

February 24th, 2010

Dear clients and colleagues,

This week we would like to profile a new stock added in the portfolio - Abercrombie & Fitch (ANF US).

Business Description

Abercrombie & Fitch (A&F) is an American high-end specialty retailer, focusing on casual wear and accessories for kids, teenagers, and young adults. The company operates 1,096 stores globally under 4 brands and also on 4 e-commerce websites. In the latest quarter, nearly 87% of revenue is generated from 2 brands: Abercrombie & Fitch and Hollister. Overseas sales account for about 15% of total revenue.

The target customers vary by brand and are portrayed as follows.

- Abercrombie & Fitch: Aged 18-22. The privileged All-American collegiate lifestyle with east coast traditions and Ivy League heritage.
- Hollister: Aged 14-18. The spirit and adventure of Southern California.
- Abercrombie: Aged 7-14. The privileged All-American prep school lifestyle, younger sibling of Abercrombie & Fitch.
- Gilly Hicks: for teenage girls with Sydney sensibility.

Market Data

Market Cap US\$3.1B, net cash US\$641M, dividend yield 1.98%, annual sales of US\$3B, Sales growth 1998-2007 CAGR of 21.8%, Rev/t12 sales 0.83x, ev/t12 ebitda 7.47x, fwd p/e (01/2011) 21.4x, gross margin 63.5%, operating margin 10.2%, profit margin 5.1%, one-year return 68%, www.abercrombie.com

Target Market

Teen population is usually defined as people aged between 12 and 19. There are about 461 million teens in the world with more than \$592B in spending power, according to The TRU Study: 2009 Global Teen Edition.

In the US alone, the teen population has been growing in the past decade and shown increasing spending power. In 2009 there were about 33.9 million US teens with spending power of \$176B, compared with 31.6 million teens with spending power of \$155B in 2000.

Competitive Advantages

- Iconic brands: Hollister and Abercrombie & Fitch were ranked #2 and #5 in clothing brand preference among teens, in the latest survey of "Taking Stock With Teens" conducted by Piper Jaffray in fall 2009.
- Leading market share: According to research of The NPD Group on the US specialty apparel market share for 14-17 years old, Hollister and Abercrombie & Fitch were ranked #2 and #4 respectively for guys' apparel, and ranked #4 & #6 for girls' apparel.
- Solid balance sheet: The net cash of \$641M provides ample funding for new store openings.

This report is provided solely for informational purposes and nothing in this document constitutes an offer or a solicitation of an offer to purchase any security. This report has no regard to the specific investment objectives, financial situation or particular needs of any specific recipient and does not constitute a representation that any investment strategy is suitable or appropriate to a recipient's individual circumstances. Global Alpha Capital Management Ltd. (Global Alpha) in no case directly or implicitly guarantees the future value of securities mentioned in this document. The opinions expressed herein are based on Global Alpha's analysis as at the date of this report, and any opinions, projections or estimates may be changed without notice. Global Alpha, its affiliates, directors, officers and employees may buy, sell or hold a position in securities of a company(ies) mentioned herein. The particulars contained herein were obtained from sources, which Global believes to be reliable but Global Alpha makes no representation or warranty as to the completeness or accuracy of the information contained herein and accepts no responsibility or liability for loss or damage arising from the receipt or use of this document or its contents.

Performance figures are stated in Canadian dollars and are net of trading costs and gross of operating expenses and management fees. Further information about the Global Small Cap Composite is available by contacting the firm. Global Alpha Capital Management Ltd. (Global Alpha) claims compliance with the Global Investment Performance Standards (GIPS[®]) and has prepared and presented this report in compliance with the GIPS. Global Alpha has not been independently verified.

- High margin business: The company offers premium brands that support superior margin vs. its peers. From 2005 to 2007, the average gross margin was 67% and the average operating margin was 20%. Management aims to restore the operating margin back to its historical level, from the current 10.2% to at least 15% by 2012.

Competition

Very competitive market. In the US alone, other brands favored by teens are West Coast Brands (e.g. Pacific Sunwear, Volcom, Quicksilver, Zumiez), Forever 21, American Eagle, Aéropostale, Old Navy, Rue 21, Charlotte Russe, and Gap, etc.

Growth Strategy

Distribution strategy: Especially international expansion.

The company opened its first overseas store in Canada in 2005. Now it has a total of 28 overseas stores in Canada, UK, Italy, Germany and Japan. The performance of existing overseas stores has been very successful in terms of sales volume and margin. E.g. the average volume of UK stores is about 6 times that of the domestic stores. The sales per square foot of 7 Hollister international stores are among the top 10 performing stores company wide.

Management

Directors and executive officers as a group hold 7.26% of stake. The Chairman and CEO Michael Jeffries owns 6.82%. He joined the company in 1992 and since then has successfully repositioned it to offer upscale brands of an aspirational “Casual Luxury” life style.

Risks

- New store openings in the European and Asian markets are relatively recent. Uncertainty remains regarding sustainable outperformance.
- Fashion risk and currency risk.
- Weak consumer demand due to economic downturn.

Investment Themes

- A premium brand with huge potential in the international market: The company is still at the early stage of overseas expansion. Its strong focus of accelerating international expansion will serve as the key driver of aggressive growth.
- A turnaround story: The company reached its record revenue of \$3.75B in 2007, but the same-store sales deteriorated in the past three years and dropped 30% in Q1 and Q2 of 2009. Unlike most other specialty retailers who chopped prices substantially during the economic downturn, A&F had insisted on protecting its premium brand image by not giving promotions. As a result, A&F experienced one of the worst same-store sales in the sector, and its stock plunged from about \$84 in Oct 2007 to \$14 a year later. In Sep 2009, management loosened certain price points but still emphasizes that its business is not based on promotion which is a short-term solution with dreadful long-term effects. Since then same-store sales

This report is provided solely for informational purposes and nothing in this document constitutes an offer or a solicitation of an offer to purchase any security. This report has no regard to the specific investment objectives, financial situation or particular needs of any specific recipient and does not constitute a representation that any investment strategy is suitable or appropriate to a recipient's individual circumstances. Global Alpha Capital Management Ltd. (Global Alpha) in no case directly or implicitly guarantees the future value of securities mentioned in this document. The opinions expressed herein are based on Global Alpha's analysis as at the date of this report, and any opinions, projections or estimates may be changed without notice. Global Alpha, its affiliates, directors, officers and employees may buy, sell or hold a position in securities of a company(ies) mentioned herein. The particulars contained herein were obtained from sources, which Global believes to be reliable but Global Alpha makes no representation or warranty as to the completeness or accuracy of the information contained herein and accepts no responsibility or liability for loss or damage arising from the receipt or use of this document or its contents.

Performance figures are stated in Canadian dollars and are net of trading costs and gross of operating expenses and management fees. Further information about the Global Small Cap Composite is available by contacting the firm. Global Alpha Capital Management Ltd. (Global Alpha) claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS. Global Alpha has not been independently verified.

have improved, and in Jan 2010 turned into a strong +8%. We consider the more flexible pricing strategy a positive, which can be partially helped by lower AUC this year. Same-store sales should be able to continue the uptrend.

Valuation

Target price = \$66, using DCF model at growth rate of 18% for 10 years, 6% at maturity, and risk premium of 10%.

Regards

The Global Alpha Team

This report is provided solely for informational purposes and nothing in this document constitutes an offer or a solicitation of an offer to purchase any security. This report has no regard to the specific investment objectives, financial situation or particular needs of any specific recipient and does not constitute a representation that any investment strategy is suitable or appropriate to a recipient's individual circumstances. Global Alpha Capital Management Ltd. (Global Alpha) in no case directly or implicitly guarantees the future value of securities mentioned in this document. The opinions expressed herein are based on Global Alpha's analysis as at the date of this report, and any opinions, projections or estimates may be changed without notice. Global Alpha, its affiliates, directors, officers and employees may buy, sell or hold a position in securities of a company(ies) mentioned herein. The particulars contained herein were obtained from sources, which Global believes to be reliable but Global Alpha makes no representation or warranty as to the completeness or accuracy of the information contained herein and accepts no responsibility or liability for loss or damage arising from the receipt or use of this document or its contents.

Performance figures are stated in Canadian dollars and are net of trading costs and gross of operating expenses and management fees. Further information about the Global Small Cap Composite is available by contacting the firm. Global Alpha Capital Management Ltd. (Global Alpha) claims compliance with the Global Investment Performance Standards (GIPS[®]) and has prepared and presented this report in compliance with the GIPS. Global Alpha has not been independently verified.