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Independent Equity Research

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SNAPSHOT RESEARCH REPORT
Pacific Sunwear of California, Inc. (PSUN)

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Snapshot
Industry
Apparel Stores
Recent Price
$23.06
Exchange
Nasdaq
52 Week Range
$17 to $29
Market Cap
$1.7 Billion
Shares Outstanding
75 Million
Float
67 Million
Avg Volume (3 Month)
1.8 Million
Fiscal Year Ends
January
Latest Year Sales
$1.2 Billion
Latest Year Profit
$107 Million
Latest Year End Cash
$144 Million
EPS FY04
$1.38

Investment Highlights

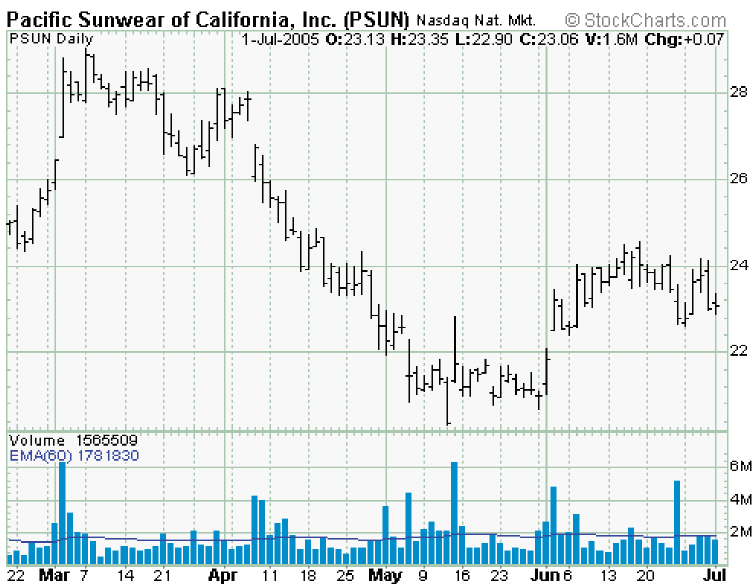
Pacific Sunwear of California, Inc. (PacSun) is a leading specialty retailer of everyday casual apparel, accessories, and footwear for teens and young adults. Highlights include ...

- **Proven Success.** The company is the dominant player in the board-sport inspired retail apparel market with 4 year historical CAGRs (compound annual growth rates) of 20% sales, 28% operating income, and 28% net income.
- **Good Store Expansion.** The company is on track to have 1,110 stores and 3.9 million square feet of store space in operation by year-end. The company also plans to introduce a new store concept in FY05. The company's store portfolio provides excellent platform support for its growth strategy.
- **Merchandising: A Good Mix.** PacSun and PacSun Outlets offer a broad array of board-inspired casual apparel, accessories, and footwear. d.e.m.o. stores offer a similar array of hip-hop inspired products. Both store concepts want to be the dominant "lifestyle" retailer for men ("boys") and women ("girls") roughly between the ages of 12 and 24.
- **Great Brands.** The company offers many of the biggest brand names around. For PacSun, that includes Quiksilver/Roxy/DC Shoes, Billabong/Element, Hurley and Volcom. For d.e.m.o., their brand names boast such labels as Ecko, Phat Farm/Baby Phat, and Apple Bottoms.
- **Seasoned Management.** The company is headed by a seasoned management team, including CEO Seth Johnson. Although no longer CEO, PacSun veteran Greg Weaver remains as Executive Chairman of the Board.
- **Risks.** The teen/young adult apparel market is notoriously fickle. Please read about these and other risks in the "Risks" section.
- **Disclosures.** This report contains important disclosures. Please read them thoroughly.

Profile

Pacific Sunwear of California, Inc. -- incorporated in August, 1982 -- is a leading specialty retailer of everyday causal apparel, accessories and footwear targeting the active teen and young adult market. The company operates three mall-based, nationwide retail apparel formats: Pacific Sunwear/PacSun, Pacific Sunwear Outlets/PacSun Outlets, and d.e.m.o.

PacSun and PacSun Outlets carry products based in the company's surf and board-sport inspired roots. d.e.m.o. carries products inspired by the hip hop, urban lifestyle.



Both concepts cater to men ("boys") and women ("girls") roughly between the ages of 12 and 24. The company also runs websites for its PacSun concept (www.pacsun.com) and d.e.m.o. concept (www.demostores.com). Both sites offer a broad array of apparel, footwear, and accessories. In addition, PacSun website visitors can login to a variety of "lifestyle" content areas that promote the board-sport inspired and include music, downloads, and contests.

PacSun and d.e.m.o. stores offer a lively, fun, and accessible shopping experience. From music to interior design, the stores fit the lifestyles they promote. The company merchandise model pushes "fashion" and not "fads," with considerable time spent with focus groups, manager feedback, and simple listening. Customer service is attentive but non-intrusive. As of the end of the first fiscal quarter 2005 ending 4-30-05 (FQ105) the company operated 1,013 stores, including 754 PacSun stores, 86 PacSun Outlets, and 173 d.e.m.o. stores. By the end of fiscal 2005 on 1-28-06 (FY05), the company should have about 1,110 stores in operation.

PacSun offers a wide array of board-inspired brands including such surf apparel icons as Quiksilver/Roxy, Billabong, and Volcom. d.e.m.o. offers equally popular brands like Ecko, Phat Farm/Baby Phat, and Apple Bottoms. The company also offers its own, typically higher-margin, proprietary brands.

As of the end of FY04, the company produced $1.2 billion in sales, $170 million in operating income, and $107 million in net income. Cash flow from operations was $143 million and the company had $144 million in cash on hand with no debt.

Stores and Products

PacSun Stores Reach Far and Deep

From 11 stores in California in 1986 to 990 the stores across the U.S. as of the end of FY04, PacSun has undertaken aggressive, but manageable, store expansion.

Store Expansion Continues

During FY04, the company opened 113 net stores and plans to open another 120 net new stores during FY05, capping a string of store expansions:

As of the end of FQ105, the company operated 1,013 stores, on pace to meet its 1,110 goal by the end of FY05. As of the end of FY04, the company has successfully executed about 70% of the leases needed to meet that goal.

Merchandising: A Good Mix

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The company offers many of the biggest brand names around. For PacSun, that includes Quiksilver/Roxy/DC Shoes, Billabong/Element, Hurley and Volcom. For d.e.m.o., their brand names boast such labels as Ecko, Phat Farm/Baby Phat, and Apple Bottoms.

The company limits its significant vendor concentrations. During FY04, Quiksilver made up 10.9% of sales and Billabong accounted for 9.4%. No other branded vendor made up more than 4%, which is a big positive.

Proprietary Brands are Key

The company enhances its branded vendor offerings with its own proprietary brands. PacSun's proprietary brands ...

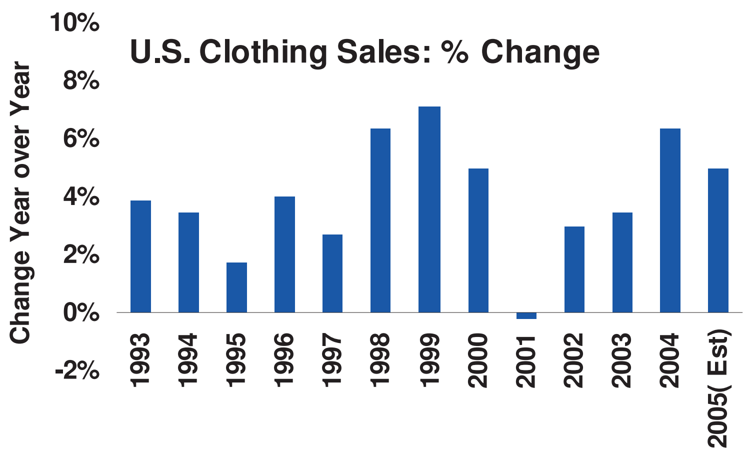
- Typically carry higher margins than vendor products
- Offer better merchandise flow-control
- Broaden customer reach with comparable quality products at lower prices
- Give management improved agility to respond to shifting styles and tastes

Market Opportunity

U.S. Clothing: A $199 Billion Market

Clothing sales in the U.S. tipped the scales at $190 billion during 2004. That's a 6.4% increase over 2003 and marks a solid reversal from the bleak days of 2001. In 2005, we expect the trend to continue, albeit at a more moderate 5% pace, and increase the U.S. clothing market to $199 billion. Currently, teens spend about $21 billion on clothing, according to the NPD Group. So, from both a broad and focused perspective, PacSun has a massive market opportunity.

Successful Surf-related IPOs



Also providing lift to the market is the recent successful debuts of surfwear-maker Volcom and extreme sports retailer Zumiez. In fact, the extreme sports space -- once only a niche market -- is quickly becoming a burgeoning mainstream play. And apparel -- rather than hardlines like boards and equipment -- are likely going to lead the charge.

PacSun's Growth Strategy

PacSun's primary goal is simple: Become the leading lifestyle retailer of casual fashion for teens and young adults. The company offers apparel, footwear, and accessories for young men and women between the ages of 12 and 24. In essence, PacSun wants to offer a complete wardrobe solution for young people wanting to stay ahead of board-sport inspired fashion trends. And so far, the company has had considerable success achieving this broad goal. To continue that trend, the company's growth strategy includes ...

Market Name Brands and Proprietary Brands

Through the company's three store formats -- PacSun, PacSun Outlet, and d.e.m.o. -- the company offers a carefully chosen array of popular name brands as well as its own proprietary, higher margin private brands. The company's merchandising choices differentiates it from other stores where either name brands or proprietary brands dominate offerings. The company also seeks to stay focused on its age and lifestyle markets: Young people with board-sport inspired lifestyles.

Discover Merchandise Trends

The company focuses more on trend discovery than promoting the latest fad. To do so, it uses a wide array of techniques, including focus groups, feedback from customers, feedback from store employees, new merchandise tests, and close relationships with vendors and other sourcing relationships. As a result, the company is able to respond effectively to emerging and changing trends and adjust their name brands and proprietary brands mixes accordingly.

Promote Outstanding Vendor Relationships

Vendor relationships are key for any retailer and PacSun is no different. Through its size and scope, the company offers a rich and enticing distribution channel for vendors. In addition, the company is the largest customer to many of its vendors. As a result, PacSun and its vendors work together to capitalize on emerging fashion trends and respond quickly to shifts in the often fickle space. In addition, these powerful relationships mean vendors can supply PacSun with "exclusives" -- merchandise not found at any other retailer.

Provide Outstanding Customer Service

PacSun discovered early on that treating teens with the same level of respect offered their adult counterparts was really good for business. That strategy continues to this day.

Competition is Fierce

The retail apparel business is highly competitive. The company's store concepts -- including PacSun, PacSun Outlets, and d.e.m.o. -- compete with national chains, department stores, and local merchants that sell the same and similar merchandise. However, the space narrows considerably when you look at competitors that have a similar mall-based presence, target the teen/young adult apparel market, and have similar resources.

Abercrombie and Fitch

Aeropostale

American Eagle Outfitters

Gap

Hot Topic

Risks

Merchandise and Fashion Sensitivity

The company's success is tied to its ability to predict and respond to fashion trends in the often fickle teen fashion space. The company's failure to manage these trends and respond accordingly with an effective merchandise mix could have a substantial effect on its operations and profitability.

Vendor Limitations and Concentrations

Some of the company's vendors have limited resources and production capabilities while others limit the amount of product they'll sell to the company. These factors could limit the company's ability to respond to changes in the retail environment. Plus, the company has two significant vendor concentrations: As of the end of FY04, Quiksilver and Billabong accounted for 10.9% and 9.4% of the company's net sales respectively.

Planned Expansion

The company's on-going success depends on its ability to grow by opening new stores and expanding its operations. That expansion is dependent upon the company's ability to acquire favorable mall sites, stock the stores properly, hire the right people, and pay for build-out. Should the company fail to accomplish these goals, profitability and operations could be adversely effected.

Economic Factors

Adverse economic conditions -- including poor economic growth and consumer spending -- could effect the company's ability to expand operations and provide goods at a decent profit margin.

New Retail Concept

The company plans to launch a new retail concept during FY06. The ability of the company to make this new retail concept a success is exposed to a number of potential problems, including an inability to properly gauge the target market, inability to create the proper vendor relationships, and competition from other retailers. Plus, the new concept could strain capital resources and distract management from the company's current operations.

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Analyst Certification

I, J. Wayne Burritt, hereby certify that I have prepared this report, and the content within it, including all opinions, are solely my own.

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J. Wayne Burritt, President & Director of Research

Wayne has over 24 years of experience in financial analysis, investment analysis, and business development. Before starting Burritt Research, Inc. Wayne was a senior equity research analyst and editor for Weiss Research, a nationally acclaimed independent research and advisory firm. He directed all fundamental and editorial aspects of a variety of domestic and international option and stock services. In addition, Wayne designed, developed, and maintained proprietary information systems for the firm's research efforts. He also collaborated on the successful design and delivery of stock research reports based on in-house ratings of over 6,000 securities. Prior to his tenure at Weiss, Wayne was an equity analyst, marketing and trading specialist for Pan-American Financial Advisers, a boutique investment management firm. In that capacity, he provided security analysis, marketing support, and trading services for a large portfolio team engaging institutional and high net worth clients. Wayne also produced and starred in the critically acclaimed stock market radio show Inside the Market while at Pan-American Financial. Wayne has also held positions as Managing Director, Senior Credit Analyst, and Controller. He holds an MBA from Golden Gate University and a BA in English and Philosophy from Indiana University.

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