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Date: 11/19/11

Business Description

Urban Outfitters, Inc. (Urban Outfitters), incorporated in 1976, is a lifestyle specialty retail company that operates under the Urban Outfitters, Anthropologie, Free People, Terrain, Leifsdottir and BHLDN brands. The company also operates a wholesale segment under the Free People and Leifsdottir brands. Its retail stores offer collections of fashion apparel, accessories and home goods. In addition to its retail stores, the company offers its products and markets its brands directly to the consumer through its websites, and also through its Urban Outfitters, Anthropologie and Free People catalogues.

➤ **Retail Segment**

Urban Outfitters targets adults aged 18 to 28 years through its merchandise mix. The product offering includes women's and men's fashion apparel, footwear and accessories, as well as a mix of apartment wares and gifts. Its stores are located in metropolitan areas, select university communities, specialty centers and enclosed malls. As of January 31, 2011, it operated 176 Urban Outfitters stores in North America and Europe. Urban Outfitters' North American and European store sales accounted for approximately 31.8% and 5.3% of consolidated net sales, respectively, during the fiscal year ended January 31, 2011. Urban Outfitters offers a direct-to-consumer catalogue offering select merchandise, most of which is also available in its Urban Outfitters stores. During fiscal 2011, the company circulated approximately 12.1 million Urban Outfitters catalogues. Urban Outfitters operates a website, which accepts orders directly from customers. The website offers a similar selection of merchandise as found in the stores.

Anthropologie tailors its merchandise to women aged 28 to 45 years. Anthropologie's product assortment includes women's casual apparel and accessories, shoes, home furnishings, and a range of gifts and decorative items. Stores are located in specialty retail centers, upscale street locations and enclosed malls. As of January 31, 2011, the company operated 153 Anthropologie stores in North America and Europe. Anthropologie's North American and European store sales accounted for approximately 35.1% and 0.8% of consolidated net sales, respectively, for fiscal 2011. Anthropologie offers a direct-to-consumer catalogue that markets select merchandise, most of which is also available in the Anthropologie stores. During fiscal 2011, the company circulated approximately 17.6 million catalogues. Anthropologie operates a website, which accepts orders directly from customers. The website offers a range of apparel, accessories and household and gift merchandise as found in the stores.

The company's Free People retail stores primarily offer Free People-branded merchandise targeted to women aged 25 to 30 years. Free People offers a merchandise mix of casual women's apparel, shoes, accessories and gifts. Free People retail stores average are located in enclosed malls, upscale street locations and specialty retail centers. As of January 31, 2011, it operated 42 Free People stores in the United States. Free People retail store sales accounted for approximately 2.3% of the net sales for fiscal 2011. Free People offers a direct-to-consumer catalogue offering select merchandise, most of which is also available in its Free People stores. During fiscal 2011, the company circulated approximately 7.6 million catalogues. Free People operates a website, which accepts direct orders. The website exposes consumers to the product assortment found at Free People retail stores, as well as all of the Free People wholesale offerings.

Terrain is designed to appeal to men and women interested in outdoor living and gardening experience. Merchandise includes lifestyle home and garden products combined with antiques, live plants, flowers, wellness products and accessories. Terrain also offers a variety of landscape and design service solutions. Terrain operates a website that accepts orders directly from customers. The website exposes consumers to a portion of the product assortment found at the Terrain retail store. Direct-to-consumer sales for all brands combined were approximately 19.1% of consolidated net sales for fiscal 2011.

➤ **Wholesale Segment**

The Free People wholesale division develops, in conjunction with Urban Outfitters, private-label apparel lines of women's casual wear. During fiscal 2011, Free People's range of tops, bottoms, sweaters and dresses were sold worldwide through approximately 1,400 better department and specialty stores, including Bloomingdale's, Nordstrom, Lord & Taylor, Belk, and its own Free People stores. Free People sells its merchandise under its Free People and other labels. It also distributes its Free People products in certain department stores using a shop-within-shop sales model. Free People maintains wholesale sales and showroom facilities in New York City, Los Angeles and Chicago. Free People wholesale sales accounted for approximately 4.9% of consolidated net sales during fiscal 2011. In addition to selling its merchandise to specialty retailers, Free People wholesale also shares production sourcing with the company's retail segment.

The Leifsdottir wholesale division designs, develops and markets women's apparel, including dresses, tops and bottoms, as well as shoes and accessories. Leifsdottir is sold through luxury department stores, including Bloomingdale's, Nordstrom, Neiman Marcus and Bergdorf Goodman, select specialty stores and the company's own Anthropologie stores. The company also distributes its Leifsdottir products in certain department stores using a shop-within-shop sales model. Leifsdottir maintains a wholesale sales and showroom facility in New York City.

Thesis Points

➤ Growth Potential

URBN has a history of growth. Over the past five years, the company has consistently grown, both in terms of revenue and profit margins. In fact, over that period of time, the company's annual growth rate was around 15%. Going forward, URBN has even more potential for growth. According to Stacy Pak, an analyst at Barclays Capital, "URBN is only 37% penetrated relative to its ultimate growth potential." In an attempt to further tap the market, management has plans to grow both sales and operating margins by more than 20% per year by opening new stores and growing the direct-to-consumer channel.

Direct-to-Consumer

Merchandise sold through one of the URBN websites or catalogues is sent directly to the customer from a distribution center. As this merchandise does not go through a store, it incurs very little overhead costs to the company. As a result, the profit margins on merchandise sold through this channel is around 1.5x that for merchandise sold through a store. The direct-to-consumer channel has been one of the most impressive growth features of URBN. Since 2000, it has grown at a compound annual growth rate of 35% and management is hoping to expand it more in the future.

New Stores

URBN has opened 30 stores per year on average since 2001. As of the end of the last quarter, that put the URBN store count at 408 stores worldwide. Management believes there is potential for over 1,000 stores worldwide. In order to reach that goal, they are planning to add another 50-60 stores per year over the next several years, including 57 stores in 2012 and 55-60 in 2013. These new stores will almost certainly be more productive than the older ones as management has gotten better at site selection and store design.

➤ Inventory Management

Flexible Inventory

URBN has always been on the forefront of new fashion. Sometimes this strategy results in huge gains. In 2006, URBN pushed the "big-over-little" fashion before the look was mainstream. The success of that trend resulted in huge gains in URBN's same-store sales, increasing from -6% in 2006 to +9% in 2007 to +12% in 2008. This demonstrates how well URBN performs when it correctly predicts fashion trends.

Sometimes, however, this fashion forward strategy results in losses. Over the last year, fashion missteps by URBN resulted in a large quantity of unsold and slow-moving products at Anthropologie and Urban Outfitters stores. As a result, total inventories were up 27%, prices were marked down and gross profits were pressured. According to management, the main problem was tops, specifically knits and sweaters, which make up more than half of women's apparel sales.

According to Chris McIntyre, an analyst at First New York Securities, the leftover inventory is not an issue. He says, "Inventories are high, but they'll burn through it in the quarter." Furthermore, Mr. McIntyre said, "The business isn't broken; it's just in a slump and that slump is priced in." Management echoed a similar opinion in the latest earnings call. URBN has experienced fashion slumps before and they have skillfully navigated out of them.

They are able to do this because of effective inventory management. They keep inventories lean, allowing them to drive sales without excessive discounting. Additionally, they are able to maintain a high product turnover rate, providing new products every few weeks. This provides them with incredible flexibility. When an item is popular, they sell out quickly and at a high price. When an item is unpopular, it is discounted and the inventory is moved.

This strategy has the side-benefit of creating a boutique-like appeal. Stores are designed to creatively present a constantly renewing stock of fashionable items. Lauren Houck, a 19-year-old customer of Urban Outfitters, said, "The store decor is also a part of the experience, and makes you feel more as if you're shopping in a small boutique as opposed to a nationwide chain." It is because of this boutique atmosphere that the average shopping time is one hour in an Anthropologie store and 45 minutes in Urban Outfitters, compared to 15-20 minutes for most stores.

Technology Investments

In an effort to improve gross margins, URBN has invested in new software applications. The goal of these investments is not only to provide inventory flexibility on the back end, but also to provide a better customer service experience.

- **Mobile Point of Sale Systems**

Mobile POS systems allow branches to facilitate purchases from their stores, other stores, online and the URBN catalogue all from one device and all in one transaction. By tapping into all three channels (brick-and-mortar, catalogue and online), URBN creates a customer who spends, on average, between 3-5 times as much as a single-channel customer. These systems were tested with positive results during the first half of 2011 and since June, URBN has been rolling out the systems to about 10 stores per brand per week. Eventually, URBN hopes to have 2 mobile POS systems in each store.

- **Single Stock-Keeping Unit Software**

As of this summer, all divisions of URBN are using single SKU software made by Sterling Commerce. This software enables stores to search the inventories of other branches for a product that is out of stock and then ship that product directly to the customer from a location determined by quantity of inventory and shipping costs. Currently, the technology only allows for stores to view the inventories of nearby branches, but by early 2012, stores will be able to view inventories nationwide. This new software will maximize efficiency and provide for even more flexibility in the URBN inventory. Stores will be able to maintain a lean inventory while also meeting the demand needs of customers.

- **Supply Chain Software**

By the end of 2011, TradeStone supply chain software will be live at around 2,500 vendors. Currently operational at 90% of those vendors, TradeStone will improve visibility from the factory to the distribution center, shorten the design and manufacturing cycle by at least 2 weeks, and eventually assist in product development. Urban Outfitters Inc. runs a very complicated operation, with almost 170 different product calendars, compared to 10-12 at most other companies. According to Kimberly C. Greenberger, an analyst at Morgan Stanley, "TradeStone software will allow URBN to better manage the complexity in the business and could lead to a reduction in lead times."

➤ **New Leadership**

Glen Senk

Glen Senk was appointed President of Urban Outfitter's Inc. after the departure of Steve Murray. Mr. Murray did not do a very good job as CEO. He came from a background in footwear with Reebok, Vans and Reef, failed at apparel, and quickly returned to footwear with DECK's European Ugg operations. While Mr. Senk is only serving as Mr. Murray's temporary replacement until the company can find a new president, he has proved to be an excellent judge of fashion trends, with a background as President of Anthropologie for 13 years, and he is dedicated to reversing the recent decline in earnings.

Charles Kessler

Charles Kessler was hired as Chief Merchandising Officer for the Urban Outfitter's brand. He has experience as the Senior Vice President of Corporate Merchandising at Coach and Executive Vice President of Women's Merchandising at Abercrombie & Fitch. Before that, he spent 16 years at Abercrombie & Fitch performing other various merchandising roles. He has come in with an experienced team, having an impressive 39 years of experience between the three of them.

Johanna Uurasjarvi

Johanna Uurasjarvi was hired as Executive Creative Design Director of product design for the Anthropologie brand. She had ten years of experience at Anthropologie before leaving to start her own brand, Leifsdottir. Now that Leifsdottir has been bought by Urban Outfitter's Inc., she has returned to the Anthropologie brand as Executive Creative Design Director of product design. She led Anthropologie through some of its most profitable years and management is confident that her experienced insight will be helpful in determining product direction.

Judy Collinson

Judy Collinson was hired as Executive Director of women's apparel for the Anthropologie brand. She worked at Barney's, a luxury department store chain, for twenty years before coming to Anthropologie. During her time there, she was an extremely influential force behind creating Barney's chic image in the 1990s and 2000s. She was a huge hire for Anthropologie, bringing years of experience and success to the table. She is very familiar with the cyclical nature of the fashion industry and will be able to provide invaluable expertise in helping URBN regain its footing.

David McCreight

David McCreight was hired as the CEO for the Anthropologie brand. He was another huge hire for URBN. He had previously been appointed President of Smith and Hawken, President of Under Armour, and President of Lands' End. He had also worked as Senior Vice President of Merchandising at Lands' End and Senior Vice President and General Merchandising Manager of Disney Stores. In his new position, he will oversee Anthropologie North America, Anthropologie Europe, and BHLDN. According to Mr. Senk, Mr. McCreight "David is a powerful leader with an intimate knowledge of the women's apparel industry and a proven track record for growing multi-channel, multi-category brands."

Risks/What Signs Would Indicate We Are Wrong?

➤ **Increased Competition**

URBN is operating within the extremely competitive fashion retail industry. Local department stores, discount stores and specialty stores are all scaling up their operations. Additionally, aggressive pricing by competitors could put pressure on sales numbers and profit margins. As a result, national chains like Urban Outfitters need to increase their operational efficiency to remain competitive.

➤ **Lack of Fashion Trend**

One of URBN's strengths is its ability to react quickly to shifts in fashion trends. A combination of flexible inventory and responsive management allows for a few fashion misses to take place without severe consequences. If, however, management does a consistently poor job of predicting and reacting to these shifts, URBN could suffer. Misses result in markdowns and markdowns hurt margins.

➤ **Weakening Macroeconomy**

Due to the discretionary nature of its products, URBN is affected by consumer spending trends. Again, URBN is able to navigate through this problem due to its flexible business plan. It is able to react appropriately to shifts in customer demand quickly and cheaply. It must maintain this flexible position if it hopes to prosper in tough economic times.

Important Data Points and Trends to Monitor as We Re-Evaluate the Thesis

- Growth rates
- Profit margins
- Same-store sales
- Productivity
- Inventory Turnover