

TO: THE MCINTIRE INVESTMENT INSTITUTE, MANAGERS

FROM: MEGAN JI

SUBJECT: PIER 1 IMPORTS INC. (SHORT)

DATE: APRIL 22, 2007

Share Price as of 4/20/07 \$7.76
Shares Outstanding: 87.80 Mil
Market Capitalization: 681.30 Mil
LT Debt: 184 Mil
Enterprise Value: 698.13 Mil
52-Week Range: \$5.61-\$12.95
Float: 82.20
Short Interest: N/A
Avg. Daily Vol (3 mo): 1640230

	2003	2004	2005	2006	
Revenue (\$Mil)	1755	1868	1898	1777	
Growth	13.3%	6.5%	1.6%	(6.4%)	
EBITDA (\$B)	251.09	250.59	173.87	35.97	
Growth	N/A	(.1%)	(30.6%)	(79.3%)	
EPS (In \$)	1.04	1.36	1.29	.68	-0.46
Growth		30.7	(5.5)	(47.3)	(32.4)

Business Description:

SECTOR: Consumer Services INDUSTRY: Furniture Retail

Pier 1 Imports, Inc. is a specialty retailer of decorative home furnishings, gifts and related items. The Company imports merchandise directly from over 40 countries and sell a variety of furniture collections, decorative accessories, bed and bath products, housewares and other seasonal assortments in its stores. Pier 1 Imports, Inc. operates stores in the United States and Canada under the names, Pier 1 Imports and Pier 1 Kids. Pier 1 Kids stores sell children's home furnishings and decorative accessories. As of fiscal year ended February 25, 2006, the Company operates 1,100 Pier 1 stores in the United States and 83 Pier 1 stores in Canada, and supports five franchised stores in the United States.

Investment Thesis: I believe that Pier 1 Imports is a short because the company has being hit by a perfect storm of a sluggish home furnishings market, increased competition, and merchandising and marketing missteps. In spite of the management's attempt to turn the company around, the company's financial result continues to deteriorate, as indicated by a 3% sales decline, \$43 million in operating losses, and more than \$110 million in negative free cash flow in fiscal 2006. Because there is a tremendous amount of work to be done, I predict that Pier 1 Imports will not return to profitability in the next few years.

Investment Summary:

- **Competition.** Growing competition of imported, home furnishings from other retailers is reducing Pier 1 Import's market shares.
- **Poor Merchandise Selection.** Pier 1 Import's contemporary and high-end merchandises are alienating loyal customers and does not bringing in new ones.
- **Ineffective and Inconsistent Market Strategy.** The excessive spending on marketing does not boost sales.
- **Sluggish home markets/ Shift in consumer home-focused goods.** Customers are shifting their spending on home-furnishing goods to other digital entertainment products.
- **Managerial Issues.** A management team of more retailer background is needed to reinvigorate Pier 1 Import's brand.
- **Higher-than-expected costs.** The higher Operational and SG&A costs will furtherer reduce profit margins and returns.

Competition:

Once recognized as a niche retailer renowned for its imported merchandise, the company lost its identity when other retailers began stocking similar Pier 1 offerings. Target and Wal-Mart, are among few stores that now hawk the affordable, seemingly exotic imported furniture that once defined Pier 1

Worse yet, cheap sourcing in China are available to all competitors. As a result, consumers are gravitating away from Pier 1 and toward TJ Maxx, Target and Wal-Mart. Phil Rist, vice president of strategy for the consumer insights firm BIGresearch, say his research shows that even Pier 1's loyal customers rarely think of the store as a first choice for furniture. Instead, they'll turn to Ikea or Wal-Mart.

While Pier 1's sale starts to decline in 2003 due to increased competition from discounters, it was not until last years where the sales have fallen dramatically. In fact, the operation margin declined by 2.4% last year and by 10.4% year to date.

Poor Merchandise Selection:

Because every retailer has now gotten into imported goods, Pier 1 has attempted to regain its competitive position by adding more upscale merchandise through its new Loft 21 furniture line.

A pier 1 Import's dramatic change to its product mix has missed the mark. Bad merchandising decisions are to blame, since rivals such as Crate & Barrel and Williams-Sonoma are at least doing ok selling home furnishings and related goods. In fact, morning stars analysts are questioning if the company will be successful competing with upscale home furnishings purveyors like Williams-Sonoma and Crate and Barrel, since they are the some of the savviest retailers operating today.

Pier 1 has now reported eight straight quarterly losses as customers have resisted its modernized furniture selections and wider array of home fashions like curtains and glassware.

Ineffective , Inconsistent Market Strategy:

Throughout the years, the Company has struggled to maintain and increase customer traffic, which the Company believes was the result of its inability to differentiate its merchandise from competitors through its marketing campaign. In order to boost sales, the company has implemented new marketing strategies including new television advertisements, catalog mailings, magazine advertisements, and direct mail and Internet marketing.

Since the inception of the new marketing campaign, the cost of using various marketing technique outweighs the costs. The sale continues to decline in spite of the marketing expenditures were up \$ 16.0 million. Because of the excessive marketing cost does not boost sales, Pier 1 Imports had to discontinue its television advertising campaign.

More importantly, the ineffective and inconsistent marketing strategy is the symptom of the problem, but the cause lies in the products. Pier 1 is loaded with inventories that do not meet the needs of its customers and promotion of those products did not bring additional revenue.

Sluggish home markets/ Shift in consumer home-focused goods:

Like other retailers in its sector, the Company has continued to experience softening consumers demand. Many consumers remain concerned with the macro-economic outlook and have shifted discretionary spending to essential items. High gasoline and home heating prices have also crimped the spending power of Pier 1's largely middle-income customer base.

Add a slowing market for home furnishings, the past couple of years as consumers shifted home-focused spending to high-definition televisions and other digital entertainment products. The lack of demand for home-furnished goods will exacerbate the firm.

Managerial Issues:

Pier 1 needs a change in its top management and merchandising ranks for it to have any real chance of reinvigorating its brand and returning to sustainable, profitable growth.

Currently, the board comprises Girouard and six outside directors, only one of whom has much retail experience. If the board has a few more members with retail background, the company could make better decisions.

In February 2007, Pier 1 Imports announced the appointment of Alex Smith as president and CEO of the company. Smith was recently served as senior executive vice president of TJMAX Companies. While the move to hire a CEO from outside the company smart, there is a tremendous amount of work to be done. Until we learn more about Smith's strategy to turn the company around, our assumptions will remain unchanged.

Higher-than-expected costs:

The higher costs will further reduce profit margins and returns. Gross profit, after store occupancy costs, declined 740 basis points versus last year. Selling, general and administrative costs increased 4.5% from the same period last year primarily as a result of increased marketing expenses and the effects of unusual and other one-time charges. (The company took a charge of \$4.1 million to write down the value of its Pier 1 Kids assets, and a charge of \$6.8 million in connection with retirement plans).

While Pier 1 has made several efforts to cut costs , such as reducing its workforce by 175 positions and closing about 60 stores in the next year, the cost-cutting is at a glacial pace.

Joshua Hertz, a portfolio manager at Elliott Associates, suggested in the letter that Pier 1 close 250 to 300 stores, slash overhead expenses, lease part of its headquarters tower in Fort Worth, and he urged the company to act quickly.

"It is imperative that the company immediately focus on existing cost-cutting and restructuring initiatives in order to stem its current cash bleed," Elliott wrote.

RISKS:

- Pier 1's new Loft 21 line of upscale merchandise places the company in the crosshairs of some of the best-run home furnishings retailers, including Williams-Sonoma and Crate and Barrel. The company runs the risk of alienating what is left of its loyal customer base.
- Pier 1 is facing a loss of market shares since many companies have entered the imported-good furnishings.
- The general strength of the economy and levels of consumer spending may affect Pier 1's financial performances.
- The lack of qualified management may destroy shareholders' values.
- The increased duties or quotas to the U.S. distribution centers may reduce profit margins.
- Financial Debt could reduce long-term profitability.

VALUE-ADDED RESEARCH

Barbara Thau (senior editor for retail at Home Furnishings News)

- Said that Pier 1 Imports seem to be battling concept obsolescence
- "They had a big niche in imported goods, but now every retailer has gotten into imported goods."

Jonelle Gilden (shopper)

- Said that she now turn to T.J. Maxx, Marshall's and Target for the imported home furnishings they used to rely on Pier 1 for
- "Why would I go to Pier One when I could go to Home Goods or Marshall's or Target and get almost the same thing – and shop for many more things?"

Elizabeth Dore (shopper)

- Said that Pier 1's products have gotten better in the 15 years she's shopped there
- She finds "unique and distinct gifts, and they are not only lovely to look at, they are very practical."

Phil Rist (Vice President of Strategy for the consumer insights firm BiGresearch)

- Said that Pier 1 imports is losing its core customers when it tried to modernize its furniture selections
- "They've moved to merchandise and price points that aren't attractive to their core consumers. They have to make a decision: Who do they want to be?"

George Gutowski (author of Financial Self-Defense for Investors)

- Said that Pier 1 needs leadership or possible takeover to regain its competitive advantage
- "Fortunately the cash position is still positive, but will not be for long without immediate changes. Debt position is also manageable; what is needed is leadership. My advice is to look for a take over. The new owners will need to show up with a strategy ready to go. This will include a new management team."

Alex Smith (Operational Manager at Pier 1 Imports)

- Said that Pier 1's problem can be solved within
- "Fiscal 2007 was truly a horrible year for Pier 1. Pier 1 has been bleeding, not because of the economy, but from self-inflicted wounds, specifically a failure to evolve and adapt, and a failure to become streamlined and cost effective."

Pier 1 is no doubt as relevant today as it ever was and the chain can be returned to profitability.

Alan Rifkin (Lehman Brothers analyst)

- Said the company is taking small steps in the right direction, but he remains cautious in light of Pier 1's daunting rebuilding effort
- "Given the hefty challenge of turning around this company, we continue to believe that near-term risks outweigh benefits."

Joan Storms (Wedbush Morgan Securities analyst)

- Reiterated her hold rating on the retailer with caution on the timing of the turnaround
- "After several attempts to turn around the business, we are disappointed with the new spring assortment, marketing and traffic levels. We expect to see some turnover in other senior management positions as the new CEO formulates the turnaround strategy."

Stephen P. Brown (Chartered Financial Analyst, former equity analyst, investor, and freelance financial writer living in Brighton, Colorado)

- Discussed his reservations about Pier 1's success to remake itself
- "A Pier 1 investment will require fortitude and patience, to be sure. The company has many balls in the air, and no one is sure how they are going to land."