# Applied Investment Management (AIM) Program

## AIM Class of 2013 Equity Fund Reports
## Fall 2012

***Date: Friday, September 14, 2012 Time: 3:00 pm – 4:30 pm***
***Road Show Location: Cortina Asset Management***

| Student Presenter | Company Name | Ticker | Price | Page No. |
|---|---|---|---|---|
| Peter Lemek | Zix Corporation | ZIXI | $2.61 | 2 |
| Catie Collins | Lululemon Athletica | LULU | $75.45 | 5 |
| David Maio | Columbia Banking System | COLB | $18.50 | 8 |
| Taylor Nordmark | Destination Maternity | DEST | $18.44 | 11 |

Thank you for taking the time today and participating in the AIM 'road show' at Cortina Asset Management. These student presentations are an important element of the applied learning experience in the AIM program. The students conduct fundamental equity research and present their recommendations in written and oral format – with the goal of adding their stock to the AIM Equity Fund. Your comments and advice add considerably to their educational experience and is greatly appreciated. Today, each student will spend about 5-7 minutes presenting their formal recommendation, which is then followed by about 8-10 minutes of Q & A. Again, thank you for allowing us the opportunity to present at Cortina.

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**Zix Corporation (ZIXI)**
September 14, 2012

Peter Lemek — Information Technology

*Zix Corporation (NASDAQ: ZIXI) is a leader in providing email encryption services. ZixCorp's Email Encryption Service ensures the use of secure email for sensitive information primarily in the financial, healthcare, and government markets. This Email Encryption Service is enhanced by ZixDirectory which includes approximately 30 million members and allows for emails to be sent seamlessly across the largest email encryption community in the world. ZixCorp's service is primarily a software-as-a-service (SaaS) offering which generates 100% of its revenue through yearly subscription fees. These contracts are generally on a three year basis with a 99% completion rate, and the company has a 90% customer retention rate. The company was incorporated in Texas in 1988, renamed Zix Corporation in 2002, and has approximately 130 employees.*

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Price ($): (9/6/2012) | 2.61 | Beta: | 0.7 | FY | 2011A | 2012E | 2013E |
| Price Target: | 4.90 | WACC (%): | 10.56 | Sales (mil) | 38.15 | 41.24 | 45.37 |
| 52 week H-L($) | 3.41-2.16 | M-Term Rev Gr Rate Es | 3.62% | %Growth | 15.36% | 8.12% | 10.00% |
| Market Cap (mil): | 159.8 | M-Term EPS Gr Rate Es | 2.18% | Gross Margin(%): | 81.10% | 81.95% | 83.06% |
| Float (mil): | 57.5 | Debt/Equity: | 0 | Operating Margin(%): | 27.73% | 25.24% | 27.96% |
| Short Interest (%): | 7.51 | ROA (%): | 31.2 | EPS | 0.34 | 0.32 | 0.33 |
| Avg Daily Volume | 193,071 | ROE (%): | 43.1 | FCF/Share | 0.18 | 0.23 | 0.33 |
| Dividend ($): | 0 | | | P/E | 7.46 | 15.42 | 14.93 |
| Yield (%): | 0 | | | EV/EBITDA | 15.64 | 15.90 | 13.04 |

## Recommendation

More than 1,200 hospitals and 1,600 financial institutions, including governments, use ZIXI's services. ZixCorp differentiates itself from its competitors through its ease-of-use cloud based service which is designed to alleviate the receiver's burden of encrypted email and reduce the need for a firm's in-house IT personnel. The company's 100% subscription based model significantly reduces short-term debt while allowing for a high level of visibility and predictability. Adding to relatively low short term risk is a wide, diversified customer base of 7,000 corporate customers with no customer accounting for more than 2% of sales, and their 1.8 million end users breaks down to $23/user/year. During the company's recent quarter filings, new first year orders (NFYO's) reached a record $2.5 million, a 22% Q2 y/y growth. This increase reflects a broad based increase in demand for email encryption and opportunities to replace outdated solutions. ZIXI has solid revenue CAGR of 9.61% over the past five years with expectations to surpass this growth rate in the future due to a record backlog of $55.5 million reported in 2012 Q2. A low level of debt on the books contributes to management's ability to almost double R&D expenses in 2012 in order to increase the company's exposure to emerging markets. It is recommended that ZIXI be added to the AIM Domestic Equity fund at a target price of $4.90, an upside of 87%.

## Investment Thesis

- **Growth in Cyber-Security Markets.** In 2012, Gartner estimates that total worldwide market for data loss prevention (DLP) is over $500 million and estimated to grow at 25% per year. The best current defense against information phishing threats is outbound email data loss prevention (DLP) capabilities which monitor the "edge" of enterprise networks and make sure data leaks are not occurring. ZIXI is positioning itself to capitalize on this growth opportunity and has increased R&D expenses by 25% in this growing area and plans on selling DLP as an add-on to their current email encryption service. Also with the demise of the security comfort of Blackberry, corporations are shifting to a bring-your-own-device (BYOD) policy for employees creating a new Mobile Device Management market. This market is also expected to be $500 million in 2012 with 20% y/y growth. In March 2011, ZixMobility was introduced to combat email security threats particularly aimed at iPhone and Android devices. Prior to this easy to use technology, no mobile email encryption platform allowed seamless transparency for encrypted email on their mobile devices, and in 2012, about 75% of increase R&D went to further mobile email encryption development.

- **Increase in Regulations.** ZixCorp has gained added market penetration, particularly in its targeted vertical markets of healthcare, finance, and government, through significant increased regulations. ZIXI plans to continue to capitalize on increased email encryption regulations in government legislation such as the federal HITECH Act of 2009, requiring healthcare services have stricter patient security rules, and state regulations, such as Massachusetts' 2010 legislation requiring businesses to have comprehensive encryption requirements. Even when there is a lack of government intervention, corporations and industry standards are increasingly requiring comprehensive email encryptions for sensitive data and information.

**Valuation**

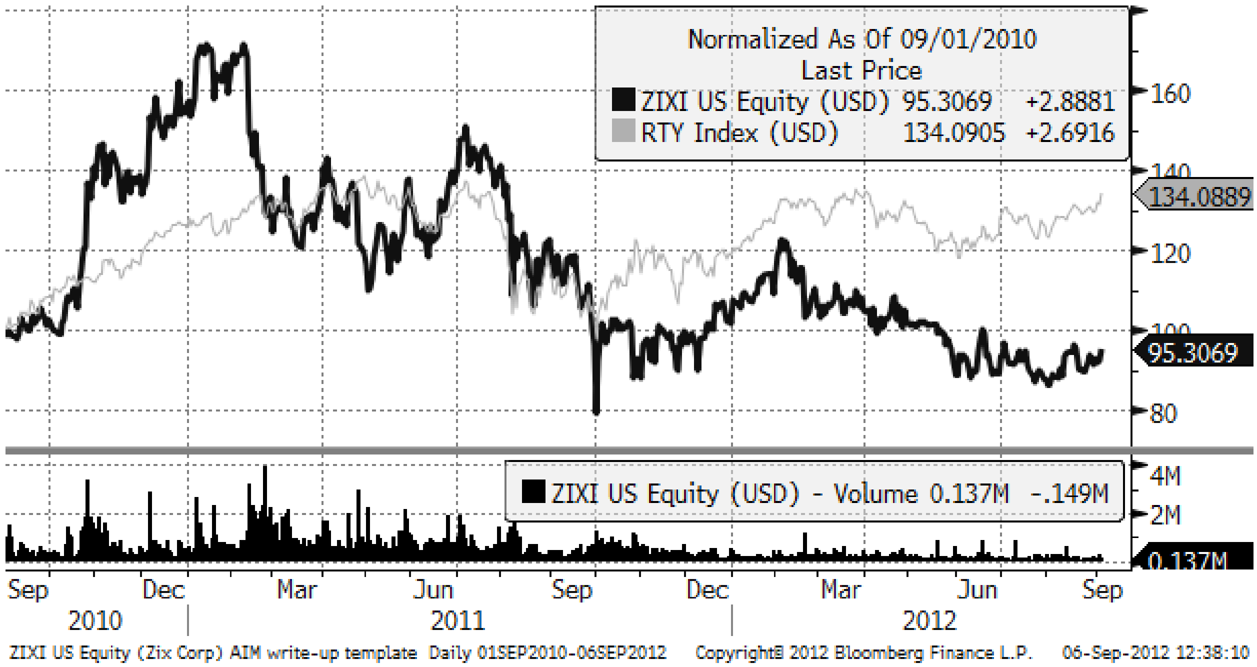
To find an intrinsic value of ZIXI, a five-year DCF model was constructed. Sales and earnings growth rates were varied according to management and economic outlooks concerning the company's subscriptions and backlog. The firm's current WACC of 10.56% was given a 300bps risk premium and used as a discount rate along with a 3% perpetuity growth rate to arrive at a value of $7.84. A sensitivity analysis was conducted varying the discount rate and the growth rate which yielded a low of $5.98 and a high of $7.84. Along with the DCF, an EV/Sales multiple was determined by dividing the company's historical EV by historical Sales to return a multiple of 5.8X and a price of $1.96. A 50/50 mix of DCF to EV/Sales yielded an intrinsic value of $4.90, an upside of 87%.

**Risks**

- **Encryption Key Integrity.** An obvious risk to ZixCorp's business model is their reliance on a public key cryptography technology used to encrypt and decrypt messages. This key is predicated to be very difficult to break mathematically, but fast-paced changes in technology and hacker sophistication could put this key at risk in the future. If the code was to be cracked and the company's cloud email database compromised, it would be detrimental to the business, so a 300bps premium was added to the discount rate.
- **Reliance on Third Party Contributors.** ZixCorp sells their Email Encryption Service through a direct sales force, a telesales force, and network of resellers and other distribution partners. NFYO's derived from third party resellers accounted for 52% of total NFYO's with Google representing 15% of those orders. Failure to maintain profitable marketing alliances with these third party members could negatively affect their business model and growth of new sales and customers.
- **Competitors.** ZixCorp faces a significant amount of competition from both large and small competitors. Rivals are often larger with a wider variety of supportive products and services. Also, barriers to entry into an ever-changing market place are low.

**Management**

Mr. Richard Spurr is the current CEO, Chairman of the Board, and COO for ZixCorp. Mr. Spurr joined the company as President and COO in 2004. He has over 30 years of global IT experience with IBM and two start-up companies, SEER Technologies and Entrust, which he successfully brought to IPOs. Mr. Michael English is the firm's CFO and joined the company in 2007. Mr. English is a CPA, and he brought over 30 years of finance and accounting experience to the company. He received his masters in accountancy from DePaul University.




## Ownership

| | |
|---|---|
| % of Shares held by All Insider and 5% Owners: | 12% |
| % of Shares Held by Institutional & Mutual Fund Owners: | 45% |

Source: Yahoo! Finance

## Top 5 Shareholders

| Holder | Shares | % Outstanding |
|---|---|---|
| Perimeter Capital Partners LLC | 2,077,878 | 3.39 |
| BlackRock Institutional Trust Company | 2,008,690 | 3.28 |
| MIG Capital, LLC | 1,858,108 | 3.03 |
| Stephens Investment Management Group | 1,805,305 | 2.95 |
| Vanguard Group, Inc. | 1,575,270 | 2.57 |

Source: Yahoo! Finance

**Lululemon Athletica Inc. (LULU)**
September 14, 2012

Catie Collins International Consumer Discretionary

*Lululemon Athletica Inc., together with its subsidiaries, designs, manufactures, and distributes quality athletic apparel for women, men, and female youth. Their comprehensive product line includes fitness pants, shorts, tops, and jackets along with accessories such as bags, yoga mats, and instructional yoga DVD's that promote healthy living and general fitness. LULU operates under three main business segments with 189 corporate-owned stores (82%), a direct to consumer e-commerce website (11%), and a network of wholesale channels (8%). LULU maintains diversified sales throughout the United States (60%), Canada (35%), Australia and New Zealand (5%). This annual growth is the direct result of LULU's unique position within the retail industry and their elite status over other athletic brands. LULU was founded in 1998 and is headquartered in Vancouver, Canada where they distribute their products. They have over 6,000 worldwide employees.*

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Price (09/07/12) ($): | 75.45 | Beta: | 1.44 | FY: Jan 31 | 2012A | 2013E | 2014E |
| Price Target ($): | 98.70 | WACC | 11.33% | Revenue ($, M) | $1,001 | $1,345 | $1,846 |
| 52WK H-L ($): | 81.09-41.70 | M-Term Rev. Gr Rate Est: | 55.0% | % Growth | 41% | 57% | 60% |
| Market Cap ($, B): | 9.87 | M-Term EPS Gr Rate Est: | 60.0% | Gross Margin | 56.88% | 54.00% | 54.00% |
| Float (M): | 101.11 | Debt/Equity: | 0.0% | Operating Margin | 28.62% | 24.00% | 24.00% |
| Short Interest: | 7.20% | ROA: | 29.07% | EPS (Cal) | $1.29 | $2.29 | $3.09 |
| Avg. Daily Vol (M): | 5.02 | ROE: | 36.98% | FCF/Share | 0.86 | 2.15 | 3.10 |
| Dividend: | N/A | Financial Leverage | 1.24x | P/E (Cal) | 50.49 | 46.23 | 36.85 |
| Yield: | N/A | | | EV/EBITDA | 23.45 | 26.00 | 20.53 |

## Recommendation:

Since their inception in 1998, LULU has completely transformed into a strategically innovative corporation, balancing short and long term growth with outstanding operational performance and financial advancement. Exceeding the industry average of 17.6% revenue growth, LULU reported 1Q12 revenue growth of 53% on a YoY basis. LULU has consistently maintained a debt-to-equity ratio of zero since 2006, alongside net operating cash flow which increased by 182% when compared to 1Q11. Alongside its solid financial position, LULU is well positioned to ward off competition and support its operations in future. With expansion into overseas markets, the extension of their female youth dance apparel (Ivivva) and category development into tennis, volleyball, and swimming apparel, LULU will tap into new and fresh markets, retaining high profit margins. With a long runway ahead of them, and a recent comparable same store sales growth of 15% in 2Q12, 35 new retail locations are expected to be released by the end of fiscal year 2012. This will allow the current $2,400 in sales per square foot of retail space to drastically increase, maintaining LULU’s retail business model that competitors cannot mimic. As a result of the favorable trends and strong profitability, it is recommended that LULU be added to the AIM International Equity Fund with a price target of $99, representing a 31% upside.

## Investment Thesis:

- **International Expansion.** With a limited presence in the market compared to competitors, LULU continuously places their retail stores in top-tier cities, while tactically planting seeds globally as well. In April 2012, LULU opened their first showroom in London. This site has already outperformed its other original showrooms placed in the U.S. and similar performance is expected for the new Hong Kong showroom opening next month. With 179% e-commerce growth in 1Q12, LULU is furthering this expansion with country specific web pages as well as the election of Jerry Stritzke, the COO of Coach, to LULU's board of directors. His experience and innovative vision will significantly aide management in expanding their cult-like following and high end equipment across the nation.

- **Brand Loyalty and High Technology Products.** LULU consumers pay a premium for what they consider to be not just products, but a lifestyle. Management has strategically built this brand name through limited inventory levels, avoiding markdowns and brand availability. LULU has turned their athletic symbol into a fashion icon through their functional designs and technical fabrics. This functionality is accredited to their Silverscent technology, which incorporates silver directly into the fabric to reduce odors. Along with Luon fabric, designed to wick away moisture, move with the body, and reduce irritation. This fabric is exclusively imported from Taiwan.
- **Rapid Expansion of the Yoga Industry.** With the percentage of people practicing yoga increasing 20-25% each year, the holistic exercise of yoga is advancing around the world. In 2001, 4.3 million people in the United States alone practiced yoga. Ten years later, this number had risen to 14.3 million. This growth is an international phenomenon as well. With 60 studios in Hong Kong, the largest chain, Pure Yoga, has an estimated 18,000 members. In Singapore, an estimated 55,000 people practice yoga at least once a week – a large number in a country of only 4 million people. Currently, yoga is the fastest growing sport in America and it is anticipated that this rapid expansion will soon be replicated internationally as well.

**Valuation**

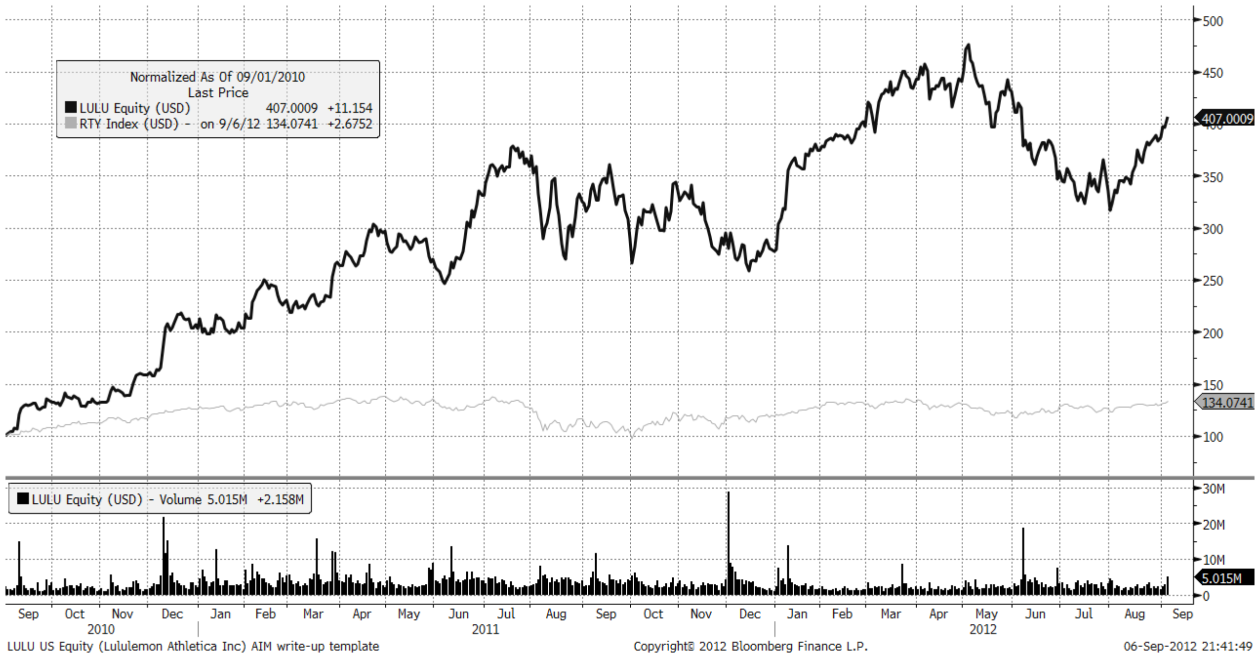
LULU was valued via a five-year DCF analysis in combination with an EV/EBITDA multiple. Based on a WACC of 11.33% and 3% terminal growth rate, the DCF analysis yielded an intrinsic value of $110.32 In addition, a 23X EV/EBITDA multiple approach was used, generating an intrinsic value of $87.08. Weighing the two values 50/50, a price target of $99 was established, representing a 31% upside.

**Risks**

- **Aligning Supply Needs with Growing Demand.** Since fiscal 2004, net revenue has increased from $40.7 million to $1,000.8 million in fiscal 2011. This is attributed to LULU's ongoing commitment to low turnover rates and long term, flagship products. If operations continue to grow at this pace LULU may experience difficulties in acquiring raw materials and manufacturing capacity, as well as delays in production and shipments. This would require the expansion of distribution functions, retail space and an added workforce. These difficulties could result in the erosion of brand image, adversely effecting financial condition.
- **Reliance on Third-Party Suppliers.** Due to their persistent commitment to high quality garments, many of LULU's specialty fabrics used in their products are technically advanced textile products developed and manufactured by third parties. These may be available, in the short term, from a very limited number of sources. LULU has no long term contracts with their suppliers and the intellectual property rights in the technology, fabrics and processes used to manufacture their products are owned by their suppliers and are not patented by LULU.
- **Seasonality.** LULU is affected by the seasonal trends common to the retail apparel industry. Net sales are weighted substantially toward the fourth fiscal quarter, reflecting the increase in sales during the holiday season. This directly causes results of operations to fluctuate, and as a result comparison of operating results between quarters within a fiscal year may not necessarily be meaningful or indicative of the results expected for future periods.

**Management**

Christine Day has been CEO of LULU since June 2008. Prior to LULU, Christine spent 20 years at Starbucks. John Currie has served as Executive VP and CFO since 2007. Prior to joining LULU, Currie was CFO of Intrawest Corporation, a world leader in destination resorts and leisure travel.




## Ownership

| | |
|---|---|
| % of Shares Held by All Insider and 5% Owners: | 10% |
| % of Shares Held by Institutional & Mutual Fund Owners: | >90% |

Source: Bloomberg

## Top 5 Shareholders

| Holder | Shares | % Out |
|---|---|---|
| Fidelity Management & Research Company | 16,049,169 | 14.75 |
| Capital World Investors | 12,454,500 | 11.45 |
| Jennison Associates LLC | 12,069,401 | 11.09 |
| Wilson (Dennis J) | 10,502,199 | 9.65 |
| Columbia Wanger Asset Management, LLC | 6,331,200 | 5.82 |

Source: Bloomberg

**Columbia Banking System, Inc. (COLB)**

September 14, 2012

David Maio Financials

*Columbia Banking System, Inc. (NASDAQ: COLB) is the bank holding company for Columbia State Bank, which provides banking services and products to small and medium-sized businesses, professionals, and individuals. Columbia offers the typical wide range of products and services provided by community banks. The majority of loans on the bank's balance sheet are commercial real estate and commercial business loans, respectively making up 42% and 46% of the loan portfolio. The company has 102 different branch locations with 77 in Washington and the remaining 25 branches in Oregon under the name "Bank of Astoria". COLB has acquired assets from 5 different banks over the past three years that were all facilitated by the FDIC. Covered loans on the balance sheet as of June 31 were $463 million, which accounts for16% of total loans. As of June 31, 2012 total assets were $4.8 billion, loans were $2.8 billion, and total deposits were $3.8 billion. The company was founded in 1988 and is headquartered in Tacoma, Washington with 1,256 employees.*

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| Price ($): (09/06/12) | $18.50 | Beta: | 1.22 | FY: Jan | 2011A | 2012E | 2013E |
| Price Target ($): | $23.47 | WACC: | 10.60% | Revenue (mil): | 228.57 | 266.68 | 266.30 |
| 52WK H-L ($): | 23.09-13.00 | M-Term Rev. Gr Rate Est: | 0.00% | % Growth | 10.02% | 16.67% | -0.02% |
| Market Cap (mil): | 745.12 | M-Term EPS Gr Rate Est: | 20.60% | ROE | 6.55% | 5.78% | 6.01% |
| Float (mil): | 38.9 | Debt/Equity: | 18.21% | EPS (Cal) | $1.18 | $1.14 | $1.19 |
| Short Interest (%): | 4.61% | ROA: | 1.18% | BVPS | $19.22 | $19.73 | $20.58 |
| Avg. Daily Vol: | 167,967 | ROE: | 6.55% | P/B | 0.96x | 1.00x | 1.02x |
| Dividend ($): | $0.36 | NIM: | 5.88% | NIM | 5.88% | 5.83% | 5.52% |
| Yield (%): | 1.95% | Tier 1 Capital Ratio | 19.79% | | | | |

## Recommendation

COLB has set itself up in a favorable position to move forward once the U.S. economy begins to gain more confidence and sustained growth. Columbia has been a darling of the FDIC during the past three years, being chosen to acquire assets from five different banks facilitated by the FDIC. This has led their loan portfolio to have one of the country's strongest NIM (5.88%), while other banks have struggled to maintain their NIM (peer average 3.77%). In addition, since these loans are facilitated by the FDIC, they are "covered" loans, reducing the non-performing risk to carrying high-yielding loans. Beyond that, COLB has been able to organically grow their non-covered loans at 3% QoQ and 15% YoY in 2Q2012. Management has stated it intends to be active in M&A in the near future when the right opportunity presents itself to expand its market share in the Northwest region. That being said, management has proven to be patient in waiting for the right opportunity by giving out a "special dividend" (ranging from $.05-$.21 per share) the past 3 quarters with their excess cash over their regular quarterly dividend ($.09), returning the excess cash straight to the shareholders. For such reasons, it is recommended that COLB be added to the AIM Equity Fund with a price target of $23.47, representing a 24.5% upside.

## Investment Thesis

- **Continued Expansion:** COLB has been a favorite of the FDIC since the financial crisis began. They have acquired assets from five regional banks facilitated with the loans covered by the FDIC. These acquisitions have had a positive impact on the bank's NII, since the non-performing loans are partially covered by the FDIC, liability is contained and loans yield above normal levels. Management has stated they are actively looking for M&A possibilities at the right price. They have been giving out "special dividends" the past 3 quarters with their excess cash but have stated these should not be expected going forward as that money will be used towards expansion. Between being on the FDIC's radar for failing banks and actively pursuing M&A opportunities, there is good reason to believe COLB will increase its market share in the coming years.

- **Solid Organic Loan Growth:** COLB has organically been able to grow loans on its non-covered portfolio at a rate and consistency exceeding their competitors (11% vs. national community bank average 2.25% YoY). In a tough environment last quarter for lenders to small businesses, many of which waiting for the election and European situation to be resolved before beginning new projects, the bank found a 3% growth in newly originated loans. Speaking for the consistency of their organic growth, the bank has increased the non-covered loan portfolio 9% in geometric growth the past five years.
- **Northwest Banking Economy:** COLB is in an attractive market in the near term. Their concentrated location in the Puget Sound region covers 62% of Washington's 7 million population. Employment in the area appears to be on the rebound. Boeing has added 7,000 workers to the Seattle area in the past year. In addition, Amazon recently announced that they would be adding one million square feet to their facility in Seattle, which is expected to double their current 8,000 person workforce in their downtown office. Population increases in metro areas bode well for Columbia, as they are very active in the multifamily loan segment.

**Valuation**

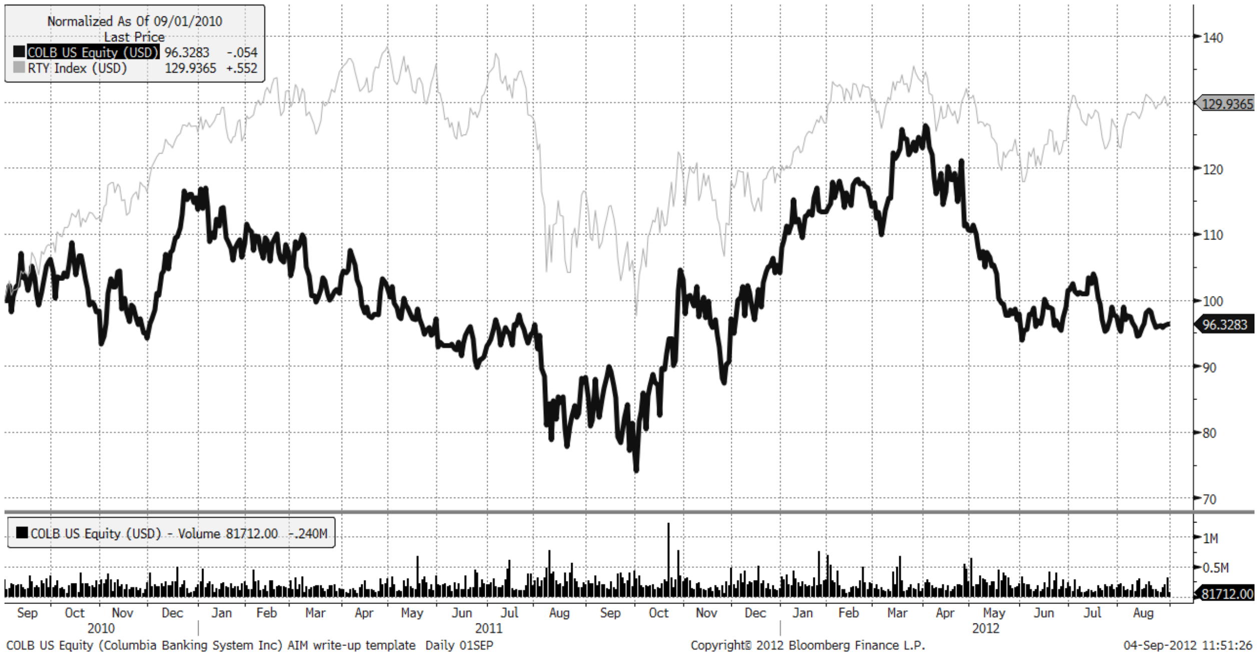
To find the intrinsic value of COLB, a price-to-book multiple was used. Due to the uncertainty of continued "special dividends" and future M&A activity, price-to-book was the single best valuation metric applicable to this particular bank. With a 5 year average P/B of 1.07x and a Bloomberg peer average of 1.21x weighted 50% each, a multiple of 1.14x was reached. Applying this multiple to expected 2013 BVPS of 20.59 yielded an intrinsic value of $23.47, representing an upside of 24.5%. The company paid a $0.36 dividend last year, yielding 1.95%.

**Risks**

- **Interest Rate Environment:** The current low interest rate environment has adversely affected many banks as it has made loan pricing lower and hence tightened bank's net interest margin. Ben Bernanke recently commented he expected to keep short term interest rates near zero until at least late 2014. These low rates will continue to compress bank's net interest margin as loans continued to be originated at low levels. In addition, increases in the interest rates could adversely affect COLB's ability to originate new loans as well as affect the ability of current floating-rate borrowers to meet their payments, causing an increase in nonperforming assets.
- **Loan Portfolio Mix:** COLB is highly concentrated in commercial real estate and commercial business loans, generally viewed as having a higher default risk than many other loan types. If a further downturn in the economy or real estate value in the Pacific Northwest occurred, it could affect the borrower's ability to repay and in turn the diminished value on the collateral behind the loan could cause an inability to recover on the defaulted loans.
- **Increasing Regulatory Costs:** With the increased regulation and requirements being placed on banks it has raised costs across the board in terms of hiring employees to comply with the new requirements, such as "Stress Tests". Since COLB is a smaller community bank, these costs have not yet been applied to them but the marginal costs of hiring extra employees could affect earnings more than it will for the larger scale banks.

**Management**

Melanie Dressel, 59 years old, has served as CEO of COLB since February of 2003, as well as being President and CEO of Columbia State Bank, the largest subsidiary of COLB, since 2000. She has worked for COLB in some senior management position since 1993. She was named one of the 25 most powerful women by U.S. Banker magazine for three consecutive years in the mid 2000's. Melanie also currently serves on the board for the American Bankers Association. On August 28th, COLB named Clint Stein to CFO after the retirement of Gary Schminkey.




Source: Bloomberg

**Ownership**

| | |
|---|---|
| % of Shares Held by All Insider and 5% Owners: | 2% |
| % of Shares Held by Institutional & Mutual Fund Owners: | 95% |

Source: Bloomberg

**Top 5 Shareholders**

| Holder | Shares | % Out |
|---|---|---|
| Lord Abbett & CO | 2,966,426 | 7.48 |
| Vanguard Group, Inc. | 2,189,845 | 5.52 |
| Dimensional Fund Advisors LP | 1,798,404 | 4.53 |
| Price (T. Rowe) Associates, Inc. | 1,682,990 | 4.24 |
| BlackRock Fund Advisors | 1,678,121 | 4.23 |

Source: Bloomberg

**Destination Maternity Corporation (DEST)**

September 14, 2012

Taylor Nordmark — Consumer Discretionary

*Destination Maternity Corp. is the leading designer and retailer of maternity apparel in North America and the only nationwide chain of maternity specialty stores. The company sells its merchandise in 636 company-owned locations in the U.S. and Canada, 1,380 leased departments within domestic retailers, and through e-commerce platforms with separate American and Canadian URL's. DEST also sells its apparel outside of North America through licensed franchise agreements, in shop-in-shop locations, and through an e-commerce platform available in South Korea. DEST offers a wide variety of multi-seasonal apparel ranging from value to luxury price points. The company sells its merchandise under four brands: Motherhood Maternity, A Pea in the Pod, Two Hearts Maternity, and Oh Baby by Motherhood. Destination Maternity was founded in 1982 and is based in Philadelphia, PA.*

| | | | | FY September | 2011A | 2012E | 2013E |
|---|---|---|---|---|---|---|---|
| Price ($) (9/6/2012): | $ 18.44 | Beta: | 1.49 | | | | |
| Price Target ($): | $ 20.82 | WACC: | 12.48% | Revenue ($Mil) | $545.39 | $542.00 | $545.00 |
| 52WK H-L ($): | 12.17 - 22.53 | Debt/Equity: | 15% | % Growth | 2.67% | -0.62% | 0.55% |
| Market Cap (mil): | $ 248.17 | 2011 ROE: | 28% | Gross Margin (%): | 54.00% | 52.50% | 52.25% |
| Float (mil): | 13.042 | 2011 ROA: | 11% | Operating Margin (%): | 7.00% | 4.80% | 4.08% |
| Short Interest (%): | 3.5% | Mid-term Rev Gr Rate Est (2-3 yr) | 2% | EPS | $ 1.70 | $ 1.09 | $ 0.89 |
| Avg. Vol (3 month): | 138,072 | Mid-Term EPS Gr Rate Est (2-3 yr) | 5% | EPS % Growth | 23% | -36% | -18% |
| Yield (%) | 3.8% | EV/EBITDA | 5.54 | P/E (Cal) | 10.85 | 23.39 | 13.70 |

**Recommendation**

Despite this being one of the most adverse environments the firm has ever faced, both in terms of the weak economy and a depressed birth rate, DEST's management has shown resolve in finding ways to return to profitability after an extremely challenging three-year period. From 2007 to 2009, DEST posted an average annual EPS loss of -$1.19 with sales dropping an average of -4% each year. The firm bounced back in 2010 ($1.33 EPS) and 2011 ($1.75 EPS) and posted two of the most profitable years in its history, largely due to a much improved business model. DEST is in its third year of the transition to a strategy that is based on a reduction in number of stores, an increase in average sales per store, and a push towards more online-based business (with on-line sales up 30% on the year). As a result, margins have improved as costs have been drastically cut and inventory remains lean. While 2012 has been somewhat of a disappointment, the company missed guidance by more than 10% for the 9-months ended June 30, DEST is still well-positioned to continue and expand its profitability. Top and bottom line results may decline in coming quarters as the company continues its transition, but the efficiencies of this new model will translate to increasing profitability in coming years, making DEST an attractive addition to the portfolio.

**Investment Thesis**

- **Increased Operational Efficiency from Consolidating Locations.** DEST has achieved success in closing or pruning unproductive locations and opening up multi-brand superstores which tend to offer a more diverse set of products and services at multiple price ranges. Some of the services offered include facials, massages, body treatments, and workout classes. In addition to promoting products with higher margins, the consolidation of smaller, less-efficient stores leads to reduced operating expense percentages through economies of scale. Typically, two smaller locations are closed to open a larger store in a geographic area, and the firm has enjoyed better overall sales in past consolidations. From 2005 through fiscal 2011, DEST closed 117 stores in connection with the opening of Destination Maternity nameplate stores and for 2013, management aims to open 2-5 superstores and 4-7 multi-brand stores while closing 25-40 underperforming stores.
- **Increased Penetration into Foreign Markets.** Currently, the firm derives roughly 90% of its revenue in the US. It has been successful in building and expanding its operations in foreign countries through franchising and licensing, and in 2012 it opened its first Destination Maternity nameplate store in India with its partner Mahindra Retail. DEST has consistently expanded its

locations overseas over the past three years, as opposed to its domestic store count which has been reduced by roughly 50 stores annually. If DEST can continue to execute its plan to grow overseas and gain acceptance in these foreign markets, sales growth will inevitably follow. India has roughly three times the population of the US and has a birth rate that is 50% higher. With only modest adoption rates of DEST's apparel, the positive impact on sales would be apparent.

- **Additional Celebrity Licensing Agreement.** In the past, Destination Maternity has found success teaming up with high profile celebrities like Heidi Klum and Nicole Richie to release signature fashion lines. In June the company announced that it had signed a licensing agreement with music star Jessica Simpson for her own line which will hit stores in the fall.

**Valuation**

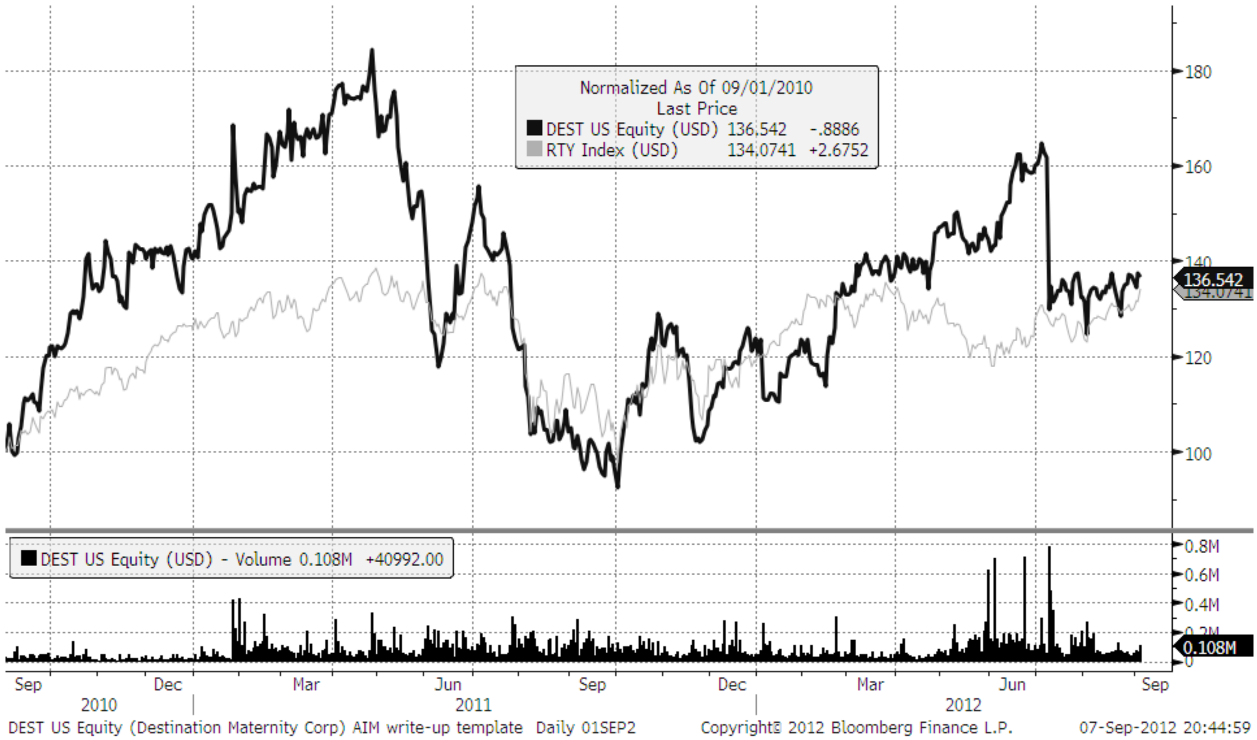
To find the intrinsic value of DEST, a five-year DCF using a computed WACC of 12.47% was performed to yield an intrinsic value of 23.24. Additionally, an industry average P/E multiple of 14 was applied to forward EPS of $1.09 equaling a value of $15.26; a multiple of 14 was obtained by computing the 5-year average P/E of its four most similar competitors. Finally, a sensitivity analysis was applied with the WACC and terminal growth rate varying 8-15% and 1-3% respectively to yield $27.08. The three approaches were then weighted 40%, 40%, and 20% respectively to obtain an intrinsic value of $20.82. This offers an upside of approximately 13% and the firm pays an annual dividend of $0.70 (3.8% yield).

**Risks**

- **Unattractive Birth Rate Trend in United States.** The number of births in the US hit an all-time high of 4,316,233 in 2007. Since that record year, the birth rate has dropped to its lowest in 25 years; this significant drop in births is likely due, at least in some part, to the weakening economy as couples postpone pregnancy for more certain times financially. To quantify the trend, the birth rate has dropped almost 20% from around 17 births per thousand women in 1992 to a meek 14 births per thousand women. This is an obvious negative trend for DEST as it reduces the number of potential customers; however, the company has remained profitable throughout the downturn and looks to improve top-line results as the recovery progresses.
- **Lack of Barriers to Entry.** DEST's ability to maintain its healthy gross margin is subject to pricing competition and their ability to defend their position as having the exclusive brand of maternity apparel within the stores in which they have licensed agreements in place. In each of the department stores they sell merchandise in, which includes Bloomingdales, Macy's, Kohl's, Gordman's and Sears, their products are the only maternity apparel carried. If the exclusivity clause in these agreements were to expire, their sales could be negatively impacted as competing brands would likely enter. The company has stated that its relationships with these retailers are in good condition.

**Management**

Edward Krell is the CEO of Destination Maternity. He has served as senior executive for ten years and has over 25 years of business experience encompassing apparel, retail, and finance. He holds an MBA from Stanford University and a BBA from Harvard University. Prior to entering the apparel industry with London Fog as CFO, he worked as an investment banker for Kidder, Peabody & Co. In 2010, Mr. Krell was named Citizen of the Year by March of Dimes. Chris Daniel is the president of the firm; Chris has over 20 years of women's apparel merchandising experience.




**Ownership**

| | |
|---|---|
| % of Shares Held by All Insider and 5% Owners: | 8% |
| % of Shares Held by Institutional & Mutual Fund Owners: | 88% |

Source: Yahoo! Finance

**Top 5 Shareholders**

| Holder | Shares | % Out |
|---|---|---|
| MILL ROAD CAPITAL LP | 1,302,126 | 9.74 |
| WELLINGTON CAPITAL MANAGEMENT LLP | 1,210,402 | 9.05 |
| FMR LLC | 794,895 | 5.94 |
| RENAISSANCE TECHNOLOGIES LLC | 767,500 | 5.74 |
| BERWYN FUNDS, THE-BERWYN INCOME FUND | 680,818 | 5.09 |

Source: Yahoo! Finance