

Specialty Retail

First Signs of Recovery Surface

EXECUTIVE SUMMARY

While rising unemployment, tight availability of credit, and lackluster retail sales have been widely covered in the media, several emerging positive trends, including rebounding retail valuations, have not. The S&P Retail Index increased more than 50% since March; consumer confidence lifted off its catastrophic lows; retail M&A activity has increased, and economists now believe that the recession may have ended during the second quarter of 2009.

RETAIL ECONOMIC INDICATORS

- Consumer confidence rebounded strongly in August, after having retreated in both June and July, indicating that consumers now view conditions more favorably. The Consumer Confidence Index stood at 54.1 in August, up from 47.4 in July. Further, the Expectations Index improved to 73.5 from 63.4 in July, and is now at its highest level since December 2007.
- Retail stocks have been on a run, with the S&P Retail Index now up 50% from its March low. The Street has clearly placed a bet on a near term turnaround in the retail sector.
- Some retailers, namely off-price retailers, discounters, and warehouse club stores, are benefiting from the structural shift in consumer buying habits toward value, while mall based specialty apparel retailers, mid-tier department stores, and luxury retailers have been hit with double-digit negative comparable store sales declines. Investors are closely watching the consumer's gravitation toward value and discount retailers.
- While comparable store sales remain overwhelmingly negative, sales should stabilize as retailers increasingly come up against easier comparisons beginning in September.

M&A TRANSACTIONS

M&A in the Specialty Retail sector finally took an upward turn in the 2nd quarter of 2009, after having stalled for much of the 4th quarter of 2008 and 1st quarter of 2009. Twelve transactions closed or announced in the second quarter, twice the volume in Q1'09 and nearly on par with activity in the 2nd quarter of 2008.

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While activity was up, the other story is that distressed sales dominated the market – representing more than two-thirds of all transactions. Moreover, most acquirers were strategic buyers, in stark contrast to 2006, 2007 and early 2008, when the majority were private equity groups. In fact, private equity backed deals fell to fewer than twenty percent of transactions over the last nine months, due to concerns over the sector and a lack of debt available for retail buyouts.

Announced Date	Target	Buyer	Doors
08/24/2009	Charlotte Russe Holding	Advent International	500
07/24/2009	Tory Burch, LLC	Tresalia Capital, S.A. de C.V.	18
07/22/2009	Zappos.com, Inc.	Amazon.com	n/a
07/17/2009	Eddie Bauer Holdings, Inc	Golden Gate Capital	364
07/13/2009	Baskin's Department Stores	Banyan Mezzanine Fund, L.P. , CapSources Inc. , Diamond State Ventures , MidStates Capital L.P.	16
07/09/2009	Golfer's Warehouse, Inc.	Worldwide Golf Enterprises, Inc.	4
07/03/2009	Goody's Family Clothing (brand name only)	Stage Stores, Inc.	50*
06/24/2009	Tween Brands, Inc. (Justice)	Dress Barn Inc.	908
06/18/2009	Filene's Basement	Syms, Inc.	23
06/21/2009	Man Alive	Jimmy Khezrie	75
06/17/2009	Spiegel Brands, Inc.	Patriarch Partners, LLC	n/a
06/10/2009	Al Baskin Co. dba Mark Shale	JOB Investments LLC	3
06/07/2009	J. Jill Group, Inc.	Golden Gate Capital	204
05/28/2009	FAO Schwarz, Inc.	Toys "R" Us Inc.	2
05/27/2009	Levi's and Dockers Outlets	Levi Strauss & Co.	73
05/01/2009	Against All Odds USA, Inc.	New Deal, LLC	27
04/17/2009	American Greetings and Carlton Cards stores	Schurman Fine Papers, Inc.	341
04/14/2009	Olsen's Mill, Inc.	A group led by Phillip J. Martini	8
04/08/2009	Agriliance LLC, Nine Retail Locations	Agri-AFC, LLC	9
03/24/2009	Dial-A-Mattress Operating Corp.	Sleepy's, LLC	34
02/26/2009	Calendar Club	Calendar Club L.L.C.	800
02/20/2009	Blessing Music Company	Quinlan & Fabish Music Company	3
01/23/2009	Eyeglass World, Inc.	National Vision Inc.	64
01/05/2009	Academic Superstore	Journey Education Marketing, Inc.	n/a
12/19/2008	12 Corral West And Western Warehouse Retail Stores In AZ	BootBarn, Inc.	12
12/16/2008	Rosey Rentals, L.P.	Aaron's, Inc. (NYSE:AAN)	35
11/26/2008	14 Corral West And Western Warehouse Retail Stores in WY and NV	BootBarn, Inc.	14
11/26/2008	Mattress Discounters Corp.	RoomStore, Inc.	70
11/25/2008	Gerber Childrenswear Inc. and Hanna Andersson Corporation	Sun Capital Partners, Inc.	29
11/04/2008	Boscov's Department Stores, LLC	private group led by Albert Boscov	39
10/27/2008	22 Corral West And Western Warehouse stores In AZ, NM And NV	BootBarn, Inc.	22

Source: Capital IQ, Tully & Holland Analysis

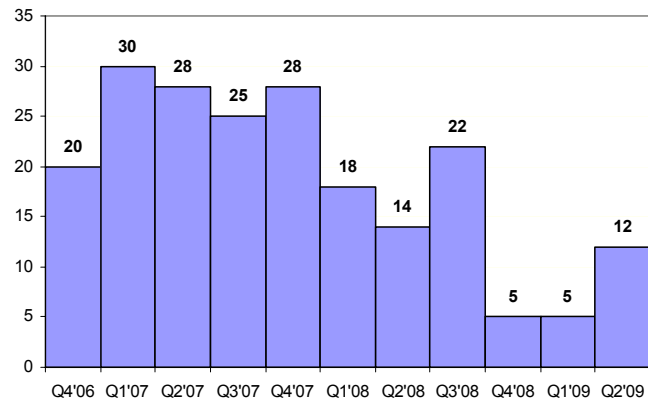
So far, the 3rd quarter is much more positive – with three notable healthy transaction announcements, perhaps signaling the return of the market. First, a consortium of private equity groups, led by Diamond Capital and sponsored by Consumer Growth Partners, acquired Baskins Department Stores, a 16-door general merchandise retailer operating in rural Texas markets. Interestingly, the investors ultimately participated in both the debt and equity layers of the capital structure to overcome lenders reluctance to bank the sector.

Next, Amazon acquired Zappos.com in an \$823.0 million all stock transaction valued at 1.3x revenue. Through this move, Amazon acquired its largest online competitor in apparel. This mega strategic deal signals Amazon’s confidence in the market and may lead others to follow suit.

Finally, Charlotte Russe, which had rejected an unsolicited bid early in the year and had been on the market since March, announced its sale to

Advent International, a private equity group, for \$371.0 million. This represents the first large healthy private equity buyout in several months and could be a sign of things to come.

**U.S. Specialty Retail
Quarterly M&A Transactions**



Source: Capital IQ, Tully & Holland Analysis

PUBLIC OFFERINGS

In another positive sign, Dollar General, the discount retailer owned by KKR, filed an IPO on August 20, 2009. The move exploits investors’ new interest in the discount sectors of retail, which have performed exceedingly well in this recession. This may be the start of a trend where private equity groups go back to pursuing the IPO as an exit vehicle - after having largely relied on M&A for the past several years.

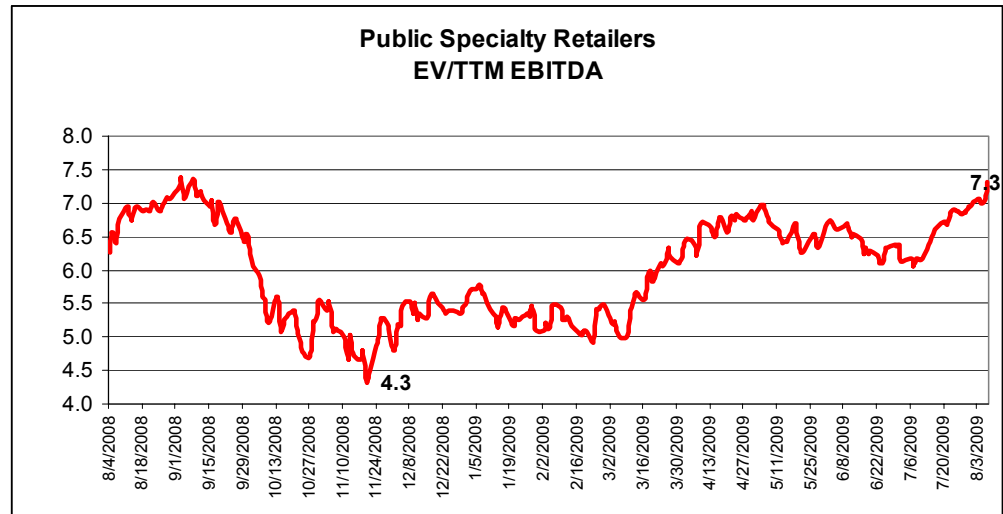
PRIVATE PLACEMENTS

MyShape, an online apparel retailer, received funding in August, perhaps ushering in the return of growth capital for innovative and unique retail concepts. MyShape secured \$10.56 million of a \$12 million Series C round from Draper Fisher Jurvetson, Tenaya Capital and Tech Coast Angels.

VALUATION

While most recent specialty retail deals have been private transactions, below public materiality disclosure, or distressed sales and thus have not publicized valuation metrics – we note three recent transactions that traded within historical retail valuation norms. First, Tween Brands, which does business as Justice, was acquired by Dress Barn for 5.6x EBITDA on June 24 2009. Next, Eddie Bauer was acquired by Golden Gate Capital, a private equity group, for 5.9x EBITDA on July 17 2009. Finally, Charlotte Russe was acquired by Advent International, a private equity group for 6.6x EBITDA on August 24 2009.

Beyond precedent transactions, we look to the equity markets to provide additional valuation guidance. Notably, Retail Stocks continue to be on a run, with the S&P Retail Index now up 50% from its March low. As of 8/31/2009, fifty select public specialty retailers traded at median Enterprise Value multiple of 7.3x EBITDA, up from only 4.3x during the November panic.



Source: Capital IQ, Tully & Holland Analysis

CONCLUSION

The market appears to be turning for the specialty retail sector, as M&A activity is up considerably in recent months; valuations have returned to more historical norms; and the recession appears to have ended. M&A, which lags the public equity markets, should continue to follow the recent run up in retail stock prices. Pent up demand and the gradual economic recovery should slowly prompt the consumer to begin spending again. Clearly, consumers have changed their buying habits to benefit off-price retailers and discounters. It remains unclear how luxury retailers will perform as the economy rebounds.

ABOUT TULLY & HOLLAND

INVESTMENT BANKING SOLUTIONS FOR CONSUMER PRODUCT COMPANIES

Tully & Holland, Inc. is a leading US investment bank that provides sophisticated corporate finance advisory services to consumer product 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. Founded in 1992, Tully & Holland's transaction success is facilitated by long-term relationships with financial and strategic buyers around the world.

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