	23.6
2006		3,869,536	107,014	2.8	4.9	21.8
2007		3,994,823	126,697	3.2	3.2	18.4
2008		3,959,957	132,257	3.3	(0.9)	4.4
2009		3,683,087	134,957	3.7	(7.0)	2.0
2013 P		4,035,615	172,966	4.3		

Source: U.S. Census Bureau Quarterly Retail E-Commerce Sales and Tully & Holland estimates

MARKET INDICATORS – A LOOK FORWARD

- Forecasted sales for internet retailers are projected to progress at a “modest” 6.4% CAGR through 2013 according to Mintel Research and US Census Bureau data. Growth is projected to accelerate after a weak recovery in 2010 and 2011. This will bring yearly internet sales to 4.3% of total retail sales should total retail sales grow at their historic CAGR of 2.3%.

CONTENTS

Executive Summary

Market Indicators
A Look Back

Market Indicators
A Look Forward

M&A Transactions

Public Comparables &
Valuation

T&H Conclusions

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- Within the Internet Retail sector, we expect that social media and mobile shopping will be the fastest growing segments, and will be sources of considerable revenue growth as consumer purchasing habits continue to evolve.
- Traditional brick & mortar retailers will increasingly focus on online store sales as they seek revenue growth. Recently Joseph A. Bank, Marks & Spencer, Sears, and Charming Shoppes, Inc. have each re-launched their website to accommodate increased traffic and enhanced customers' shopping experience.
- Since there are few significant barriers to entry in online retail and companies continue to look for revenue growth in e-commerce, price competition will continue to increase and put increased pressures on margins.
- Strong brands will, as always, be the best protection against price competition. Furthermore, as branding importance grows, pay-per-click advertising will diminish in importance but its cost will continue to rise.
- As these trends develop, the industry will consolidate around established entities. Small players unable to compete in an increasingly competitive marketplace will exit or eke out a sub-standard existence. Mid-size players with weak brand recognition and value propositions or poor supply chain and fulfillment economics will be picked off by larger, better recognized, and stronger competitors.

Total U.S. ecommerce retail sales, 2007-13		
Year	(\$B)	% change
2007	127	13.0
2008	132	3.1
2009	135	(2.3)
2010*	134	2.7
2011*	142	6.0
2012*	156	9.8
2013*	173	10.8

**Forecasted sales*
Source: Mintel, U.S. Census Bureau

M&A TRANSACTIONS

The Internet retail M&A market suffered a 37% decline in overall deals in 2009, from 57 reported deals in 2008 to 36 reported deals in 2009. Additionally, the vast majority of reported aggregate transaction size in 2009 was driven by 5 large transactions (Retail Convergence, Zappos, NextRx, Circuit City, and Ticketmaster) of \$200 million or more, totaling over \$3.9 billion. Decreased deal flow in 2009 can mostly be attributed to difficulties in the larger U.S. economy, weak retail sales generally, and decreased availability of credit for potential acquirers.

With the strengthening of markets in 2010 we are seeing an increase in M&A activity, particularly "industry consolidation" acquisitions by some larger players. An example of this activity currently underway can be seen in the online printer toner industry, where Lexon Technologies, Inc. recently acquired Nanoinkjet.com on 1/25/10 after announcing the acquisition of 7inkjet.com in November 2009. Similar to the Lexon acquisitions is Toys R' Us' acquisition in February 2009 of BabyUniverse, Inc., ePregnancy and eToys.com from The Parent Company. In this situation, The Parent Company was experiencing severe financial distress, and was forced to sell assets when it filed for reorganization under Chapter 11.

Announcement Date	Target	Buyer	Segment
04/16/2010	Condition Nutrition Inc.	Musclmartonline, Inc.	Nutritional Supplements
03/23/2010	Vitacost.com, Inc.	Great Hill Partners, LLC	Health & Wellness Products
03/01/2010	Good Apples LLC	Right by Nature, LLC	Grocery, Food & Beverages
02/28/2010	Makeup.com, Ltd.	L'Oreal SA	Beauty Products
02/25/2010	World of Good, Inc.	eBay, Inc.	Retailer of Fair Trade Products
02/24/2010	Promopeddler, Inc.	Branders.com, Inc.	Promotional Products
02/16/2010	HarmonyOnline.com Music	Moppet Management, Inc.	Musical Instruments & Accessories
02/09/2010	Rhapsody International Inc.	Universal Music Group, Inc.	Music Store
01/25/2010	nanoinkjet.com	Lexon Technologies, Inc. (OTCBB:LEXO)	Toner Cartridges
01/11/2010	Buzzskin Inc.	Strategic Holdings Group, Inc.	Grooming Products
01/01/2010	CoolCupsandStuff, Inc.	CoolCups	Retailer of Party Supplies
12/11/2009	StuffedAnimals.com	Beverly Hills Teddy Bear Company	Toy Retailer
11/03/2009	7inkjet.com	Lexon Technologies, Inc. (OTCBB:LEXO)	Toner Cartridges
10/22/2009	Entelechis, Inc.	Aero Financial, Inc.	Retailer of Self-Education Products
10/22/2009	Socks4Life.com LLC	One Click Ventures LLC	Sock Outlet
10/05/2009	Frogfile Office Essentials Inc.	Costless Express Ltd.	Retailer of Office Supplies
07/22/2009	Zappos.com, Inc.	Amazon.com Inc. (NasdaqGS:AMZN)	Retailer of Apparel and Footwear
07/03/2009	Puretracks, Inc.	Somerset Entertainment Income Fund	Digital Media Services

Source: CapIQ

PUBLIC COMPS & VALUATION

Valuations for publicly traded internet retail companies have rebounded substantially over the past 12-months, from a low EBITDA multiple of 4.96x in November 2008, to 12.93x EBITDA by the end of March 2010. Internet Retailers typically trade at a premium over Catalog and traditional Brick & Mortar retailers, because of the better growth prospects and more favorable economics of the segment.

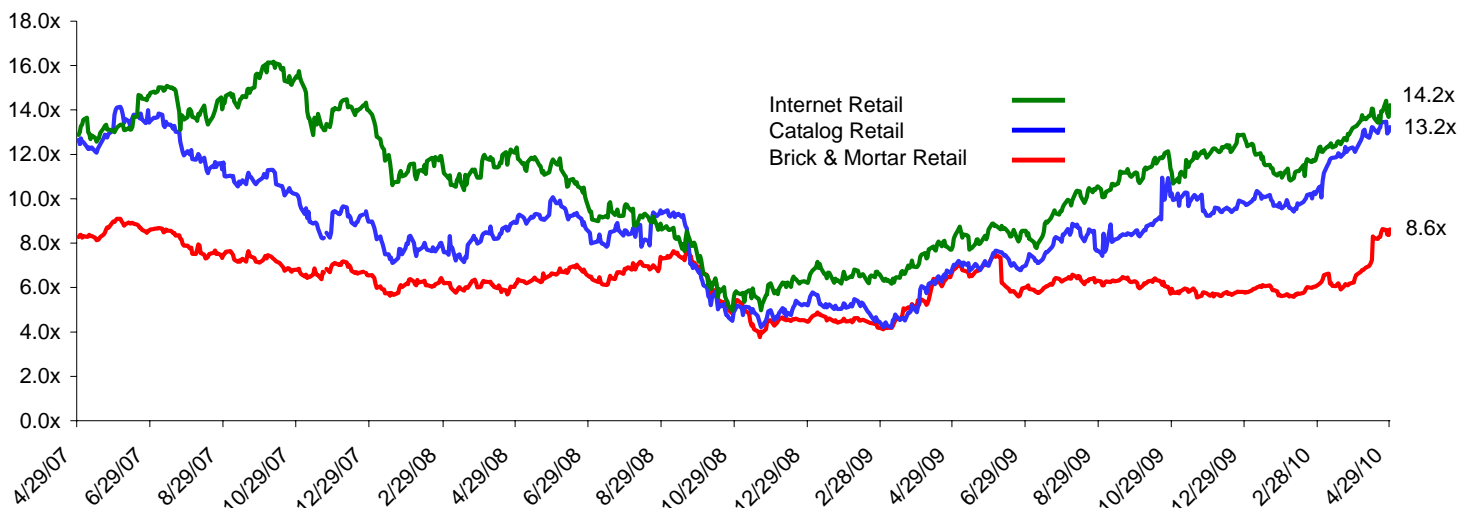
While online retailers have not been immune to the national economic downturn, as evidenced by the 3 companies in our index that posted negative EBITDA over the past twelve months, most companies in the sector have done well and continue to post meaningful EBITDA margins averaging 12.3% in our index. This relatively strong performance was primarily due to the scalability of Internet Retailers, who were able to respond much more quickly to the downturn and cut expenses in line with stagnant revenues.

As the Catalog Industry continues to rely on the web for its marketing and sales channel, over time we expect the Catalog Index will be merged with the Internet Index to create one "Distance Marketing Index."

Company Name	Total Enterprise Value (US\$)	Total Revenue LTM (US\$)	EBITDA LTM (US\$)	EBITDA Margin	TEV/Revenue (TTM)	TEV/EBITDA (TTM)
priceline.com Incorporated (NasdaqGS:PCLN)	\$ 11,839.3	\$ 2,338.2	\$ 509.0	21.8%	5.1x	23.3x
Expedia Inc. (NasdaqGS:EXPE)	7,234.7	2,955.4	750.7	25.4%	2.4x	9.6x
Netflix, Inc. (NasdaqGS:NFLX)	5,363.2	1,769.8	251.4	14.2%	3.0x	21.3x
Orbitz Worldwide, Inc. (NYSE:OWW)	1,232.1	738.0	131.0	17.8%	1.7x	9.4x
United Online, Inc. (NasdaqGS:UNTD)	925.8	990.1	204.1	20.6%	0.9x	4.5x
NutriSystem Inc. (NasdaqGS:NTRI)	551.4	527.7	61.6	11.7%	1.0x	8.9x
PetMed Express Inc. (NasdaqGS:PETS)	488.1	236.0	40.9	17.3%	2.1x	11.9x
Shutterfly, Inc. (NasdaqGS:SFLY)	477.4	246.4	32.6	13.2%	1.9x	14.7x
Overstock.com Inc. (NasdaqGM:OSTK)	360.3	876.8	13.7	1.6%	0.4x	26.2x
U.S. Auto Parts Network, Inc. (NasdaqGS:PRTS)	236.9	176.3	9.8	5.6%	1.3x	24.1x
1-800-Flowers.com Inc. (NasdaqGS:FLWS)	232.8	673.7	31.5	4.7%	0.3x	7.4x
Vitacost.com, Inc. (NasdaqGM:VITC)	205.9	191.8	12.5	6.5%	1.1x	16.4x
RealNetworks Inc. (NasdaqGS:RNWK)	202.1	562.3	NM	NM	0.4x	NM
Stamps.com Inc. (NasdaqGS:STMP)	97.4	82.1	7.0	8.6%	1.2x	13.8x
BIDZ.com, Inc. (NasdaqCM:BIDZ)	43.9	110.4	5.1	4.7%	0.4x	8.5x
Hollywood Media Corp. (NasdaqGM:HOLL)	24.0	103.4	NM	NM	0.2x	NM
Anything Brands Online, Inc. (OTCPK:ANYT)	20.5	15.6	NM	NM	1.3x	NM
Mean	\$ 1,737.4	\$ 740.8	\$ 147.2	12.4%	1.5x	14.3x

Source: CapIQ - Mean is average of multiples

TOTAL ENTERPRISE VALUE / EBITDA T&H RETAIL INDEX LAST THREE YEARS



As of 4/30/10

Source: CapIQ and Tully & Holland

EV / EBITDA multiple represents the quotient of the summation of EVs and EBITDAs for each component over LTM

CONCLUSION

- Internet Retail has performed well over the past several months, and is well on its way to recovery.
 - As consumer spending continues to show signs of a recovery, with March's 0.6% increase, as reported by the U.S. Department of Commerce, consumer expenditures have recorded growth for 6 straight months.
 - The shift to internet shopping has been accelerated by current economic conditions. Price conscious consumers increasingly prefer shopping over the internet to compare prices.
 - The convenience and expedited nature of shopping online also drives time-constrained consumers to the internet.
- Recent growth in the sector, combined with a strong finish to 2009, will attract additional investment from traditional and catalog retailers as management looks to increased internet retail presence as the primary vehicle for growth.
- Increased competition will continue to drive down retail prices, and contract margins. The result will be that small to mid-sized players with less brand recognition, supply chain weaknesses or poor financial performance will be acquired by stronger rivals.
- Branding will grow in importance as a defense against increasing price competition as the industry consolidates. National and large regional retailers will gain share at the expense of smaller firms.
- As this trend develops we expect that the number of substantial industry players will contract, fueling increased M&A activity over the next 5 years.

ABOUT TULLY & HOLLAND

INVESTMENT BANKING SOLUTIONS FOR CONSUMER PRODUCT COMPANIES

Founded in 1992, Tully & Holland, Inc. is a leading US investment bank that provides merger & acquisition advisory services and private placements to consumer companies with special emphasis on food companies, multi-channel marketers, consumer product manufacturers/distributors, and retailers. Tully & Holland's Managing Directors have a combination of deep industry knowledge and sophisticated financial experience enabling them to craft innovative solutions for each client's needs.

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